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Hylton v. United States & the Practical Difficulties of Apportionment

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In early June of 1794, Congress passed a "carriage tax" aimed at carriages used for business purposes. The tax was to be collected annually for as long as the carriage owner maintained ownership of the carriage. The original Constitution of the U.S. recognized a distinction between direct taxes and indirect taxes, but it did not establish definitive guidelines for determining whether a new tax is direct or indirect. At the time of the adoption of the Constitution, it was established that poll taxes (or "capitation" taxes) and land taxes were direct taxes, but there was no formal mechanism for sorting a given tax into either category. Hence, though the authority of Congress to pass the carriage tax was never brought into question, what category the tax should be assigned was unclear.

In *Hylton v. United States* (1796), a suit was brought to collect a debt which was derived from the carriage tax. Hylton (the defendant in the original case) claimed that the carriage tax statute was unconstitutional. Hylton reasoned that the carriage tax was a direct tax and because the statute did not follow the rule of apportionment the tax had to be struck down under the Constitution. At the time of the suit, Hylton was in possession of 125 carriages.

The justices of the Supreme Court – who all wrote their own opinion of the case – determined that the carriage tax was an *indirect tax* and that, consequently, Hylton was liable for the debt. The justices decided that there was no compelling reason to suppose that the carriage tax fell within the meaning of a direct tax as understood by the framers of the Constitution. The framers understood that poll taxes and taxes on land were "direct" taxes; this classification had a basis in the conditions present among the states at that time. Although the carriage tax may have been superficially dissimilar from other indirect taxes in some ways, the justices could not find that this level of dissimilarity warranted classification as a direct tax.

Hylton entered the case with one critical disadvantage: the practical difficulties of apportioning the carriage tax by population were such that classifying the tax as a direct tax would have led to absurd results. Carriage ownership varied greatly from state to state, and so the carriage tax would have imposed an unfair burden on certain states if it were apportioned as a direct tax. The federal government would have been compelled to adopt new and unusual measures in order to artificially correct the unfair burden created by such a tax. The justices all concurred that the unfair results and practical difficulties of apportionment provided sufficient grounds for classification as an indirect tax.

Because the carriage tax was a tax on personal property, the *Hylton* decision came to the fore nearly one hundred years after it was made during the case of *Pollock v. Farmers' Loan & Trust Co.* (1895). The *Pollock* case ruled that a tax on income from personal property (and real property) was a direct tax and must follow the rule of apportionment; this ruling effectively overturned the decision made in *Hylton*. Those who objected to the *Pollock* decision predicated their objection on the fact that the decision made the imposition of a federal income tax a near impossibility. Implementing a federal income tax which followed the apportionment rule would have been excessively burdensome for the federal government for a number of reasons. The sixteenth amendment was drafted in order to bypass the sort of practical difficulties associated with apportionment which was discussed in *Hylton*.

The Will of the People

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The phrase “the will of the people” has greater importance for Americans than it has for citizens of other states around the world. In large part, this stems from our deeply entrenched view of our system of government as a system which has developed entirely from the collective will of a free populace. The American public firmly believes that its governmental institutions are a direct extension of its collective will, a sort of living representation of its political voice. And to a good extent this view is accurate: our system has been informed by non-elite citizens to a considerably greater degree when compared with foreign systems across the globe. Though the history of these United States is much less egalitarian than most people care to appreciate, it is correct to say that the American project is more of a “popular” phenomenon than has been the case throughout most of history.

What most Americans do not realize, however, is that the will of the people can move society in any conceivable direction. Common perception tends to see the people’s collective will as an inherently benign force ceaselessly pushing our country in a way which maximizes our freedom and dispels injustice. But, as is often the case, common perception does not faithfully reflect reality. The will of the people is neither benign nor nefarious; it simply expresses whatever whims the people may have at a given moment. And if the people’s whims happen to push us toward less freedom or less justice – however that is defined – then that is precisely the direction we will be pushed in. Our constitution does not guarantee a certain quantum of freedom; as we learned in our prior installment, it provides that our lives may be encroached upon in any number of ways so long as the people's will is expressed in the form of amendment.

This fact may come as a shock to many Americans. Our optimism tends to impart benevolent motives onto the public's collective will in nearly every situation. What we have to understand, however, is that it makes little sense to ascribe any particular value to our collective will because our will can be shaped by just about any force imaginable – expediency, necessity, desire, passion. The sixteenth amendment did not simply address the practical difficulties associated with the apportionment requirement, it also expressed a public desire to ameliorate the widespread economic inequality which was present at the time of its passage. And it also enlarged the sovereignty of the federal government in relation to the states. It would be inaccurate to say that the results which followed the amendment were inherently just or proper; what is true is that these results were congruent with the collective sentiment of that era.

As we explore the sixteenth amendment in greater and greater detail, it is important for us to keep in mind that this amendment only represents the ability of our constitution to express the desires of the public, it is not an example of benevolent societal change.

In our next installment, we will discuss the case of *Hylton v. United States* (1796) and look at the impact that the ruling of this case had on the development of the sixteenth amendment.

The Sixteenth Amendment & the Issue of State Sovereignty

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In the next several installments of Huddleston Tax Weekly, we will discuss in great detail some of the controversies which were stirred by the sixteenth amendment. As we've noted in previous installments of HTC, the sixteenth amendment to the U.S. Constitution was an act of awesome importance. Through this amendment, the Congress was freed of the various constraints on its taxing power which had existed since the founding of the country. The original U.S. Constitution expressly gave Congress the power to tax, but it also set certain restrictions on this taxing power; excise (indirect) taxes had to be uniformly imposed, and direct taxes had to be properly apportioned among the several states. Prior to the sixteenth amendment, judicial opinions on tax law often dealt with determining whether a given tax should be classified as either direct or indirect. The sixteenth amendment removed the necessity of making such determinations.

