1967

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Repository Citation
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In the estate tax area, the cases of the Second National Bank of New Haven, Exr. v. United States and Commissioner v. Estate of Herman J. Bosch,1 decided June 5, 1967, reached the Supreme Court because of a widespread conflict among the circuits.2 The question presented in these cases was whether a Federal court or agency in a Federal estate tax controversy is conclusively bound by a state trial court adjudication of property rights or characterization of property interests when the United States was not a party to such proceeding. This is an issue which had plagued the Internal Revenue Service and taxpayers for years.

The facts in Bosch best illustrate the problem. There the decedent created a revocable inter vivos trust, under the terms of which the income was to be paid to his wife for life. She had a general power to appoint the trust corpus by her will. Five and one-half years before the decedent’s death, in an effort to prevent the trust corpus from being taxed as part of her estate, the wife executed an instrument which purported to release her general power of appointment and convert it into a special power of appointment.

When the decedent died, his estate claimed a marital deduction for the value of the inter vivos trust. But, as the wife had only a special power of appointment instead of a general power of appointment, the Internal Revenue Service took the position that the inter vivos trust did not qualify for the marital deduction.

The decedent’s estate filed a petition in the Tax Court. While the Tax Court proceeding was pending, the decedent’s executor-trustee filed a petition in the New York State Supreme Court, the lowest state court of original jurisdiction, seeking a determination of the validity of the widow’s release.

Three briefs were filed in the state court action: One for the trustee, one for the wife, and one by a guardian ad litem on behalf of a minor. All three briefs argued that the release was a nullity. Since no argument to

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*The author expresses his appreciation for the aid in preparing this paper provided by George N. Watson of the Refund Litigation Division.


the contrary was presented to the state court, it adopted the unanimous position of the parties that the release was a nullity.

The Tax Court accepted the state court determination without examining New York law. The Court of Appeals for the Second Circuit upheld the Tax Court's decision, concluding that the judgment of the New York Supreme Court—which was rendered by a court having jurisdiction over the parties and subject matter—authoritatively settled the rights of the parties, not only for New York, but also for purposes of the Federal estate tax law, and thus there was no occasion for the court to inquire into the general law of the state.

Previously, another panel of the Second Circuit, in Second National, had concluded that decrees of the Connecticut Probate Court are not binding and conclusive upon a Federal court in construing and applying the Federal tax laws, noting that under Connecticut law the Probate Court's decisions are not binding on the state's higher courts and are even subject to collateral attack in another probate district.

The Supreme Court, in an opinion by Mr. Justice Clark, with Justices Harlan, Fortas and Douglas dissenting, held that where the Federal estate tax liability turns upon the character of a property interest held and transferred by the decedent under state law, Federal authorities are not bound by the determination made of such property interests by a state trial court.

The Court noted that at least three positions had emerged among the Circuits. First, if the question at issue is fairly presented to the state court for its independent decision and is so decided by the court, the resulting judgment, if binding upon the parties under the state law, is conclusive as to their property rights in a Federal tax case. Second, the Federal court will consider itself bound by a state court decree only after independent examination of the state law as determined by the highest court of the state. Third, the one the Government primarily urged in the Supreme Court, a state trial court adjudication is binding in such cases only when the judgment is the result of an adversary proceeding in the state court.

3. 43 T.C. 120 (1964).
4. Commissioner v. Estate of Herman J. Bosch, supra, note 2
5. 351 F. 2d 489 (2nd Cir. 1965).
6. Gallagher v. Smith, supra, note 2. This is the position that was taken by the Second Circuit in its Bosch decision.
7. Faulkerson's Estate v. United States, supra, note 2. The Government alternatively took this position, being the so-called Erie R. Co. v. Thompson, 304 U.S. 64 (1938) approach, to the effect that Congress intended the Federal Courts, faced with a tax case turning on a question of state law, to determine state law in accordance with the Rules of Decisions Act and Erie v. Thompson.
The Supreme Court noted that the Commissioner was not made a party to either of the proceedings and neither had the effect of res judicata nor did collateral estoppel apply, that both state proceedings were brought for the purpose of directly affecting Federal estate tax liability, and that it was passing on a Federal taxing statute enacted by the Congress and therefore the legislative history surrounding the Federal statute must be examined. The Court stated that Congress intended the marital deduction to be strictly construed and applied by providing that only proper regard was to be accorded state decrees and by placing limitations on the allowance of the deduction, and that this was in keeping with the long-established policy of the Congress, as expressed in the Rules of Decision Act. This Act provides that in the absence of Federal requirements, such as the Constitution or Acts of Congress, the laws of the several states are to be regarded as rules of decision in civil actions in the courts of the United States in cases where they apply. The Supreme Court noted that it has held that judicial decisions are laws of the state within the Act.

The Court concluded that when the application of a Federal statute is involved, the decision of a state trial court as to an underlying issue of state law should not be controlling, and pointed out that this was but an application of the rule of Erie R. Co. v. Tompkins, where state law as announced by the highest court of the state is to be followed. The Court noted that the State's highest court is the best authority on its own law, and if there is no decision by that court, then Federal authority must apply what it finds to be the state law, after giving proper regard to relevant rulings of other courts of the State.

In a post-Second National and Bosch decision, the District Court for the Eastern District of Tennessee in the case of J. M. Underwood v. United States concluded that a judgment of the County Court of Anderson County fixing the compensation of the trustees at eight percent when the will provided that the fee should not exceed five percent was not binding on the District Court. The District Court upon its own interpretation of state law concluded that the rule in Tennessee forbids a court from allowing compensation to trustees in excess of the amount fixed in the will and thus limited the Federal estate tax deduction to five percent.

