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These remarks might well be susceptible to the criticizm that they include a rather large measure of instant analysis. I nevertheless have chosen a handful of 1969 tax cases which at this early date seem to be among the more important. The following discussion begins with decisions involving gross income, business related expenses, personal expenses and tax rates. These are followed by decisions bearing particularly upon the corporate income tax, decisions involving tax investigations and litigation and finally several decisions involving the estate and gift taxes.

Income Taxation.

Income—Insurance Proceeds; Prepayments for Goods. Regarding the treatment of insurance proceeds, section 101(a)(1) provides, in part, that "gross income does not include amounts received . . . under a life insurance contract, if such amounts are paid by reason of the death of the insured." [1] Relying upon that section, the taxpayer in *Landfield Finance* [2] made a loan to a company all the stock of which was owned by one Carl Matson. Matson, as a condition to obtaining the loan for his company, was required by the taxpayer finance company to take out a life insurance policy on his life, to pay the premiums and to name the taxpayer as irrevocable primary beneficiary and co-owner. By separate agreement, the taxpayer was obligated, if it received the proceeds, to pay over any excess after satisfying the loan to secondary beneficiaries.

Matson died, and the insurance proceeds were paid to the taxpayer who retained all the proceeds as necessary to pay off the loan. The Seventh Circuit affirmed the district court and held that the proceeds had to be included in income regardless of section 101(a)(1). The court held that the word "received" as used in §101(a)(1) means not only the right to receive initially but to retain, both by reason of the death of the insured. In *Landfield Finance,* the taxpayer retained only because of the loan and not "by reason of the death of the insured."

As to prepayments for goods, the Sixth Circuit affirmed the Tax Court decision in *Hagen Advertising*[3] which extended the rule of *Schlude*[4] and

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[1] The references to various sections are to sections of the Internal Revenue Code of 1954.

[2] Landfield Finance Co. v. United States, 69-2 USTC ¶9680 (7th Cir.), aff'g 296 F. Supp. 1118 (N.D. Ill. 1969).

[3] Hagen Advertising Displays, Inc. v. Commissioner, 407 F.2d 1105 (6th Cir. 1969), aff'g 47 T.C. 139 (1966).

[4] Schlude v. Commissioner, 372 U.S. 128 (1963).

American Automobile Association.[5] That rule requires prepayments of income for services to be included in the income of an accrual basis taxpayer if there then exists an unconditional right to retain the payments even if the services have not yet been performed. In *Hagen Advertising* the taxpayer, a manufacturer of electric signs, received some unsolicited advance payments on orders which had been placed for signs. The signs were not finished by the end of the taxable year so that the total cost of manufacture was not yet known. Even so, the court of appeals held that the prepayments, less an estimate of cost, should have been included in income in the year of receipt even though the taxpayer was on the accrual method. The court based its decision upon legislative history. Although Congress in 1954 had passed section 452 which would have permitted a deferral for prepayments, that section was repealed retroactively the next year due to the potentially large revenue loss which it would have created. Both services and goods were included under section 452, and this same legislative history had formed the basis for the holdings in *Schlude* and *American Automobile Association.*

Hagen Advertising is contrary to *Artnell*[6] decided last year by the Seventh Circuit. In *Artnell,* advance income from sales of baseball game tickets was permitted to be deferred because the deferred technique "so clearly reflects income that it would be an abuse of discretion if the Commissioner were to refuse it." Although these two cases undoubtedly could be distinguished on their facts, the two opinions reflect a hard-line and a soft-line approach respectively that seem to conflict over the amount of flexibility which the repeal of section 452 left behind.

Income—Scholarships vs. Compensation. The first case to come before the Supreme Court involving section 117, the exclusion from income for scholarships and fellowships, was decided this year. At issue in *Bingler*[7] was the validity of Regulations section 1.117-4(c). The Secretary in subsection 4(c) has marked off as items not to be considered scholarships or fellowships any amount (except for required part-time employment which is covered elsewhere) which "represents either compensation for past, present, or future employment services . . . [and] any amount paid or allowed to . . . an individual to enable him to pursue studies or research primarily for the benefit of the grantor."

The Third Circuit in *Bingler* relied on an *expressio unius* argument: Since section 117 expressly excludes that portion of any amount which is pay for required part-time employment which employment is not required of non-recipients, the Third Circuit thought that Congress had

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5 American Automobile Ass'n v. United States, 367 U.S. 687 (1961).

