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NOTES

EFFECT OF EQUITABLE CONVERSION
ON INHERITANCE TAXATION

In the recent case of *In re Ryan's Estate*,¹ it is important to note the view taken by the North Dakota Supreme Court on the question of imposing a state inheritance tax on a non-resident decedent's interest in land located within this state but subject to an existing contract for sale. In the above case it was held that the contract of sale for the realty operated to change the real property into intangible personality, thus taxable only by the state in which decedent was domiciled. This change was effected by virtue of an "equitable conversion", and had the effect of excluding decedent's interest from our statute which imposes an inheritance tax on all real property situated within this state and owned by a non-resident.²

In view of the significant consequences of this decision it seems appropriate to examine the historical background of the doctrine of equitable conversion and then attempt an analysis of the various court decisions that have dealt with this problem.

I. HISTORICAL BACKGROUND OF EQUITABLE CONVERSION

Equitable conversion may be defined as that constructive alteration in the nature of property, whereby in equity, real property is converted into personalty, or vice versa, and is transmissible and descendible as such.³ This doctrine was first clearly stated in the case of *Seaton v. Slade*⁴ where it was said, "The effect of a contract for purchase of land is very different at Law and in Equity. At Law the estate remains the estate of the vendor; and the money that of the vendee. It is not so here. The estate from the sealing of the contract is the real property of the vendee. It descends to his heirs. It is devisable by his will; and the question whose it is is not to be discussed merely between the vendor and the vendee; but may be discussed between the representatives of the vendee". One legal writer questions whether or not this doctrine existed prior to *Seaton v. Slade*.⁵

North Dakota formally adopted this doctrine in the case of *Clapp*

1. 102 N.W.2d 9 (N.D. 1960).

2. N.D. Rev. Code § 57-3703 (1943).

3. *Bennett v. Bennett*, 282 Ill. 266, 118 N.E. 391 (1918); *Hardcastle v. Sibley*, 107 S.W.2d 432 (Tex. Civ. App. 1937); *Griggs Land Co. v. Smith*, 46 Wash. 185, 89 Pac. 477 (1907).

4. 7 Ves. 265, 32 Eng. Rep. 108 (1802).

5. See 25 Ky. L. J. 166 (1937).

v. *Tower*⁶ where it was stated, "The vendor still holds the legal title, but only as trustee and he in turn acquires an equitable ownership of the purchase money. His property, as viewed by equity, is no longer real estate, in the land, but personal estate, in the price; and, if he dies before payment, it goes to his administrator, and not to his heirs".

The origin of the doctrine is in the maxim that equity looks upon that as done which ought to have been done.⁷ However, the courts generally assert that this doctrine is based solely on a "fiction",⁸ and will be invoked only when necessary to accomplish justice.⁹ The doctrine has been subjected to much criticism¹⁰ resulting in modification by statute in some states.¹¹

II. GENERALLY

A fundamental limitation upon the power of a state to enact an inheritance tax is namely that it must have jurisdiction over the thing taxed.¹² When a state gives nothing in return for enacting a tax it may be said that there is no jurisdiction to tax;¹³ therefore a fundamental question is whether or not the state seeking to impose the tax has conferred benefit or protection to the property or to the owner.¹⁴ It is well established that by virtue of this test, real property, as such, is subject to inheritance taxation only by the state where it is located irrespective of the domicil of the decedent.¹⁵ However, intangible personalty, the product of the doctrine of equitable conversion, is taxable by any state which (1) has dominion over the converted property,¹⁶ (2) has dominion over the

6. 11 N. D. 556, 93 N.W. 832 (1903) quoting 1 POMEROY, EQUITY JURISPRUDENCE § 105 (5th ed. 1935).

7. See *Grayham v. Grayham*, 202 Ala. 56, 79 So. 450 (1918); *Lockner v. VanBebber*, 364 Ill. 636, 5 N.E.2d 460 (1936); 4 POMEROY, EQUITY JURISPRUDENCE § 1159 (5th ed. 1935).

8. *In re Maquire's Estate*, 296 N.Y. Supp. 528 (1937); *In re Foote's Will*, 159 Wis. 179, 149 N.W. 738 (1914).

9. *State v. O'Connell*, 121 Wash. 542, 209 Pac. 865 (1922).

10. See *Detroit and Security Trust Co. v. Kramer*, 247 Mich. 468, 226 N.W. 234 (1929) (court refused to apply the doctrine where an equitable result would have obtained); *Stone, Equitable Conversion by Contract*, 13 Col. L. Rev. 369 (1913); Pound, *Progress of the Law*, 33 Harv. L. Rev. 813 (1920); Comment, 37 U. Det. L.J. 258 (1959).