The full text of the sixteenth amendment is as follows: "The Congress shall have power 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." Clearly, this amendment was directly responsive to a number of judicial decisions which, through their treatment of certain forms of taxation, had curtailed the taxing function of Congress. For instance, the *Pollock* case ruled that taxes on income derived from real property and personal property (such as stocks and bonds) were direct and therefore subject to the apportionment requirement. *Pollock* and other judicial opinions made the imposition of a federal income tax a practical – though not theoretical – impossibility. By removing the apportionment requirement, the sixteenth amendment made the implementation of such a tax an exceedingly simple matter.

The potential impact of the sixteenth amendment on state sovereignty was an issue immediately recognized by both the legal profession and the political establishment. Since it allowed Congress to collect taxes on incomes from any conceivable source, it apparently encompassed state securities; and by taxing state securities the Congress would be effectively lessening the power of the states in relation to the federal government. In his 1919 essay entitled "Power of Congress to Tax State Securities Under the Sixteenth Amendment," Albert Ritchie argued that the amendment did not actually extend to state securities because the amendment was never intended to grant any new taxing powers to the Congress; the amendment was merely designed to consolidate Congress' existing taxing powers, and since the power to tax state securities had historically been considered unconstitutional, and the authors of the amendment were themselves wary of the taxing of state securities, it follows that the amendment could not have granted a new power to tax state securities.

At the time of its publication, this essay by Mr. Ritchie must've had a great appeal. If taken solely on its words, the sixteenth amendment undoubtedly encompassed state securities, and it certainly raised the sovereignty of the federal government in relation to the states. But Mr. Ritchie's reasoning involves looking behind the plain text of the amendment and considering the larger historical context in which this amendment was birthed. Given the conclusions to which it led, this reasoning certainly would've found plenty of open ears in 1919.
But Mr. Ritchie's argument had at least one major weakness: it failed to recognize that the limited nature of state sovereignty has always

been an established constitutional principle. As Mr. Harry Hubbard pointed out in his *Harvard Law Review* article entitled "The Sixteenth Amendment" in 1920, there is no constitutional basis for the notion that either the states or the federal government must have a certain degree of sovereignty. The Constitution provides that state sovereignty may be reduced if the people so desire with the power of amendment. The only principle which cannot be amended is the right of each state to have equal political representation. Thus, if the states choose to enlarge the role of the federal government through a constitutional amendment there is no higher authority which can be invoked to bar such a choice.

Mr. Hubbard argued that, given this reality, the sixteenth amendment was intended to cover state securities. The text did not need to specifically mention state securities in order to address any sort of historical trend against this type of taxation; if the amendment reduced state sovereignty simultaneously at the time that it consolidated Congress' taxing power then this would have been a natural extension of the will of the people. We may like to suppose that, past a certain point, state sovereignty may not be encroached upon. But there is actually no constitutional foundation for this supposition. State sovereignty may be an ideal, but it is not unassailable and is very much subject to transformation depending on the whims of the public. In the end, the authors must have been aware of the amendment's impact on state sovereignty, and it follows that any reduction in state sovereignty was fully permissible because these authors were merely acting as instruments of the people.

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Mercantile Trust Co. v. Commissioner & the Limited Importance of Contingencies

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Nearly every legal concept presently in use in these United States has an established pedigree. Very few of our concepts are recent inventions. This observation holds true not just in one or two areas of law but for quite literally our entire legal edifice. Section 1031 is no exception to this rule. Section 1031 is derived from a number of earlier tax acts which addressed the non-recognition of gains (or losses) when real property held for business or investment purposes is exchanged for like-kind property. Today, courts utilize the judicial opinions made in previous eras which were informed by one of these earlier tax acts. The case of *Mercantile Trust Co. v. Commissioner* (1935) is among the most significant of these opinions.

As we will see, *Mercantile Trust Co.* set an important precedent for viewing complex real property exchange transactions. Like the parties in *Alderson v. Commissioner*, the parties of *Mercantile Trust Co.* engaged in a complex transaction which involved multiple independent contracts, the use of an intermediary and a cash payment as "boot" on top of the exchange. In its opinion, the court emphasized that non-recognition depends primarily on what *actually occurred*, rather than on the various methods and motives which ultimately led to the transaction. Simply because a contingency *could* have given rise to a sale – and therefore would have created a taxable gain – does not necessarily bar non-recognition; the most important fact is whether an exchange of like-kind property actually transpired.

Facts

The representatives for Mercantile Trust Co. (the petitioners) appealed a judgment for a tax deficiency arising from a transaction involving Mercantile Trust Co., an intermediary (known as Title Guarantee & Trust Co.) and Emerson Hotel Co. The Commissioner of Internal Revenue (the respondents) claimed that the transaction amounted to a sale and that the petitioners had a recognized gain of $179,621 (approximately $2,521,070.02 when adjusted for inflation in 2016). The petitioners argued that the transaction had been an exchange of real property of like-kind within the scope of existing statutory provisions.

Title Guarantee & Trust Co., the intermediary, developed separate contracts with Mercantile and Emerson. To conclude certain of these contracts Title Guarantee made cash payments to the other party, and to conclude other contracts Title Guarantee accepted cash payments. Mercantile Trust Co. ultimately received the deed to the property (known as Lexington Street) originally held by Emerson Hotel Co. as well as a total of $24,426.90 in cash. Emerson Hotel Co. received the deed to the property originally held by Mercantile Trust Co. (known as Baltimore Street). Title Guarantee received commissions and title fees which added up to $8,573.10.

The respondents assessed the tax deficiency on the premise that Mercantile Trust Co. acquired the Lexington Street property in a separate transaction which should be considered a sale. The question before the court was whether the evidence on record supported this premise.

Law

The statutory provisions which applied to the case arose from section 112 of the Revenue Act of 1928. Section 112 (of the act of 1928) is the predecessor of section 1031 and includes many of the same provisions as the current law.