6 Artnell Co. v. Commissioner, 400 F.2d 981 (7th Cir. 1968).

7 Bingler v. Johnson, 89 S. Ct. 1439 (1969).

intended no other exclusions based upon pay for services or benefit to the grantor. The Supreme Court disagreed and held that Congress merely had intended to treat expressly those abuses which were brought to its attention at the time of the passage of section 117 and to leave further molding of the section to the Secretary.

In *Bingler,* the taxpayers were employees of Westinghouse who were given a chance to undertake post-graduate study in engineering, physics or mathematics. The company, under an established plan, gave them time off of up to 8 hours per week with pay, plus tuition remuneration and incidental expenses. Later, as each employee was ready to begin his doctoral dissertation, he was given a leave of absence with 70 percent to 90 percent pay plus additional amounts for family expenses. Each taxpayer, however, had to furnish a *quid pro quo* in that he was required to submit his thesis topic to Westinghouse and to the AEC for prior approval, to submit periodic reports of what he was doing on his thesis, and finally to return after obtaining his degree to work for Westinghouse for a period of two years.

The Court gave no direct indication of what modifications in the Westinghouse plan would have rendered the payments excludible as scholarships, but it did note the close tie-in between section 117 and the exclusion in section 102 for gifts. Prior to 1954 there was no counterpart to section 117, and scholarships were excludible, if at all, on the ground that they were gifts. Although section 117 was intended to do away with the need to search for evidence of the motive of the donor,[8] subsection 4(c) would seem to bring back in at least part of this search. Thus one major objective in the enactment of section 117 (to do away with issues concerning the motive of the donor) has been partially defeated by subsection 4(c) with the Court's blessing in *Bingler.*

A similar case decided this year by the Tax Court demonstrates how fine the line has become under subsection 4(c). In *Schwartz,*[9] the taxpayer was a teacher who was paid certain amounts to pursue a course of study in France which would enable her, upon her return, to teach a course in Modern European Thinking. No period of service, however, was expressly required of the taxpayer. The court held that the amounts received were not scholarships or fellowships because they were proscribed by subsection 4(c). Possibly, if the taxpayer and her employer had not been quite so far-sighted about future applications of her study at the Sorbonne, the amounts might have been excludible.

An alternative to subsection 4(c) in some cases involves the deduction for education expenses under section 162. If the individual can

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[8] See 1 *Mertens, Law of Federal Income Taxation* §7.42 (1962).

[9] Schwartz v. Commissioner, T.C. Memo. 1969-151.

convince the Service that the amounts received were merely reimbursements for expenditures either to maintain or improve skills required by the individual in his employment or to meet express requirements of the individual's employer for retention of his established employment, as outlined in Regulations section 1.162-5, then the amounts paid would be deductible as business expenses under section 162. This approach probably would not have availed the employees in *Bingler* as they were to be placed in new work upon their return for which they had never before been qualified. As to *Schwartz*, however, the section 162 deduction might have been available as she apparently was qualified for no new teaching position but rather merely returned to teach a new course.

Expenses—Business Related.

Interest to Purchase or Carry Tax Exempt Securities. Three cases were decided by the Third Circuit, Second Circuit and Court of Claims, respectively, which deal with various aspects of section 265(2): "No deduction shall be allowed for . . . interest on indebtedness incurred or continued to purchase or carry obligations . . . the interest on which [obligations] is wholly exempt from the taxes imposed by this subtitle."

In *Wynn*,[10] the taxpayer was an 8 percent partner in a brokerage firm which traded extensively in tax-exempt municipals. All of the municipals were held by a bank as security for indebtedness to the extent that purchases exceeded sales—that is, a loan would be created for this excess—and the firm would then pay interest on this loan. The Third Circuit held that section 265(2) is constitutional in that it does not constitute an indirect taxing by the federal government of municipalities and that the section precluded taxpayer Wynn from taking as a deduction 8 percent of the interest paid to the bank by the firm.