11. See Simpson, *Legislative Changes in the Law of Equitable Conversion by Contract*, 44 Yale L. J. 559 (1935).

12. *Frick v. Pennsylvania*, 268 U.S. 473 (1925); *State ex rel Peterson v. Dunlap*, 28 Idaho 784, 156 Pac. 1141 (1916). See *Maxwell v. Bugbee*, 250 U.S. 525 (1919). It should be noted that in *State v. Probate Court*, 128 Minn. 371, 150 N.W. 1094 (1915) the state had power to impose a succession tax in respect to certain property upon which it could not impose an ordinary tax.

13. See *State Tax Comm'n v. Aldrich*, 316 U.S. 174 (1942).

14. *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819).

15. *People v. Kellogg*, 268 Ill. 489, 109 N.E. 304 (1915); *Succession of Westfeld*, 122 La. 836, 48 So. 281 (1909); *In re Marrs' Estate*, 240 Pa. St. 38, 87 Atl. 621 (1913).

16. *State Tax Comm'n v. Aldrich*, 316 U.S. 174 (1942); *Curry v. McCanless*, 307 U.S. 357 (1939).

persons whose contract gave rise to the conversion,¹⁷ or (3) has extended benefits or protection to the intangible property.¹⁸ The necessary result of these rules is that under certain conditions, transfer of intangible personalty is subject to double taxation.¹⁹ However, many states refuse to impose an inheritance tax on intangible personalty owned by a non-resident by virtue of a reciprocity statute.²⁰

III. INTEREST OF VENDOR

It should be noted that there are two distinct tax situations involving the vendor's interest. First, a state may attempt to tax a resident vendor's interest in foreign property, in which event operation of the doctrine of equitable conversion would render the vendor's interest taxable as intangible personalty.²¹ Second, the taxing state may attempt to tax a non-resident vendor's interest in land located within the state. In this case application of the doctrine would exempt this interest from being taxed as realty.²² Unfortunately we not only have uncertainty in the law as to whether or not the doctrine of equitable conversion affects the imposition of an inheritance tax, but the New York courts, prior to *De Stuer's Estate*, refused to apply the doctrine in the first case, that is, when the property is in a foreign state,²³ but felt no apparent compunction against recognizing and applying the doctrine when the property was within the state and its vendor was a non-resident.²⁴ Therefore, New York did not collect a tax in either case.

In *De Stuer's Estate*,²⁵ which brought an end to this inconsistency, the testator was a non-resident and prior to his death had contracted to sell real estate located in New York. The court citing the cases

17. *Graves v. Schmidlapp*, 315 U.S. 657, (1942) (A state is not debarred from taxing a transfer of intangible property by the fact that the transferee must depend in part on the law of another state to enjoy the benefits of the property).

18. *Kelly v. Bastedo*, 70 Ariz. 371, 220 P.2d 1069 (1950); *Stone v. Stapling Machine Co.*, 220 Miss. 470, 71 So.2d 205 (1954); *State v. Atlantic Oil Producing Co.*, 174 Okl. 61, 49 P.2d 534 (1935).

19. *Curry v. McCanless*, 307 U.S. 357 (1939) (Intangible property may be subject to double taxation without violating the U.S. Constitution).

20. *St. Louis Union Trust Co. v. State*, 348 Mo. 725, 155 S.W.2d 107 (1941); *City Bank Farmer's Trust Co. v. New York Cent. R. Co.*, 253 N. Y. 49 (1930); *In re Eilermann's Estate*, 179 Wash. 15, 35 P.2d 763 (1934) (These statutes provide in effect that personal property of a non-resident decedent otherwise subject to a tax shall be entitled to an exemption providing the law of decedent's residence grant a similar exemption to citizens of this state). See *In re Miller's Estate*, 239 Wis. 551, 2 N.W.2d 256 (1942).

21. *State v. Probate Court*, 145 Minn. 155, 176 N.W. 493 (1920); *In re Briebach's Estate*, 132 Mont. 432, 318 P.2d 223 (1957) (here a reciprocity statute barred the tax); *In re Plasterer's Estate*, 49 Wash. 339, 301 P.2d 539 (1956).

22. *In re Ryan's Estate*, 102 N.W.2d 9 (N.D. 1960); *In re Eilermann's Estate*, 179 Wash. 15, 35 P.2d 763 (1934).

23. *In re Walcott's Estate*, 157 N.Y. Supp. 268 (1916); *In re Baker's Estate*, 124 N. Y. Supp. 827 (1910).