Ruling

The court (the U.S. Tax Court, known as the Board of Tax Appeals in 1935) ruled in favor of the petitioners and declared that the deficiency assessed by the Commissioner was without basis. The Commissioner argued that what had occurred was a "fictitious" exchange and that the Lexington Street property was acquired by Mercantile Trust Co. in an independent sales transaction. The tax court rejected this argument. The contract made between Mercantile Trust Co. and Title Guarantee included a contingency whereby Title Guarantee would pay $300,000 in cash in the event that the deed to the Lexington Street property could not be transferred. The court determined that this contingency did not negate non-recognition treatment given that an exchange of like-kind property did occur.

The reasoning employed by the tax court in *Mercantile Trust Co.* influenced later decisions, including the decision made in *Alderson*. The determination of non-recognition treatment depends heavily on the end result and not as much on the methods used to reach that result.

Tracing the Bounds of Section 1031 through Alderson v. Commissioner

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In our previous installment, we learned that whether a transaction falls under section 1031 of the Internal Revenue Code is an extremely important determination. Section 1031 enables taxpayers to receive non-recognition of capital gains when they exchange their real property for another property of like-kind. Real estate transactions can often result in gains of many thousands – and even millions – of dollars, and so receiving non-recognition of this sort under section 1031 can potentially remove very large tax liabilities. For this reason, the qualifications of section 1031 are narrowly construed by courts and so real property owners must carefully observe these qualifications to receive non-recognition treatment.

As with other areas of law, tax law is shaped by judicial opinions. Though the provisions of section 1031 originally emanate from the language of the tax code, the precise contours of these provisions are nonetheless informed and guided by the opinions issued in cases. This is the main reason Huddleston Tax Weekly has focused so heavily on highlighting tax, contract and property cases: it is important that our readers be aware not only of the various laws which may affect them, but also of how these laws apply in real-world scenarios.

The case of *Alderson v. Commissioner* (1963) gives us a sense of the level of conscientiousness required from the parties of a real estate exchange. As we will explore in detail below, *Alderson* shows that whether a cash payment is included as a contingency within an agreement is immaterial; the critical factor in determining 1031 treatment is whether an exchange of property of like-kind actually occurred. *Alderson* also demonstrates that property may be acquired specifically for the purpose of exchanging it as part of a 1031 transaction.

Facts

Alderson (the appellant) agreed to sell his property – referred to as Buena Park in the opinion – to a company known as Alloy Die Casting Company. Before the sale was concluded, Alderson decided he would prefer to exchange his property for another property which he discovered after the original agreement was made. This newly discovered property – Salinas – was then acquired by Alloy and transferred to Alderson in exchange for Buena Park.

The amended agreement between Alderson and Alloy included a contingency clause which stated that Alloy would pay cash for the Buena Park property in event that it could not furnish the Salinas property by a specific date.

Law

To receive section 1031 treatment, a transaction must involve the exchange of properties which are of like-kind. The transaction must also be reciprocal and involve a present transfer of ownership, the transfer cannot occur gradually or incrementally over a period of time.

Ruling

The court (U.S. Court of Appeals for the Ninth Circuit) overturned the opinion of the Tax Court and ruled in favor of Alderson. As noted above, the transaction between Alderson and Alloy was a bit convoluted and involved a formal amendment to the original agreement; two escrow accounts were created as a consequence of the decision made by Alderson to acquire the Salinas property. The Commissioner of Internal Revenue (the respondent) argued that the contingency clause provided evidence for the classification of the transaction as a sale rather than an exchange; the Commissioner also felt that the separate accounts provided evidence for this same conclusion. These arguments ultimately failed to persuade the court.

When determining whether a given transaction falls within the 1031 statute, the court considers the transaction as a whole and bases its decision on the true "substance" of the transaction. Though Alderson did initially agree to a cash sale, and the exchange was complicated by the opening of separate accounts, the substance of the transaction clearly reveals an intention to make an exchange of properties of like-kind. The court does not opine on hypothetical scenarios; the critical fact of *Alderson* was that the deeds for Buena Park and Salinas were exchanged, not that such an exchange may not have occurred if Salinas were not acquired.

Starker v. United States & the Qualifications of Internal Revenue Code Section 1031

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Every real estate owner and investor should take the time to become acquainted with the elements of section 1031 of the Internal Revenue Code. This section allows taxpayers to defer recognition of either gain or loss when they exchange property of like-kind with another party. For any number of reasons, it may be wise for an owner or investor to exchange their property for another. Sans 1031, an exchange of real property would necessarily involve the realization of either gains or losses, and the management of such realization would require substantial investments of time and money. Section 1031 promotes a more open and free marketplace by eliminating the burdens which traditionally follow real estate sales.

Because of the heavy benefits it confers, section 1031 has rigid qualifications which are narrowly construed by courts. One case which illustrates the narrow reading of section 1031 qualifications is *Starker v. United States* (1977). As we will see, the plaintiff in this well-known case attempted to expand the construction of section 1031 so as to include a complex, multiyear financial transaction in which he took part. The court rejected the plaintiff's attempt and set a precedent for a narrow construction of 1031.

Before hearing *Starker*, the court had just settled an earlier case, known was *Starker I*, which was heard in 1975 and involved the son and daughter-in-law of the plaintiff of the 1977 *Starker* case. The plaintiff's son and daughter-in-law had also taken part in the same transaction which formed the basis for the suit of 1977; like the plaintiff, they tried to receive non-recognition of their capital gain under section 1031. The judge in *Starker I* concluded that the son and daughter-in-law correctly invoked section 1031 and were therefore entitled to a refund for taxes paid on the transaction. The next *Starker* case was heard by the same judge; this judge reconsidered his earlier decision and ruled against the plaintiff. As we've noted before, sometimes no amount of preparation can account for the whims of our magistrates.