In the district court opinion in *Wynn*, which the Third Circuit affirmed per curiam, the facts were distinguished from those of two 1968 cases involving substantially the same issue. In these cases, *Wisconsin Cheeseman*[11] and *Leslie*,[12] the Seventh Circuit and Tax Court, respectively, passed upon the deductibility of interest incurred to purchase or carry tax-exempt securities. Both courts permitted the deduction of this interest because it was not sufficiently related to the purchase or carrying of tax exempts. In *Wisconsin Cheeseman* the borrowing was done for a valid business reason (to build a new building), and the tax exempts were not

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10 Wynn v. United States, 411 F.2d 614 (3d Cir. 1969), aff'g per curiam 288 F. Supp. 797 (E.D. Pa. 1968).

11 United States v. The Wisconsin Cheeseman, Inc., 388 F.2d 420 (7th Cir. 1969).

12 Leslie v. Commissioner, 50 T.C. 11 (1968).

pledged to secure the loan. In *Leslie,* the Tax Court felt that the amount of tax exempts which the brokerage firm held was too small in relation to the total holdings of the firm to have any appreciable effect upon the decision to borrow money for general business operations.

On appeal to the Second Circuit, however, the Tax Court decision in *Leslie* was reversed.[13] The court found that the tax exempt requirements necessarily entered into the decision of how much money to borrow. The proscribed purpose, therefore, was found to be present even though the funds could not be traced to the purchase of any particular securities. The Tax Court had thought that it was not free to allocate the interest as between the tax exempts and the non tax exempts because to do so would violate the difference between section 265(1) and section 265(2). The former section refers to expenses "allocable" to tax exempts while the latter refers to interest incurred or continued "to purchase or carry" (i.e., for the purpose of purchasing or carrying) tax exempts. The reference to "allocable" in section 265(1), however, in the view of the Second Circuit, does not prohibit an allocation of interest under section 265(2) once the requisite purpose is found.

After *Wynn* and *Leslie,* the Service should find it much easier to show that at least part of an interest expense was paid or incurred to purchase or carry tax exempts. The requisite purpose will be found if the tax exempts are pledged for the loan without the necessity for proof by the Service that no other collateral was available. The taxpayer will not prevail merely by showing that the tax exempts were not purchased with the loan proceeds directly or that the tax exempts constituted a small part of the overall business and were not actively considered in computing loan needs, or that the tax exempts were not pledged to secure the loan, or probably even that there was other collateral available which could have been used to secure the loan.

In addition, the Service can enjoy at least partial success by proving a general purpose to benefit the business as a whole. Those who had read section 265(2) before *Leslie* as requiring a specific purpose related directly and exclusively to the purchasing or carrying of tax exempts have been set straight at least in the Second Circuit. Certiorari has been requested in these two cases.

In *Phipps*[14] the Service was not successful in an attempt to extend further the rules announced in this line of cases to include all the nondeductible interest in the tax return of one partner of a brokerage business rather than prorata in the incomes of all of the partners. There, taxpayer Phipps, a limited partner in Smith, Barney & Co., contributed $1

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13 Leslie v. Commissioner, 413 F.2d 636 (2d Cir. 1969).

14 Phipps v. United States, 69-2 USTC ¶9537 (Ct. Cl.).

million of tax exempts to the firm in 1956 upon his conversion from a general partner to a limited partner. The compensation arrangement with Phipps was as follows: Five percent guaranteed return on his capital; plus 1 percent of the net income if earned; plus the income on the tax exempts; less the interest incurred by the firm in borrowing on the tax exempts from a bank (the borrowing being necessary to convert the tax exempts into working capital).

The Court of Claims assumed that the interest paid on the loan secured by the tax exempts by the partnership fell within section 265(2) and thus was not deductible by it. The only question was whether Phipps should be charged with the full burden of the interest denial rather than spreading it out among all those entitled to the net income. The court held for the taxpayer. It felt that the partnership and not Phipps had incurred the indebtedness and that the benefit of the loan agreement with the bank accrued to the partnership rather than to the limited partner, Phipps.

The transaction in *Phipps* would seem to be the same as if Phipps had borrowed the $1 million from the bank and then had contributed the proceeds to the partnership. One difference, would be that if he had done so, the actual income of the partnership would have been higher by the amount of the bank interest saved. In the instant case, however, this was compensated for by subtracting from Phipp's 5 percent guaranteed return the amount of the interest paid to the bank. Thus the net income of the partnership after Phipp's 5 percent net of the bank interest was the same as if the partnership had paid Phipps a full 5 percent and had not paid anything to the bank. It is difficult to see how the court determined that the loan agreement was made for the benefit of the partnership and not for Phipp's benefit when the partnership charged Phipps the full amount of the interest expense against Phipps' 5 percent.

