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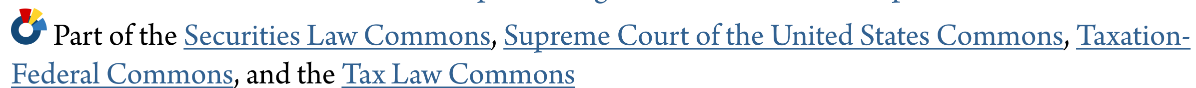
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Taft v. Bowers: The Foundation for Non-Recognition Provisions in the Income Tax

*James R. Repetti**

Taft v. Bowers[1] is a Supreme Court decision that is rarely studied in law schools or discussed by scholars. Yet, it is a case of vast significance. In the *Taft* decision, the Supreme Court confirmed that Congress may create non-recognition exceptions to the income tax that merely defer the recognition of income, rather than permanently exclude it. If the *Taft* case had been decided differently, it is likely that the number of non-recognition provisions in the Internal Revenue Code ("Code") would be significantly reduced.

Taft v. Bowers involved the constitutionality of the carryover basis rule for gifts. Prior to 1921, a donee's tax basis in a gift was equal to the fair market value of the gift at the time of the transfer.[2] This meant that taxpayers could permanently avoid recognizing gain in appreciated property by making a gift of that property to a spouse, for example, and then having the spouse sell the gifted property.[3] Since the gift would have a basis in the hands of the spouse equal to the fair market value of the item at the time of the transfer, all appreciation that had accrued prior to the gift would escape taxation.

Congress moved to end this abuse in 1921 by adopting the carryover basis rule.[4] In holding that the carryover basis rule was constitutional, the Court in *Taft* created a path for Congress to allow many forms of transfers, such as gifts, like-kind exchanges and exchanges of stock in corporate mergers and acquisitions to be tax-free without bankrupting the Treasury. With a carryover basis, the appreciation in the transferred asset would not escape taxation forever. Instead, the appreciation could be taxed in a subsequent transfer, unless the taxpayer held the property until death.

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1 278 U.S. 470 (1929).

2 ROSWELL MAGILL, TAXABLE INCOME 358 (1936); *see, e.g.*, Treas. Reg. 45, Art. 1562 (1918).

3 MAGILL, *supra* note 2, at 358.

4 Revenue Act of 1921, Pub. L. No. 67-98, ch. 136, § 202(a), 42 Stat. 227, 229 (1921); H.R. REP. NO. 67-350, at 9 (1921); S. REP. NO. 67-275, at 10 (1921).

The taxpayer in *Taft* was Elizabeth Clark Taft. Before exploring the courts' treatment of Elizabeth's argument, it is interesting to note Elizabeth's impressive connections to the legal profession.[5] Her husband, Walbridge S. Taft, was the nephew of William Taft, who had served as the President of the United States and was the Chief Justice of the Supreme Court at the time the case was litigated.[6] Elizabeth's father-in-law was Henry W. Taft, who became the "Taft" in Cadwalader, Wickersham and Taft.[7] Henry represented Elizabeth in the litigation.[8]

Elizabeth's father transferred stock to her as a gift when that stock's value was greater than the amount he had paid for it. Elizabeth sold it for an even greater value and sought to calculate her gain using as her basis the stock's value at the time of her father's gift, so that only the appreciation that had occurred after the gift would be taxed. When the I.R.S. sought to use her father's lower basis in the stock to determine her gain, Elizabeth argued that taxing her on appreciation that had occurred while her father held the stock violated the 16th Amendment because it was not her income. The 16th Amendment allows Congress "to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration."[9]

The District Court, Court of Appeals for the Second Circuit and the Supreme Court pursued significantly different tacks to resolve this issue. The District Court concluded in a very brief opinion without citing any case law that gifts cannot constitute income within the meaning of the 16th Amendment, but are instead similar to nontaxable contributions to capital.[10] As a result, the District Court concluded that the donee's basis must equal the fair market value of the gift when she received it.[11] If the donee's basis were not equal to the gift's value, the donee would in effect be taxed on the value of the gift when she sold it. The lack of authority in the District Court's opinion was attributable to the fact that the status of gifts as income under the 16th Amendment had never been

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5 *Gift Stock Tax Suit Lost by Mrs. Taft*, N.Y. TIMES, July 6, 1927, at 39; *see Elizabeth Clark Bride of Walbridge S. Taft*, WASH. POST, Sept. 21, 1923, at 7.

6 *Elizabeth Clark Bride of Walbridge S. Taft*, *supra* note 5; *Supreme Court Rules Profit on Gifts Taxable*, BROOKLYN DAILY EAGLE, Feb. 19, 1929, at 2.

7 Thomas R. Violante, *Noted New York Law Firm Donates Historical Records*, YALE BULLETIN & CALENDAR (Sept. 29, 2000), http://archives.news.yale.edu/v29.n4/story5.html.

8 *Gift Stock Tax Suit Lost by Mrs. Taft*, *supra* note 5.