Facts

The plaintiff transferred a very large amount of land – approximately 1,843 acres – to a company known as Crown Zellerbach Corporation. In return, the company created an "exchange value" balance on its books. To reduce the balance, the company was supposed to transfer a number of parcels of land to the plaintiff; as part of the agreement, these parcels did not need to be transferred all at the same time, but could be transferred one by one over the course of several years. Collectively, these parcels were supposed to be equal in value to the land given to the company by the plaintiff. The plaintiff also received a "growth factor," which was interpreted as a type of interest by both the company and the court.

The plaintiff invoked section 1031 when filing the income tax return which included this transaction. The IRS denied this invocation and assessed a tax deficiency of $300,930.31 plus interest. The plaintiff then brought a suit to receive a refund.

The question before the court was whether the plaintiff was in fact entitled to non-recognition under section 1031 given the peculiar characteristics of his exchange.

Law

Under section 1031 of the Internal Revenue Code, taxpayers are entitled to non-recognition of capital gains or losses which arise from the exchange of property of like-kind. The exchange must be reciprocal and involve a *present transfer of ownership*; it cannot involve a promise to transfer property in the future.

Ruling

The court disallowed section 1031 and ruled in favor of the government. The court rested its decision on a number of factors. One factor was the element of time: the parties did not simultaneously exchange property of like-kind, but instead created a balance which was to be paid off incrementally over a period of time. And in the event that the parcels of land given to the plaintiff did not settle the balance after a period of five years, the agreement between the plaintiff and company held that the company would then transfer cash to cover the remainder. What's more, two properties transferred by the company were not actually given directly to the plaintiff; the properties were given to the plaintiff's daughter. And on another occasion, the plaintiff did not specifically receive the title to a property, but was given cash equal to the purchase price of the property along with the company's right to acquire the property. These and other factors combined to provide a foundation on which the court made its decision to deny non-recognition treatment.

More than anything, our readers should use the *Starker* case to see the limited availability of section 1031. Where *Starker* applies, it can be an incredibly useful tool, but know that it only applies in scenarios which explicitly fall under its requirements.

In our upcoming installments, we will look at sections 1033 and 121 and highlight how these sections can also be of use to taxpayers.

The Basics of Inslee's New Tax Plan

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In the first half of this last December, Governor Jay Inslee proposed a new tax plan designed to generate funding for basic education. The plan is responsive to a recent state court opinion which held that funding for K-12 education in Washington must come from the state rather than local districts. Prior to this opinion – the *McCleary* opinion – local districts contributed a substantial part of the cost for education through local property taxes; now, the state must foot the entire bill, and Mr. Inslee's new plan addresses the deficit created by the removal of this familiar source of funds.

Mr. Inslee's plan would draw tax revenue from several sources. Let's review these sources and then take a look at the political reaction to his proposal.

Revenue Sources

The tax plan of Mr. Inslee would draw revenue from four sources. The plan would implement a capital gains tax of 7.9 percent on the sale of a number of assets, including stocks, bonds and others. The capital gains tax of Inslee's plan would not apply to retirement accounts, homes, farms and forestry. The tax would apply to earnings above $25,000 for single filers and $50,000 for joint filers. Approximately $821 million would be raised from this tax for the fiscal year of 2019.

The plan would also impose a carbon emissions tax of $25 per metric ton. This tax would raise approximately $2 billion (per year).

Also included in Inslee's plan would be an increase to the business-and-occupation (B&O) tax for attorneys, real estate agents and other professionals. The rate would be increased from its current level of 1.5 percent to 2.5 percent. This would generate roughly $2.3 billion.

Inslee's proposal would also eliminate multiple tax exemptions, such as the exemption on bottled water and the exemption which benefits oil refineries.

Political Reaction

Unsurprisingly, given the severity of its probable impact, Inslee's proposal has sparked substantial criticism from lawmakers on the other side of the political spectrum. Senate Majority Leader Mark Schoesler, for instance, was quoted as saying (disapprovingly) that the proposal by Mr. Inslee would constitute the single largest state tax increase in Washington's history. Another senator, Ann Rivers, also of the Republican Party, said she felt that Mr. Inslee's plan appeared to be an overly aggressive solution to the issue of funding state education.

Democratic lawmakers have been more sympathetic, and it seems that Mr. Inslee will likely have full support from members of his party. Importantly, newly elected Superintendent of Public Instruction Chris Reykdal has voiced his support for the proposal and even appeared alongside Inslee during the unveiling of the plan at Lincoln High School in Tacoma.

Whether Governor Inslee's tax plan will be enacted in its current form remains to be seen. What is certain is that the state must develop a workable plan in double quick time. The court of Washington has already held the state in contempt because of the state's failure to supply sufficient educational funding and has ordered the state to pay hefty fines. If it wishes to avoid further consequence, the state must develop a full funding plan by September 1, 2018.

Hawaii Housing Authority v. Midkiff & the Function of Eminent Domain

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One of the most enduring myths about government in the United States is the idea that governmental behavior is more or less congruent with standards of individual morality. In other words, most Americans believe that government authority is shaped and ruled by the same moral standards which shape and rule the behavior of the average individual. Governmental behavior may have special leeway in a few instances, but for the most part it is constrained by the same principles which constrain the typical man on the street.

This idea, while not without foundation, falls well short of capturing the truth. What most people do not realize is that governmental morality is based on processes which are altogether different from those which form the basis for the morality of the individual. Individual morality is based on reciprocity, the classic notion of "give and take": we refrain from damaging our neighbor's property or stealing goods from our friends because we expect this same kind of treatment in return. Individual morality is an exchange, it stems from the basic idea that whatever action or inaction we take will be reciprocated by whoever is affected.