If *Phipps,* holds up, of course, there are obvious opportunities for minimizing taxes: If the partner contributing the tax exempts is in a lower personal tax bracket than the other partners, he would be better off to arrange for a personal loan and then receive a higher percentage of the profits to offset his expense. If the other partners are in lower brackets, then the partner would be better advised to contribute the tax exempts in kind and take a lower percentage of the profits to compensate for the portion of the interest denial that must be absorbed by his lower-bracket partners.[15] If the partnership can use other collateral,

[15] For example, assume a 10% net return on invested capital with no outside income, and $1 million of 4% tax exempts used as collateral to obtain a $1 million loan at 6%, which then comprised five-sixths of the capital of a three-man partnership. If incomes and expenses are divided in the ratio of capital contributed, the use of the partnership rather than the individual partner to effect this loan would result in tax savings of over $7,000.

moreover, so that the interest expense stands a chance of being allocated as was done in *Leslie* then there may be substantial additional tax savings.

Litigation Expenses—Stock Valuation. Two cases, *Hilton*[16] in the Seventh Circuit and *Woodward*[17] in the Eighth Circuit, have provided an interesting dichotomy over a question involving litigation expenses. Are litigation expenses to ascertain the value of stock which must be purchased from stockholders who dissent from a change in the corporate structure capital expenditures or immendiately deductible business expenses? In *Hilton,* the taxpayer voted to merge with Waldorf of New York. Hilton was the surviving corporation and as such was required by New York law to purchase some 20,000 shares of Waldorf which were voted against the merger, the shareholders of which had filed a written demand for payment. The initial offer was rejected and litigation ensued. A settlement finally was reached after expenses were incurred for appraisers, attorneys, accountants and other items.

The court allowed the expenses to be deducted under section 162 because they were ordinary and necessary and primarily related to the business of taxpayer. Under the New York statute involved, it was the corporation which had to do the purchasing and after the certificate of consolidation was filed in New York the dissenting shareholders had no other rights than to get paid.

In *Woodward,* by contrast, the Iowa statute provided that 'in all cases of renewal [of a corporate charter], those stockholders voting for such renewal must purchase at its real value the stock voted against such renewal." Thus the taxpayers were the continuing stockholders rather than the Iowa corporation whose charter was renewed. The taxpayers attempted to take a deduction for attorney's fees, accountants and appraiser's fees and other costs incurred in bringing about a purchase of the stock of the one stockholder who dissented. The authority relied upon was section 212(2) rather than section 162—expenses related to the maintenance and preservation of income producing property rather than business expenses.

The Eighth Circuit held that section 212(2) does not cover expenses incurred in the acquisition of income producing property but only expenses incurred after the property already has been acquired. This same argument would apply to §162 as that section is limited to expenses in-

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16 Hilton Hotels Corp. v. United States, 410 F.2d 194 (7th Cir. 1969), aff'g 285 F. Supp. 617 (N.D. Ill. 1968).

17 Woodward v. Commissioner, 410 F.2d 313 (8th Cir. 1969), aff'g 49 T.C. 377 (1969), cert. granted 10/20/69.

curred or paid in "carrying on" a trade or business. The two cases are distinguishable from each other, however, on the basis of their respective statutes. The Iowa statute required a purchase by the continuing stockholders while the New York statute required the purchase to be made by the corporation. The entity in connection with which the expenses were incurred under section 212(2) in *Woodward,* therefore, would have to be the stock to be purchased. Under §162 the whole business would be the entity giving rise to the expenses which in *Hilton* was already acquired. There would seem to be no reason why a state statute would need to impose upon the individual shareholders the obligation to purchase rather than upon the corporation itself especially if the deductibility of expenses turns upon this distinction.

Expenses—Personal.

Medical Expense as Including Legal Fees and Travel. Passing to personal expenses, several decisions this year dealt with the medical expense deduction. In *Rose,*[18] the Tax Court ruled that the travel expenses of a father who later joined his wife and ailing daughter in Florida were not deductible as medical expenses of the daughter even though the daughter's trip was prescribed by a physician.

In *Montgomery,*[19] the Tax Court took a more favorable view of travel expenses when there was no question about whether the destination was a bona fide hospital and held that the expenses of a husband and wife to travel to the Mayo Clinic were deductible as medical expenses. These expenses included meals and lodging en route. The court in *Montgomery* noted that this was the first case on the point of the deductibility of such meals and lodging as medical expenses.