24. *In re Russell's Estate*, 194 N.Y. Supp. 837 (1922); *In re Boshart's Estate*, 177 N. Y. Supp. 574 (1919).

25. 99 N.Y.S.2d 739 (1950).

of *Connell v. Crosby*²⁶ and *In re Wilson's Estate*,²⁷ held that an inheritance tax could be imposed by New York on the vendor's interest in the real estate asserting that, "The doctrine of equitable conversion concerns only those who have come into relations of contract or privity with the decedent or his estate,"²⁸ and as the state is a stranger to the contract the doctrine is inoperative.²⁹ The court also stated that determination of ownership depends upon the quantum of vendor's interest in the land after execution of the contract.³⁰ The quantum of vendor's interest should be determined by weighing a variety of factors. The courts contend that subsequent to execution of the contract and until an actual conveyance is made the vendor retains legal title to the premises.³¹ In addition thereto, the law confers upon him a vendor's lien.³² In event of default the vendor may institute an action to cancel the contract as a cloud on his title, thus retaining the land unencumbered.³³ Indication of the vendor's power over the land is also found in the fact that he can, while the contract is still in force, convey complete ownership of the land to a bona fide purchaser who receives the land without notice of the contract.³⁴ Moreover the land may be sold upon execution to satisfy a judgment levied against the vendor.³⁵ Finally the vendor may maintain an action for waste against the vendee in possession if vendor's security is impaired.³⁶ Moreover, it has been intimated that the vendor is still liable for the unlawful use of the property and is responsible for injuries arising from such use.³⁷ Thus it is apparent that the vendor under a contract for the sale of real property retains substantial interest in that property and in New York his interest is great enough to give him substantial ownership meriting taxation. Along with New York, the state of Illinois refuses to apply the doctrine, but on a somewhat different basis. Illinois contends that this doctrine is

26. 210 Ill. 380, 71 N.E. 350 (1904).

27. 218 Iowa 368, 255 N.W. 489 (1934).

28. Hooper v. Peters Mineral Land Co., 210 Ala. 346, 98 So. 6 (1923); *In re De Stuer's Estate*, 99 N.Y.S.2d 739 (1950).

29. Quoting from the case of *Matter of Baker*, 124 N.Y. Supp. 827 (1910).

30. See also *State Tax Comm'n v. Aldrich*, 316 U.S. 174 (1942).

31. See *Semmler v. Beulah Coal Min. Co.*, 48 N.D. 1011, 188 N.W. 310 (1922); *Paul's Estate*, 303 Pa. 330, 154 Atl. 503 (1931).

32. *Charles v. Scheibel*, 218 N.Y.S. 545 (1926); *Connors v. Winans*, 204 N.Y. Supp. 142 (1924). See 4 POMEROY, EQUITY JURISPRUDENCE § 1263 at 773 (5th ed. 1935).

33. *Kitching v. Browne*, 197 N.Y.S. 441 (1922); *Charlton v. Sheil*, 158 N.Y. Supp. 944 (1916).

34. See *Macauley v. Smith*, 132 N.Y. 524, 30 N.E. 997 (1892); *Pollock v. Viele*, 76 N.Y.S.2d 904 (1948).

35. *Schmidt v. Steinbach*, 193 Mich. 640, 160 N.W. 448 (1916); *Wells v. Baldwin*, 28 Minn. 408, 10 N.W. 427 (1881).

36. *Moses v. Johnson*, 88 Ala. 517, 7 So. 146 (1890). See *Miller v. Waddingham*, 91 Cal. 377, 27 Pac. 750 (1891).

37. See *Baker's Estate*, 124 N.Y. Supp. 827 (1910) (dicta).

recognized in equity alone, and is not given effect in courts of law; therefore, it cannot be applied in proceedings for the collection of inheritance taxes which are actions at law.³⁸ Pennsylvania also refuses to recognize a change in the nature of property by virtue of an equitable conversion, contending that jurisdiction to tax is one of fact, and cannot turn upon theories or fiction, which have no place in a well adjusted system of taxation.³⁹

The majority of states which have decided on this issue hold that upon execution of a contract for deed, the doctrine of equitable conversion operates to change the interest of the vendor from that of real property to intangible personalty.⁴⁰ It is said that the vendor retains only the naked legal title in the real estate as security for payment of the purchase price.⁴¹ Some cases compare the vendor's interest to that of a mortgagee on the basis the parties occupy substantially the position of mortgagor and mortgagee.⁴² Thus the vendor or his heirs have in substance a chose in action for the unpaid purchase price or choses in action for the various installments if the contract of deed so provides and his interest, as such, is intangible personal property.⁴³ Moreover, the vendor has no power to devise or sell the real estate which is the subject of the contract of sale.⁴⁴

In *Paul's Estate*,⁴⁵ the dissenting opinion aptly pointed out that the contract does not "stand for" the land, i. e. serve as a substitute for the land, but the contract derives its value from the ability of the vendee to pay. Thus if the land was sold for \$100,000.00 and became worthless, the vendor's property in that contract would still be worth \$100,000.00. The vendor looks first to the ability of the vendee to pay and then to his property. Such being the case, this property is not any "make believe" legal fiction, but is an economic and legal fact.