And because our government is nothing other than a massive collection of individuals, many people assume that governmental behavior must be based on this same principle. In reality, however, this is not the case, because our government does not take part in the sort of interactions in which the individual takes part. Instead of reciprocity, government behavior is based on *reason*, it derives from a wholly rational process involving the weighing of pros and cons and the careful analysis of possible outcomes. A good deal of the confusion about government would quickly disappear if this fact were realized.

There are various ways to show that this is an accurate statement; today, we will use the concept of *eminent domain* to prove our case. Relatively few property owners are aware that the government has the constitutionally conferred power to confiscate private property, and that the exercise of this power is not limited strictly to times of war. Denuded of its lofty name, eminent domain is simply a forcible acquisition of the sort which would be punishable if committed by an individual citizen. Of course, this does not speak to its propriety, but only illustrates the fact that governmental behavior operates according to different rules. Let's take a peek at the case of *Hawaii Housing Authority v. Midkiff* (1984) to get a sense of the contours of eminent domain.

Facts

On the island of Oahu, 22 landowners held 72.5 percent of the land titles. This oligopoly led to a distorted market which involved inflated prices and general social discontent. One landowner (the Bishop Estates) held an unusually large portion of land. The Hawaii Legislature passed a measure designed to redistribute the lots held by the Bishop Estates to their corresponding lessees. The legislature reasoned that this transfer of ownership was in the best interests of the entire community. The measure was brought before the Supreme Court of the United States in order to determine its constitutionality.

Law

The doctrine of eminent domain arises from the Fifth Amendment to the U.S. Constitution. According to the so-called "public use doctrine," the government has the ability to transfer title of ownership if such a transfer serves a legitimate public good.

Ruling

In an 8-0 (unanimous) decision, the Supreme Court of the United States ruled that the measure adopted by the Hawaii Legislature was constitutionally valid. The court's decision of this case was significant because the legislature did not transfer the title of the land to the "public," but to a larger share of private homeowners. However, though this was the case, the court determined that the legislature's invocation of eminent domain was valid because the correction of the market conferred a substantial benefit to the general public. In other words, in order for eminent domain to be invoked, private land does not have to be put specifically to public use; it only has to confer a clear benefit to the wider populace.

Of course, circumstances will rarely compel the typical homeowner to master the finer points of eminent domain; but it is still important for virtually every homeowner – and nearly every citizen, for that matter – to have at least a basic understanding of this concept. As citizens, we have to be aware of all the functions of our government, not just those which are the most visible or common. Eminent domain may not dominate the headlines of our most popular media, but as we've seen it is still remarkably important.

Mannillo v. Gorski: The Case of the Intrusive Neighbor

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Most aspiring homeowners understand that owning property involves a great deal of responsibility. When you own property, all of the maintenance and liabilities which would otherwise be taken care of by a landlord are absorbed by you. A leaky faucet, faulty drain or unstable foundation is no longer someone else's obligation. Usually, the responsibilities of homeownership are fairly mundane and do not place an extreme level of stress on homeowners. Every now and then, however, homeownership presents a unique problem which demands an inordinate amount of attention and energy in order to fix. The case of *Mannillo v. Gorski* (1969) is one example of such a problem.

Facts

Gorski (the defendant and appellant) acquired possession of a piece of land in 1946. Mannillo (the plaintiff and respondent) possessed a piece of land which was adjacent to Gorski's land. Gorski's son made various improvements to Gorski's property in the summer of 1946. One of these improvements encroached upon Mannillo's property. The encroachment was quite small and was not easily visible to the casual observer. By the time Mannillo decided to bring a suit against Gorski in order to remove the encroachment, the statutory period of time required for adverse possession had been satisfied. Gorski argued that he had lawfully gained title to the disputed land because his encroachment satisfied both the element of time as well as the other statutory requirements of adverse possession.

The question before the court was: did Gorski gain title to the disputed section of land by way of adverse possession according to the state (in this case, the state of New Jersey) statute?

Law

In order to gain title by way of adverse possession, the possession must be exclusive, continuous, uninterrupted, visible and notorious, and it must satisfy the statutorily defined period of time.

Importantly, the court in *Mannillo v. Gorski* determined that there need not be an element of knowing intentional hostility on the part of the adverse possessor. Though an earlier court opinion held that such a mental state was required, the court in *Mannillo v. Gorski* concluded that such a state was unnecessary.

Ruling

The court (the Supreme Court of New Jersey) remanded the case and ordered a new trial. Mannillo had succeeded at the trial court level because the trial court included intentional hostility as part of the requirements for adverse possession. And Gorski had actually been under the impression that the disputed section of land was within his territorial boundary, and so clearly the encroachment could not be said to be knowingly hostile. The Supreme Court threw this requirement out.

However, the court found that Gorski's encroachment did not necessarily satisfy the requirements of adverse possession because the encroachment was so minor as to be practically unnoticeable without focused scrutiny. In cases involving a minor encroachment across adjacent properties, the true owner must have *actual knowledge* of the encroachment in order for the requirements of adverse possession to be met. The court ordered the new trial to utilize this updated standard. Clearly, the facts of *Mannillo v. Gorski* are not likely to be replicated very often; but *Mannillo v. Gorski* is still something homeowners should be aware of because it illustrates the sort of bizarre difficulties which can occasionally arise during the course of homeownership. Again, if you own property, you probably will not experience what Mr. Mannillo experienced, but it is still important to be aware of even the most unlikely possibilities.

The Tariff Which Shook History

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As has been noted previously, substantive changes in tax policy are often closely tied to big changes in the social order. And the tie is not unidirectional, resulting solely from a tendency for tax measures to provoke heated reaction from a population. Sometimes a social change – such as a war – can massively alter the tax policy of a state. In the historical process, tax policy is both an active agent and a reactive agent, both a cause and an effect.