Although the Tax Court was not as generous in permitting the deduction of certain attorney's fees as medical expenses, the Sixth Circuit in *Gerstacker*[20] reversed the Tax Court and permitted the taxpayer to deduct attorney's fees which were incurred to obtain the appointment of a legal guardian so that the taxpayer's wife could be committed for care against her will. The steps were taken upon a doctor's advice. The court held that the fees were deductible to the extent incurred to confine the wife but not to the extent incurred to obtain proper management for her estate.

Transactions with a Corporation.

Patents and Patent Applications. Shifting to certain tax aspects of individuals dealing with corporations, patents were the subjects of two

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18 Rose v. Commissioner, 52 T.C. — No. 56 (1969).

19 Montgomery v. Commissioner, 51 T.C. — No. 40 (1969).

20 Gerstacker v. Commissioner, 60-2 USTC ¶9580 rev'g 49 T.C. 522 (1968).

recent Tax Court decisions. The Court in *Rodgers*[21] held invalid Regulations section 1.1235-2(b)(1). These Regulations provide, in part, that "the term 'all substantial rights' does not include a grant of rights to a patent . . . which is limited geographically within the country of issuance." In *Rodgers,* the court held that "all substantial rights" were transferred to various corporations by the taxpayer so that he was entitled to capital gains treatment under section 1235 when he granted, under two patents, exclusive rights to grow, propagate, use and sell in all of California and, under a third patent, exclusive rights in Northern California to one corporation and exclusive rights in Southern California to another corporation. Although the decision did not turn on this point, the holding is weakened by the fact that the patents all involved the growing of almonds, and the only place where the commercial production of almonds takes place in the United States is in California.

In *Stahl,*[22] the second case involving patents, the Tax Court passed upon the taxation of transfers of patents and patent applications, to the taxpayer's own corporation. There the taxpayer was successful in transferring patent and patent applications to his own corporation (so that income from later licensing was income of the corporation and as such was isolated from the income of the inventor) without incurring, as to the patent applications, any more than the capital gains tax. If sold to the taxpayer's own corporation in the form of patents, rather than patent applications, section 1239 would have treated all gain as ordinary income.[23]

The court held that section 1239 did not apply to patent applications because subsection (b) makes the section applicable only to "property of a character which is subject to the allowance for depreciation." Moreover, although patents in a given case may not be capital assets because of section 1221(2), the court in *Stahl* held that patent applications were capital assets relying upon another 1969 Tax Court decision, *U.S. Mineral Products Co.,*[24] which in turn relied on an old Board of Tax Appeals case, *Samual E. Diescher,* which was affirmed by

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21 Rodgers v. Commissioner, 51 T.C. — No. 92 (1969).

22 Estate of Stahl v. Commissioner, 52 T.C. — No. 63 (1969).

23 Section 1239 provides, in part, that:

"In the case of a sale or exchange . . . [of property of a character which is subject to the allowance for depreciation] between an individual and a corporation more than 80 percent in value of the outstanding stock of which is owned by such individual . . . any gain . . . shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231."

24 United States Mineral Products Co. v. Commissioner, 52 T.C. — No. 22 (1969).

the Third Circuit.[25] In *Diescher,* however, the question was not really whether patent applications were capital assets but whether the inventions themselves can become capital assets even before the patent is issued if the inventions are reduced to production. No thought was devoted to the status of patent applications per se. Thus, the court in *Stahl* in passing upon the character of patent applications as non-depreciable really was adding something brand new.

The planning ramifications of *Stahl* are interesting: If an inventor wants to exploit his own invention in which he has a relatively low tax basis, he merely sells patent applications before they become patents to his wholly-owned corporation (being careful, of course, to avoid section 351). He realizes only capital gain and the corporation has a stepped-up basis. Then, when the patent is issued it would seem that the patent application would merge with the patent and the end result would be a depreciable asset with a stepped-up basis. Moreover, if the taxpayer later wants to sell the patent to an unrelated third party, the transfer would be made from the corporation in the form of a patent. Although the patent sale would be entitled to capital gains treatment only under section 1231 and not as a capital asset under section 1221, this would pose no problem unless the value had increased during the period the patent was held by the corporation because by that time the patent would have a stepped-up basis.