9 U.S. CONST. amend. XVI.

10 Taft v. Bowers, 15 F.2d 890 (S.D. N.Y. 1926).

11 *Id.* at 890-91.

litigated. The predecessors to the Code had excluded gifts from income since the inception of the income tax in 1913.[12]

The District Court's decision that gifts were not income under the 16th Amendment was consistent with the restricted definition of income then utilized by the Supreme Court. Earlier, in 1920, the Court in *Eisner v. Macomber*[13] had narrowly defined income as payments received by a taxpayer for services or the use or sale of her capital. Another Supreme Court decision, *Edwards v. Cuba R. Co.*,[14] had determined in 1925 that payments received by a corporation from the Cuban government to subsidize construction of a railroad in Cuba were not income under the 16th Amendment because the payments "were not made for services rendered or to be rendered"[15] and "were not profits or gains from the use or operation of [the taxpayer's capital, i.e.,] the railroad . . . ."[16] Instead, the Court characterized the payments as non-taxable contributions to capital. Similar reasoning might have excluded gifts to individuals from income for purposes of the 16th Amendment since the receipt of a gift would not be for services or the use or sale of capital.[17]

The Court of Appeals for the Second Circuit reversed the District Court in a decision that involved three separate opinions by the three-member panel.[18] Chief Judge Manton wrote that taxing Elizabeth on all appreciation that had accrued from the date that her father had acquired the stock did not violate the 5th or 16th Amendments.[19] He reasoned that Congress had a valid purpose, minimizing tax avoidance by imposing a carryover basis, and that the Elizabeth had full knowledge that the carryover basis would apply.[20] In addition, he observed that the amount of income that was taxed was not any greater than the amount that would have been taxed had Elizabeth's father sold the stock.[21]

Judge Hand concurred in a separate opinion. He said that the 16th Amendment was not violated because the gain taxed clearly represented

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12 MAGILL, *supra* note 2, at 357.

13 252 U.S. 189, 207 (1920).

14 268 U.S. 628 (1925).

15 *Id.* at 633.

16 *Id.*

17 For excellent discussions of the evolution of the definition of income, see Marjorie E. Kornhauser, *The Origins of Capital Gains Taxation: What's Law Got To Do With It?*, 39 Sw. L.J. 869 (1985); Majorie E. Korhnauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1, 11 (1992). Professor Kornhauser notes that there is some evidence that the term "income" as used in the 16th Amendment was not intended to include gifts, although the matter is far from clear.

18 Bowers v. Taft, 20 F.2d 561, 564 (2d Cir. 1927).

19 *Id.* at 563.

20 *Id.* at 562-63.

21 *Id.* at 563.

appreciation that had occurred after the donor purchased the stock.[22] He further reasoned that the 16th Amendment did not require that income subject to tax be the income of the actual taxpayer, stating that "[t]he language of the Amendment itself gives Congress power to lay 'taxes on incomes,' not on persons."[23]

Judge Swan dissented, citing *Edwards v. Cuba R. Co.*[24] He argued that property "obtained by gift is capital, not income in the hands of the donee upon its receipt."[25] He concluded that taxing gain that had accrued while Elizabeth's father had held the stock was the same as taxing a portion of the capital that Elizabeth had received as a gift.[26]

The Supreme Court (with Chief Justice Taft recusing himself) unanimously affirmed the Court of Appeals for the Second Circuit.[27] The Court noted that without a carryover basis, the appreciation that had occurred prior to the gift would forever escape taxation.[28] Moreover, the Court determined, the imposition of a tax on the taxpayer did not impose a hardship.[29] The Court stated:

> In truth the stock represented only a single investment of capital — that made by the donor. And when through sale or conversion the increase was separated therefrom, it became income from that investment in the hands of the recipient . . . according to the very words of the Sixteenth Amendment. By requiring the recipient of the entire increase to pay a part into the public treasury, Congress deprived her of no right and subjected her to no hardship. She accepted the gift with knowledge of the statute and, as to the property received, voluntarily assumed the position of her donor. When she sold the stock she actually got the original sum invested, plus the entire appreciation . . . .[30]

Adopting the reasoning of Judge Hand in the Court of Appeals decision, the Court succinctly concluded:

> There is nothing in the Constitution which lends support to the theory that gain actually resulting from the increased value of capital can be treated as taxable income in the hands of the

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22 *Id.* at 564.
23 *Id.*
24 *Id.* at 565.
25 *Id.*
26 *Id.*
27 Taft v. Bowers, 278 U.S. 470, 484 (1929).
28 *Id.* at 482-83.
29 *Id.* at 482.
30 *Id.*

recipient only so far as the increase occurred while he owned the property.[31]

The significance of the holding in *Taft* cannot be overstated. By holding that gain taxed to the taxpayer need not be the gain that had accrued while the taxpayer held the asset, the Court confirmed that non-recognition provisions may *defer* the recognition of income. The result is that gain avoided by a transferee in such non-recognition transactions as corporate reorganizations, like-kind exchanges and gifts, may be taxed at a future date when the transferee disposes of the property in a taxable transaction.

The case is also important because it represents an important step in the Court's evolution towards an expansive definition of income. Early Court decisions suggested a narrow approach to the definition of income with only amounts received by the taxpayer for her services or the use or sale of her capital qualifying as income. By holding that taxable gains need not have accrued while the current taxpayer held the property, the Court started to shift focus away from the taxpayer's activity in generating income to whether the taxpayer had simply experienced an accession to wealth. This movement to a broad concept of income stands in stark contrast to the narrow approach the Court pursued in defining the tax base of the estate tax. Early Supreme Court decisions on the estate tax, such as *Helvering v. Safe Deposit & Trust Co.*,[32] established that the estate tax base, the "gross estate" as defined in section 2033 of the Code, was to be defined narrowly. The result is that in the estate tax, Congress was subsequently always playing "catch up," expanding the scope of the gross estate by adopting or amending sections 2034 to 2044 of the Code to deal with new estate planning abuses.[33] In contrast, there has been little need to expand the concept of income in the income tax and, indeed, sections 71 to 138 of the Code generally limit the expansiveness of income as interpreted by the courts.

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[31] *Id.* at 484.

[32] 316 U.S. 56, 62-63 (1942).

[33] PAUL R. MCDANIEL, JAMES R. REPETTI & PAUL L. CARON, FEDERAL WEALTH TRANSFER TAXATION 108 (7th ed. 2015).