In most cases, it is not too difficult to determine the impact which a change in tax policy has had on society. The assessment of most changes is rather straightforward. The Morrill Tariff of 1861 – named after its sponsor, Vermont politician Justin S. Morrill – stands out among tax law because it defies this trend: although there can be no argument against its general importance, there is considerable controversy as to its specific role in history. Historians are divided as to what role the tariff act played in furthering the secessionist sentiment among Southern states: was the tariff a point of only minor irritation for Southern states? Or was it a matter of major frustration which caused Southern states to view secession as a necessary solution rather than a possibility?

The thing which is certain about the Morrill Tariff is that it raised rates substantially. In the years just preceding the Morrill act, American tariff rates had been unusually low by global standards. Between 1857 and 1860, the U.S. had average rates of approximately 17 percent overall and 21 percent on dutiable items. By 1865, the Morrill Tariff had increased these rates to 38 percent and 48 percent, respectively. Aside from bringing U.S. rates closer to global averages, the Morrill act also provided means to ameliorate the financial woes plaguing the U.S. Treasury.

Support for the Morrill act tended to vary according to political and sectional affiliation. The vast majority of Republicans voted in favor of the act and the clear majority of Democrats opposed it; there was an unmistakable sectional division as well, with every lawmaker from the Southern states except one voting against the act.

Historians who believe that the Morrill Tariff played only a minor role in furthering sectional hostility emphasize the element of time in the adoption of the act. The development of the tariff had begun well before any state had seceded from the union, but not until several states had withdrawn was the tariff act able to succeed in Congress. Historians point to this fact and infer that the tariff had only minimal significance given that a number of states had already decided to secede.

However, on the other side of the issue, historians emphasize that tariff revision had been a heated topic of discussion well before any state declared secession. The South had a clear interest in embracing free trade given the nature of its economy; Southerners also generally felt that they lacked the proper representation in the federal government which was necessary to ensure an equitable outcome. What's more, the Morrill Tariff was mentioned specifically as a source of displeasure by the conventions of both Georgia and South Carolina; the tariff was even discussed in South Carolina's secession ordinance.

The precise role of the tariff in promoting secession (and ultimately the War Between the States) will likely be debated for many years to come. Both sides of the matter have facts on which to rest their case; about which there can be no debate, however, is the fact that the tariff must be regarded among the most consequential in U.S. history.

Armory v. Delamirie & the Evolution of Property Rights

Published on January 16, 2017

The evolution of our law is truly an amazing phenomenon. It is equal parts humbling and awe-inspiring to contemplate that many foundational legal concepts trace their origin to cases which occurred hundreds of years ago. To the casual observer, it may seem as though our law emerged just recently all at once as a finished product, the miraculous outcome of one act of divine intervention; in actuality, our system has come about through an exceedingly slow, gradual process of revision and refinement transpiring over the course of many centuries.

Take, for example, the very basic idea that a person who finds an object establishes some type of claim of ownership to the object. Colloquially, this principle is referred to as the rule of "finders, keepers." This simple notion was not created by an American jurist, nor was it created within living memory. In point of fact, this idea first acquired legal significance through the famous English case of *Armory v. Delamirie* which was heard in 1722. *Armory* formally established the principle that a finder acquires a form of legal title by way of *possession*.

Facts

Armory (plaintiff) was the helper of a chimney sweep. While working on the job, he found a jewel composed of gems embedded in a ring. Armory took the jewel to a goldsmith (Delamirie, the defendant) to have it appraised. The goldsmith's apprentice took the gems from the ring so as to weigh them separately. The apprentice gave Armory an estimation of their value and then returned the ring without the gems. The apprentice made an offer for the jewel but Armory declined. Armory demanded that the gems be returned inside the sockets of the ring in the same condition as when they were initially brought to the goldsmith's shop. The apprentice did not comply – presumably on the excuse that he "lost" the gems – and subsequently Armory brought a suit against the goldsmith (via respondeat superior) for the return of the jewel.

The issue before the court was whether Armory had a superior title to the jewel despite the fact that he was not the true owner. That is, whether the title he acquired through finding the jewel was sufficient to warrant the return of the jewel from the goldsmith.

Law

In the hierarchy of ownership, the present *possessor* (or finder) has a superior title against everyone except the *true owner*.

Ruling

The court (The Court of King's Bench) ruled in favor of Armory. Since he found the jewel, Armory's title was superior to all but the true owner; and since the true owner was unknown this effectively gave Armory true ownership. The court ordered Delamirie to pay Armory for the jewel at the highest possible estimation of the jewel's value in the absence of any contradictory evidence as to the jewel's value.

The importance of possession in acquiring property rights was understood prior to the case of *Armory v. Delamirie*; in fact, the rule of "finders, keepers" has existed in some form since ancient Rome. But it was *Armory* which caused this old idea to be codified in our common law. The fact that our common law was heavily impacted by a chimney sweep helper's stroke of good fortune is nothing less than remarkable.

How Trump's Tax Plan Will Affect Individuals

Published on January 12, 2017

The election of Donald Trump to our nation's highest political office is undoubtedly one of the most surprising developments in U.S. history. This is a purely factual observation, completely removed from any sort of partisan bias. Many reliable polls taken just prior to the election showed Clinton with a firm advantage. And the fact that Mr. Trump is essentially a political outsider, having no prior political offices on his resume, seemed to cast serious doubt on the viability of his candidacy. Trump's success has triggered a mass of heated reaction, both of a supportive and antagonistic nature. No matter how much the perception of his electoral success varies at the individual level, however, what is certain is that his victory will be regarded as one of the most unlikely in our nation's history.

Trump's staunchly pro-American standpoint captivated his followers and played a large role in building his base of voters. He repeatedly claimed that he would utilize the powers of the presidency to protect the American people – especially working and middle-class people – from internationalist economic policies and improve the American standard of living.