Application of § 269. Another problem in the area of controlled corporations is the application of section 269.[26] The Ninth Circuit reversed the district court and held in *Peter Pan Seafoods* [27] that section 269 did not apply to prevent a net operating loss carryback which the Service wished to eliminate by imputing to the taxpayer corporation (New Harris) a transaction undertaken its shareholders. New Harris had purchased all the assets of Old Harris in return for two mortgage notes of New Harris. Six years later, it appeared that New Harris could acquire these notes at a substantial discount, but this would have produced income to New Harris in the form of a forgiveness of debt. Therefore, another company, Ajax, was formed by 85 percent of the stockholders of New Harris, and Ajax bought the New Harris notes from Old Harris at the reduced price with contributed capital from the stockholders and a bank

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25 Samuel E. Diescher, 36 B.T.A. 732 (1937), aff'd 110 F.2d 90 (3d Cir. 1940), cert. denied 310 U.S. 650 (1940).

26 Section 269, in general, permits the Secretary to disallow any deduction, credit, or other allowance which was the result of an acquisition of control of a corporation made for the principal purpose of evading or avoiding the Federal income tax.

27 Peter Pan Seafoods, Inc. v. United States, 69-2 USTC ¶9683 (9th Cir.), rev'g 272 F. Supp. 888 (W.D. Wash. 1967).

loan. Shortly thereafter, New Harris paid off over half of the notes, and the bank loan was reduced by that amount. Ajax did no other business.

The court of appeals distinguished the *Court Holding*[28] and *Gregory*[29] cases, which were largely responsible for section 269, by pointing to the involvement of third parties—the bank and the 15 percent shareholders of Ajax who did not own stock in New Harris. In addition, the court noted that section 269 was directed at deductions, credits or other allowances and not at income items. True, the inclusion of the debt reduction in the income of New Harris would have eliminated a loss carryover, but even though the reduction undoubtedly was granted because New Harris was in poor financial condition, the court felt that the effect upon the loss carryover was a mere "happenstance."

In another case involving section 269, however, the Tax Court demonstrated that it did not view that section as one to be interpreted loosely. The taxpayer in *Swiss Colony*[30] incorporated its research division into a separate corporation (Controls). After suffering heavy operating losses, controls borrowed money from outside sources in exchange for bonds and stock warrants. The warrants later were converted into over 25 percent of Controls' stock. Colony, which owned the remaining stock, attempted to divest itself of control by transferring a large block of stock to its shareholders, but it resumed ownership of these shares after the shareholders defaulted on their purchases.

Colony then liquidated Controls and claimed on its (Colony's) return a deduction for Controls' net operating loss under section 381. The Tax Court, however, agreed with the Commissioner that section 269 should be applied in preference to section 381 and that as a factual matter the presumption of tax avoidance under section 269 had not been overcome.

Unreasonable Accumulations. In *Donruss,*[31] the Supreme Court reversed the Sixth Circuit and adopted an unusually strict construction of the requirements relating to section 532(a) which imposes the accumulated earnings tax upon certain earnings of corporations "formed or availed of for the purpose of avoiding the income tax . . . by permitting earnings and profits to accumulate. . . ." Section 533(a) rearranges the normal burden of proof by stating that earnings and profits which are "permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax . . . unless

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28 Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

29 Gregory v. Helvering, 293 U.S. 465 (1935).

30 The Swiss Colony, Inc. v. Commissioner, 52 T.C. — No. 3 (1969).

31 United States v. The Donruss Co., 393 U.S. 297 (1969), rev'g 384 F.2d 292 (6th Cir. 1967). See also Shaw-Walker Co. v. Commissioner, 393 U.S. 478 (1969) vac'g 390 F.2d 205 (6th Cir. 1968).

the corporation by a preponderance of the evidence shall prove to the contrary."

The Supreme Court, in *Donruss,* resolved a widespread conflict which had developed among the circuits as to whether, after it has been established that the corporation did accumulate beyond reasonable needs, the taxpayer can satisfy its obligation to prove the contrary of a purpose to avoid the income tax merely by showing that it also considered other non-tax reasons in making the decision.[32] The district court refused the Government's tendered instruction that tax avoidance need only to be one of the purposes for the accumulation and instructed instead that the tax avoidance purpose must be the only purpose before the accumulated earnings tax would apply. The jury found for the taxpayer.