IV. INTEREST OF VENDEE

If the true nature of the vendor's interest in the contract of sale

38. *Connell v. Crosby*, 210 Ill. 380, 71 N.E. 350 (1904).

39. *Paul's Estate*, 303 Pa. 330, 154 Atl. 503 (1931).

40. *State v. Probate Court*, 145 Minn. 155, 176 N.W. 493 (1920); *In re Briebach's Estate*, 132 Mont. 437, 318 P.2d 223 (1957); *In re Plasterer's Estate*, 49 Wash. 339, 301 P.2d 539 (1956).

41. See *In re Wiley's Estate*, 150 Neb. 898, 36 N.W.2d 483 (1949); *Corp. v. Klindworth*, 77 N.D. 597, 44 N.W.2d 417 (1950); *Clapp v. Tower*, 11 N.D. 556, 93 N.W. 862 (1903).

42. See *D.S.B. Johnston Land Co. v. Whipple*, 60 N.D. 334, 234 N.W. 59 (1931). *Contra City of Marquette v. Michigan Iron and Land Co.*, 132 Mich. 130, 92 N.W. 934 (1903).

43. *In re Plasterer's Estate*, 49 Wash. 339, 301 P.2d 539 (1956). See dissent in *Paul's Estate*, 303 Pa. 330 154 Atl. 503 (1931).

44. *William v. Board of Commissioners*, 84 Kan. 508, 114 Pac. 858 (1911).

45. 303 Pa. 330, 154 Atl. 503 (1931).

for real property can be said to be "personalty," then, a fortiori, the interest of the vendee from the same moment becomes "realty". The arguments advanced by the courts in support of their particular theory, as to whether an actual change in the nature of the vendor's interest occurs, should apply with equal force here.

However, it is interesting to note that although the great majority of courts assert that the doctrine of equitable conversion operates immediately upon *execution* of a valid and enforceable contract,⁴⁶ the cases which apply the doctrine in the field of taxation do so only if vendor has transferred substantial "beneficial" interest in the property to the vendee. A preview of the cases indicates that the doctrine is applicable to inheritance taxation only if the vendee is in possession of the property or entitled to immediate possession.⁴⁷ Some courts have maintained that the intention of the parties as to when transfer of the land actually occurs should determine the moment of conversion, and that the court acts in accordance with the presumed intention.⁴⁸ It has been suggested that in a contract for the sale of land, no general rule can be more than an attempt to follow the intention of the parties; and that when "by the contract the beneficial incidents of ownership are to pass is the time which the parties must regard as the moment of transfer".⁴⁹ Courts applying the doctrine of equitable conversion to determine if an inheritance tax should be imposed, should distinguish cases which do not apply the doctrine by pointing out that in these cases the vendor, and not the vendee, has the right to possession of the land by the terms of the contract.

V. CONCLUSION

The operation of an equitable conversion when the beneficial incidents of ownership are transferred to the vendee seems to be the better rule as it has the effect of imposing payment of an inheritance tax on real property to the party that enjoys or has the right to enjoy the "fruits" of ownership over the property. Universal adoption of this rule would also have the desirable effect of eliminating the imposition of double taxation on the non-resident decedent's interest in land subject to a contract for sale.

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46. *In re Bernhard*, 134 Iowa 603, 112 N.W. 86 (1907). See *Rockland-Rockport Lime Co. v. Leary*, 203 N.Y. 469, 97 N.E. 43 (1911).

47. *State v. Probate Court*, 145 Minn. 155, 176 N.W. 493 (1920); *In re Stuer's Estate*, 99 N.Y. Supp 739 (1950); *Paul's Estate*, 303 Pa. 330, 154 Atl. 503 (1931).

48. *Baker v. Commissioner of Corporations and Taxation*, 253 Mass. 130, 148 N.E. 593 (1925). See 4 Mont. L.Rev. 93 (1943).

49. Williston, *The Risk of Loss after an Executory Contract of Sale in the Common Law*, 9 Harv. L. Rev. 106, 120 (1885).