But how will these things be achieved? Trump has devised a tax plan which forms one part of his overall agenda for substantive change. But will his plan actually benefit the majority of American taxpayers? Let's take a closer look at how the Trump tax plan will affect individual taxpayers.

New Tax Bracket System

Trump intends to reduce the total number of tax brackets from the current number of seven down to three. The three (ordinary) rates would be: twelve percent for individuals earning $37,500 or less; twenty-five percent for those earning between $37,500 and $112,500;

and thirty-three percent for individuals earning above $112,500. Again, these thresholds apply to single filers, the income thresholds are doubled for married couples filing jointly.

This new bracket system may result in either a tax cut or a tax increase for middle income earners depending on which bracket they fell into the preceding year.

This system would give a substantial tax cut for high income earners as it would reduce the top rate of 39.6 percent down to thirty-three percent.

The full impact of the Trump tax bracket system is still impossible to determine because we currently are unaware of what sort of credits, limitations and qualifications the system will be coupled with. But at this point it appears that the new system will provide mixed results for middle income earners and generally positive results for very high income earners.

Increased Federal Deficit

Though Trump's new tax bracket system may benefit quite a number of individual taxpayers, when combined with his corporate tax cuts this new system will add to the national deficit. If these cuts remain in place for the next ten years, projections show that federal revenue will decrease between $4.4 trillion and $5.9 trillion. Trump has stated that he plans to cut spending by approximately $1.2 trillion over the next decade; if these figures remain the same, they would result in an increase to the national deficit of around $5.3 trillion.

Thought of the Day: What's in a Tax?

Published on January 12, 2017

What's in a tax?

Divested of all misleading associations and stripped of any false labels, what does a tax truly represent?

In these last several months, Huddleston Tax Weekly has covered a wide range of topics. We've looked at tax measures from eras far removed from our own: we've examined the Tea Act which fueled our revolutionary fervor; we looked at the tax acts passed by the Confederacy in its struggle against the North; we even covered the geld, a medieval tax which provides a glimpse into the formation of the English nation. We've also touched on topical issues, such as Apple's EU tax bill and the tax instituted in Vancouver designed to stabilize the real estate market. Our treatment of these many issues has vastly increased our understanding of the role of taxes in history and in our current society.

If there were a single lesson to be drawn from all of the many issues we have covered in these recent months, the lesson would be: *tax policy is shaped by the competing interests of distinct groups*. Taxes are not developed through a completely rational process in which the interests of every relevant group are considered carefully; in a very real sense, taxes are developed through a *competitive* process, and the end result usually involves certain groups having a more favored position than others. This is not the most pleasant revelation, but it is one which accurately reflects reality. It may do more to serve the ego of our society to suppose that tax policy is strictly the outcome of reasoned, sensible debate among lawmakers, but this does not mean that such a supposition is any reflection of the truth.

Of course, there are undoubtedly plenty of other lessons to be drawn from the issues we have discussed, and in future installments of Huddleston Tax Weekly we will do our best to cover these lessons. But for now, it is important to understand what taxes represent at a very basic level. Behind all the number crunching, the box checking, the empty bureaucracy, the abstruse terminology and the lofty rhetoric, a tax is a *tool utilized to further the interests of a particular group*. A tax can be created for any number of reasons: a tax may be used to generate funds for war; a tax may be implemented in order to stabilize a specific market; or a tax may be forcibly imposed by an occupying entity, as was the case with the geld. But no matter what the reason is for its creation, it is clear that any given tax is an extension of a specific interest group.

United States v. Winthrop & the Test for Ordinary Income

Published on January 6, 2017

In our earlier article about the case of *Byram v. United States* (1983), we introduced the 7 pillars of capital gain treatment and discussed the recurring issue of distinguishing business sales from investment sales. In *Byram*, the court found the profits of multiple real estate transactions to be capital gains due to the peculiar facts which surrounded the transactions. In this article, we will discuss the specifics of an earlier case – *United States v. Winthrop* (1969) – in which the court rejected the capital gain classification and ruled that certain transactions were sales made in the ordinary course of business.

It is important that our readers have an understanding which is as clear as possible of what constitutes a capital gain so that they can avoid any unpleasant surprises. The facts of *United States v. Winthrop* contribute toward this understanding.

The case of *United States v. Winthrop* will also give readers a sense of the unpredictability in judicial reasoning. Prior to being heard by the Fifth Circuit Court of Appeals, the facts of this case were found to support a capital gain classification at the trial court; the Fifth Circuit actually had to overturn this finding to reach its conclusion. And given that there was no dispute between the trial court and appellate court over any matter of fact in the case, and that there were multiple potentially compelling cases cited by Winthrop, it follows that the outcome of even a strongly backed case cannot be predicted with mathematical certainty.

Facts

Over the course of a number of years, Mr. Winthrop (respondent in appellate case) inherited several pieces of real estate. Collectively, these pieces were referred to as "Betton Hills." Mr. Winthrop inherited his first piece of land in 1932, and he began to develop that same piece a few years later in 1936. Mr. Winthrop inherited additional pieces of land at various other dates (1946, 1948 and 1960).

In 1936, Mr. Winthrop made his first sale by selling a portion of the land he had began developing earlier that same year. Mr. Winthrop continued to develop his land and sell portions of it to interested buyers up until his death in 1963. Hence, his sales operation spanned multiple decades. Though he did not create a business office, he devoted massive amounts of energy to developing the land so as to make it more marketable. What's more, the income derived from real estate sales constituted the majority of his entire income for many years prior to his death. Mr. Winthrop also began to include "real estate" as his occupation for a number of years in official documents before his death. The question before the court was: should Mr. Winthrop's activities receive capital gain treatment given the facts which underlay them?