The court of appeals reversed and held that section 533(a) required only that the tax avoidance purpose be the "dominant, controlling or impelling motive." The Supreme Court went even further and held that the taxpayer could rebut the presumption only by establishing that tax avoidance was not even one of the purposes for the accumulation. The dissent in *Donruss* felt that the test adopted by the majority effectively eliminated the "last clear chance" of section 533(a) and that the Court should adopt a "but—for" test. It would seem, though, that the dissent is correct only if one equates knowledge of the tax effect of accumulating with purpose. Generally, purpose would imply knowledge plus action based on that knowledge. Thus it will be up to the taxpayer in similar situations in the future to show either that it had no knowledge of the potential tax savings of accumulating, a rather unlikely circumstance, or that even though it did know of the effect, its action was in no way based upon that knowledge.

Liquidations under Section 337. Turning now to liquidations under section 337,[33] the Tenth Circuit reversed the Tax Court in *Anders*[34] and held that gain from the sale of certain rental items owned by the taxpayer which had been expensed in full when purchased had to be included in income. The sales were of towels, seat covers and certain wearing apparel which the taxpayer had rented to customers in its business. The sales took place within the 12-month period following the

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32 See United States v. The Donruss Co., 393 U.S. 297, n.1 (1969).

33 Section 337 provides, in part, that:

> "If a corporation adopts a plan of complete liquidation . . . and within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period."

34 Commissioner v. Anders, 69-2 USTC ¶9458 (10th Cir.), rev'g 48 T.C. 815 (1967).

adoption of a section 337 plan and were not depreciable property within section 1245.[35] Nevertheless, the court held that since the tax benefit rule would have been applied in the absence of the section 337 plan, the existence of the plan had no effect upon the application of the rule.

The Second Circuit, however, took a more liberal view of the workings of section 337 in *West Street-Erie Boulevard Corp.*[36] There, the taxpayer had adopted a section 337 plan of liquidation on January 7, 1960 after learning that its major property was to be condemned. Toward the end of 1960, however, it became clear that the condemnation of this property would not take place within the 12-month period.

A much less valuable property was condemned within the period. On December 27, 1960, however, eleven days before the 12-month period would have expired, the stockholders met, revoked the January 7, 1960 plan and immediately adopted a new section 337 plan. The more valuable property finally was condemned within this second 12-month period, but the Government argued that the taxpayer was not free to revoke one plan and immediately adopt a new one. The court held for the taxpayer noting that, "When the corporation has taken some steps to carry out the original plan of liquidation but abandons it in good faith, the subsequent adoption of a new plan under different circumstances, should commence a new 12-month period. . . ."

Prior to *West-Street,* it was generally thought that a corporation could abandon a plan of liquidation only if it decided not to liquidate after all and then could adopt a new plan only if it decided anew to liquidate at some later date. A substantial time interval was thought necessary to demonstrate that the taxpayer had, in the interval, actually abandoned its thoughts of liquidating. Thus, the Second Circuit has modified this view so that a complete abandonment is not necessary—merely an abandonment of the original 12-month period. It should be observed, though, that the delay under the original plan was caused by an outside party over which the taxpayer presumably had no control. Perhaps this is what the court meant by "good faith" and "different circumstances."

Redemption under Section 302. Finally, in the corporate area, the Tax Court in *McDonald*[37] found that a redemption of stock was within the little-used general rule of section 302(b)(1) and thus was not "essentially equivalent to a dividend" even though none of the tests in sections 302(b)(2), (3) and (4) were satisfied. The taxpayer owned

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35 Section 1245 provides that a portion of the capital gains from the disposition of certain depreciable property may have to be treated as ordinary income if the conditions therein are met.

36 West Street-Erie Blvd. Corp. v. United States, 411 F.2d 738 (2d Cir. 1969), aff'g in part, rev'g in part 294 F. Supp. 145 (N.D.N.Y. 1968).

37 McDonald v. Commissioner, 52 T.C. — No. 8 (1969).

10 common shares out of 11 and all 435 preferred shares of E & M Enterprises. Pursuant to a plan of reorganization, suggested by the other party, the taxpayer caused E & M to redeem for cash (at its book value) all 435 shares of preferred and then exchanged his 10 shares of common for shares of the purchasing company.