Law

There are a number of common law tests which have been developed to aid the court in its determination of capital gain treatment. Though this is true, the court must also be certain to view each case as an independent matter and provide each case with its own analysis. In *United States v. Winthrop*, there was no disagreement made by the Fifth Circuit regarding the fact that the land was held "primarily for sale" by Mr. Winthrop. The only remaining issue was whether the sales executed could be classified as *sales made in the ordinary course of business*. The Fifth Circuit stated that the ordinary course of business determination depends on whether selling the land was Mr. Winthrop's *primary purpose* in holding the land.

Ruling

The Fifth Circuit overturned the trial court's finding and determined that the sales made by Mr. Winthrop were made in the ordinary course of business and therefore should be disqualified from capital gain treatment. Mr. Winthrop clearly had a reasonably strong case given that he did not actively and aggressively advertise his properties, he did not maintain a sales office, did not reinvest his profits in other real estate (for the purpose of growing his business) and he initially acquired the real estate through inheritance rather than purchase. There were certainly many facts capable of supporting his position. Ultimately, the fact that Mr. Winthrop only used the properties for the purpose of selling to customers proved to be decisive.

A Note on the Capital Gains Tax

Published on January 4, 2017

As the previous installment of Huddleston Tax Weekly made clear, our tax code draws a distinction between ordinary income and capital gains. In general, ordinary income is income derived throughout the course of running a business or trade; capital gains result from the sale of a "capital asset" (which is defined by the code). It is important for people to understand how their behavior will be classified because these classifications carry particular tax implications. In conjunction with criteria from the tax code, our common law also provides additional guidelines for classifying a given source of income.

The capital gains tax has long been the focus of controversy: many argue that its current low rate disproportionately benefits wealthy citizens and that it should be increased, while others contend that a lower rate actually stimulates more economic growth and that such growth benefits citizens of all socioeconomic levels. The evidence in favor of the latter position is considerable and should strike most objective observers as persuasive. The capital gains tax rate has fluctuated widely over the past several decades, and there is an unmistakable positive correlation between low rates and greater revenues generated from capital gains. This association may appear counterintuitive upon first glance, but a bit more scrutiny makes it very easy to understand: when the tax rate is high, people simply hold on to their assets and avoid paying the tax at a high rate; when the rate is low, people sell more frequently and this results in greater total revenues for the government.

Low rates also appear to influence stock market prices. The tax cuts in the 1980s, the late 1990s, and in 2003 all coincided with significant stock market gains. What's more, there is also an association between reduced rates and business development as measured by initial public offerings (IPOs), money raised from IPOs and the money committed to venture capital firms. Investors are less willing to commit funds when capital gains tax rates are high; this agrees with common sense given that higher rates will result in smaller returns on investment.

Though lower capital gains tax rates do appear to provide greater benefits to the economy as a whole, there is no denying that such rates disproportionately benefit higher income levels. The clear majority of gains from capital asset sales are made by those with incomes above $200,000. Going forward, it appears that the debate on capital gains tax rates will be framed by this question: can our society accept the positive impact of lower rates even though lower rates tend to benefit wealthy individuals disproportionately?

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Byram v. United States & the 7 Pillars of Capital Gain Treatment

Published on January 3, 2017

The tax code draws a distinction between ordinary income and income derived from the sale of a capital asset, or "capital gain." In most instances, this distinction is straightforward and there is little confusion about whether income falls into one category or the other. Every now and then, however, a situation develops in which the classification of income is a difficult matter. There is much at stake in the determination of whether income is either ordinary or derived from the sale of a capital asset: capital gains can be taxed at substantially lower rates than ordinary income.

The case of *Byram v. United States* (1983) provides one example of the difficulty occasionally involved in distinguishing between a "business" sale – which would trigger ordinary income – and an investment sale. The tax code recognizes a number of general characteristics of business sales and investment sales; sometimes a transaction possesses characteristics of both a business sale and an investment sale, or it lacks enough characteristics of one type of sale to merit a definitive classification.

If you engage in real transactions with any kind of regularity, be sure that you're aware of these characteristics so you can avoid any unpleasant surprises when tax time rolls around.

Facts

John Byram owned multiple pieces of real estate. Between the years 1971 and 1973, Byram sold a total of 22 pieces of real estate for a gross return of $9 million and a net profit of $3.4 million. He sold 7 pieces of real estate in 1973 alone.

Importantly, Byram did not have a business office; he did not advertise; he did not utilize the services of a broker; he did not subdivide the land; he spent only a small amount of time and effort engaging in the transactions; all of the transactions were initiated by the purchasers.

Law

The question of whether a transaction – or set of transactions – can receive "capital gain treatment" (and therefore be subject to the rates applicable to capital gains) depends on the characteristics of the transaction. Courts recognize the 7 "pillars" of capital gain treatment when deciding whether a given transaction should be deemed either an investment sale or business sale.

The *7 Pillars of Capital Gain Treatment* can be summed up as follows: (1) purpose of the acquisition of the property and duration of ownership; (2) extent of the efforts to sell the property; (3) number, extent, continuity and magnitude of the sales; (4) time and effort devoted to developing the land and advertising to increase sales; (5) use of a business office; (6) degree of supervision exercised by the owner over any representative selling the property; (7) overall time and energy dedicated to the sales.

The question before the court was: do the transactions made by Byram between 1971-1973 merit capital gain treatment based on the guidelines established through the 7 pillars?

Ruling

The court (the Court of Appeals for the Fifth Circuit) affirmed the ruling of the lower court in favor of Byram. The transactions engaged in by Byram (and his buyers) possessed enough characteristics of an investment sale to trigger capital gain treatment. The determination of whether capital gain treatment is warranted requires an independent analysis for each individual case; in the *Byram* case it was clear that the evidence supported the conclusion that the properties were not sold as part of a business enterprise but as investments.

The *Byram* case is highly useful for people who own multiple pieces of real estate and who are considering selling these pieces in the future. It is important for these owners to be conscious of the facts of *Byram* so that they can be certain to receive capital gain treatment.