The major factors which impressed the court were that the preferred shares were already under option to E & M pursuant to a buy-sell agreement at book value, that after the reorganization, taking the transactions as a whole, the taxpayer's voting position was radically reduced to a minority position within the purchasing company, and that the taxpayer had not come up with the idea to redeem but that the idea was desired solely by the purchasing company. As to this last factor, the court stated that it was not implying that the outcome would be any different if the taxpayer had suggested the redemption; this circumstance was not before the court.

Investigation and Litigation.

Several decisions furthered the knowledge of tax counsellors as to the application of *Miranda* [38] to tax investigations with a view to possible criminal prosecutions. The most favorable decision to date from the taxpayer's standpoint was rendered by the Seventh Circuit in *Dickerson.*[39] There the rule was adopted that the taxpayer must be given the *Miranda* warnings at the first opportunity after the criminal investigatory phase starts. The decision would seem to abrogate the distinction reflected in many of the cases to date between the investigatory phase and the accusatorial phase.

This Seventh Circuit rule reflects a basic difference between ordinary criminal cases and criminal tax fraud cases. In the former, the investigation into the crime can be commenced without focusing upon any one suspect as the guilty party whereas in the latter, the party involved (the taxpayer) has been isolated even before the criminal investigation has begun and the only remaining question is whether a crime in fact was committed. *Dickerson* was applied by the Seventh Circuit in *Habig,*[40] in which certiorari was denied, but is at odds with the earlier Eighth Circuit *Muse* [41] case and with the Fifth Circuit decision in *Agoranos* [42] in both of which the Supreme Court also denied certiorari.

[38] Miranda v. Arizona, 384 U.S. 436 (1966).

[39] United States v. Dickerson, 413 F.2d 1111 (7th Cir. 1969).

[40] United States v. Habig, 413 F.2d 1108 (7th Cir. 1969), cert. denied —— U.S. ——.

[41] United States v. Muse, 405 F.2d 40 (8th Cir. 1969), cert. denied —— U.S. ——.

[42] United States v. Agoranos, 409 F.2d 833 (5th Cir. 1969), cert. denied —— U.S. ——.

Estate and Gift Taxes.

In *Madden*,[43] the Tax Court passed upon one area of the relationship between the estate tax and the income tax provisions. Even though one-half of the value of certain jointly-owned shares of stock were included in the wife's estate for estate tax purposes, the husband (beneficiary of the estate) could not automatically claim a stepped-up basis for that one-half in a later sale by him. The husband in such a situation must prove that he was right in including one-half of the value in his wife's estate.

In the estate and gift tax area, inattention to procedure spelled trouble in *Southern California First National Bank*[44] where a district court in California held that gift taxes once paid could not be recovered after the statute of limitations had run even though a state court later voided the gifts for undue influence. The court held that a protective suit should have been filed to toll the statute of limitations pending the outcome of the state suit.

In *Coleman*,[45] certain estate tax treasury rulings were overturned. Revenue Ruling 67-463[46] which would have included the insurance proceeds in the estate of a mother who paid premiums on the policies for her children was declared invalid. The mother had transferred all incidents of ownership to her children. The fact that the policies were taken out in contemplation of death did not affect the proceeds. Only those premiums paid in contemplation of death were includible.

Important in the general litigation area are two procedural cases applicable to all federal taxes. First is the Supreme Court's reversal of the Court of Claims in *King*.[47] There, claim for refund was not timely filed and the Court held the Declaratory Judgment Act could not provide an alternate door to the courtroom. The Court of Claims' tax jurisdiction is limited to claims for refund. A balancing of the scales was achieved, however, when the taxpayer won a procedural point in the Tenth Circuit in *Edwards*[48] in which the Government's argument of substance over form was rejected. The court stated that, "Form, absent exceptional circumstances, reflects substances."

Whether these comments have accurately reflected the substance of this years' leading cases unfortunately will not receive the aid of any such presumption. The full significance of these cases may not be known for some time until many more of the possible "exceptional circumstances" can be foreseen.

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43 Madden v. Commissioner, 52 T.C. — No. 89 (1969).

44 Southern Cal. First Nat'l Bank v. United States, 298 F. Supp. 1249 (S.D. Cal. 1969).

45 Coleman v. Commissioner, 52 T.C. — No. 99 (1969).

46 Rev. Rul. 67-463, 67-2 C.B. 327.

47 United States v. King, 89 S. Ct. 1501 (1969).

48 United States v. Edwards, 69-1 USTC ¶9632 (10th Cir.)