In a recent decision handed down on September 6, 1967, by the District Court for the District of South Carolina, in the case of Lakewod

11. supra, note 7.
Plantation, Inc. v. United States,13 the question presented concerned the admissibility of a certain state trial court decree affecting the federal taxes at issue. The District Court concluded that the state court decree in question and all evidence of the state court proceeding with respect to the issues involved in the case at bar was inadmissible in the federal tax suit. In this case, by deed dated in 1953, V. F. Platt, Sr., transferred certain timberlands in fee to a newly formed corporation, Lakewood Plantation, Inc. During the period 1954 through 1957, certain sales of timber were made by Lakewood. Other sales of timber were made, but purportedly by Mr. Platt. The income from these sales was reported by Mr. Platt on his personal tax return and was not reported as income by Lakewood. In 1957, the Internal Revenue Service concluded that the income received under all of the timber sales agreements was taxable to Lakewood, and none to Mr. Platt. Subsequently a correction deed dated in 1953, but recorded in 1957, was executed wherein the timber on the transferred property was reserved to Mr. Platt for 20 years. It was uncontradicted that the deed was prepared in 1957 and backdated to 1953.

In 1959 a civil action was commenced in the Court of Common Pleas for Horry County, South Carolina, by Mr. Platt against Lakewood Plantation Inc., and others to reform the original deed ab initio to reflect that a mutual mistake had been made therein—that is, that Mr. Platt had intended to reserve to himself for 20 years the timber and other mineral rights on the property. The Federal Government was not a party to this reformation suit. In a decree dated March 26, 1960, it was ordered that the reformation be effective as of the date of the original deed.

The District Court stated that the validity of the decree of reformation issued by the Court of Common Pleas hinged primarily on a disputed factual question rather than upon the application or misapplication of South Carolina law. The court held that if the Government, in accordance with the Supreme Court's decision in Second National and Bosch, is not bound by a state trial court decree of property rights based on a misapplication of state law, it is also not bound by a decree based on erroneous findings of fact. Accordingly, the court concluded that the state decree in question had no binding force on the Government in the Federal tax case.

It is somewhat unusual for the Supreme Court to review two estate tax problems at the same time. In addition to Second National and Bosch, the case of Northeastern Pennsylvania National Bank & Trust Co. v. United States,14 was decided May 22, 1967, by the Supreme Court.

It reached the Supreme Court because of a conflict between the Third Circuit's decision in the instant case\(^\text{15}\) and the decision of the Seventh Circuit in *United States v. Citizens National Bank of Evansville.*\(^\text{16}\) The question presented was whether a bequest in trust providing for a monthly payment to the decedent's widow of a fixed amount can qualify for the estate tax marital deduction under section 2056(b)(5) of the Internal Revenue Code of 1954. The Internal Revenue Service took the position that the trust did not qualify for the marital deduction because the widow's right to the income of the trust was expressed as a "fixed amount" rather than as a "fractional or percentile share" of the total trust income as the regulations required.\(^\text{17}\) The Court of Appeals for the Third Circuit agreed. The Supreme Court, in an opinion by Mr. Justice Fortas, with Justices Stewart, Black and Harlan dissenting, reversed the Court of Appeals for the Third Circuit.

The marital deduction provisions of the Code were enacted by Congress in 1948 to equalize the effect of estate taxes in community property and common law states. In community property states a decedent's estate includes only one-half of the community property, and the widow's estate the other half. The marital deduction allows the transfer of up to one-half of noncommunity property to the surviving spouse free of the estate tax.

*Northeastern* involved a testamentary trust which provided the widow with the power to appoint by her will the entire corpus of the trust to her estate or named individuals. In addition, she was to receive out of the trust income and corpus, if necessary, the sum of $300 per month. The Government argued that since she was not entitled to all of the "*income from a specific portion*" of the trust corpus, the marital deduction provision did not apply. The Government urged that the intent of the Act of 1948 was to the effect that an interest in property bequeathed to a widow must be equivalent to outright ownership in order to qualify for the marital deduction. The Government argued that the statutory requirement that the widow receive "*income from a specific portion*" is but an extension of this reasoning and that under the regulations in question the "specific portion" must be expressed in the trust as "a fractional or percentile share."

The Court concluded that the regulations improperly restrict the scope of the marital deduction, noting that there was no indication in the legislative history from which one could conclude that Congress

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15. 363 F. 2d 476 (3rd Cir. 1966).
16. 359 F. 2d 817 (7th Cir. 1966).
17. Section 20.2056 (b)-5(c).
intended that the deduction would be defeated because the “specific portion” or “individual part” was not expressed by the testator in terms of a “fractional or percentile share.” The Court stated that Congress did not intend the deduction to be available only with respect to an interest equivalent to outright ownership.

As to the computation of the “specific portion,” the Court stated that it should not be a difficult matter to settle on a rate of return available to a trustee under reasonable investment conditions which could be used to compute the “specific portion” of the corpus whose income is equal to the monthly stipend provided for in the trust. The Court rejected the annuity-valuation approach to compute the “specific portion,” and stated that the question is “to determine the amount of the corpus required to produce the fixed monthly stipend, not to compute the present value of the right to monthly payments over an actuarially computed life expectancy.” Accordingly, the Supreme Court remanded the case to the District Court to make the determination.

Turning away from the estate tax area let us focus on section 162(a)(2) of the Internal Revenue Code of 1954, which provides that a taxpayer may deduct “traveling expenses (including amounts expended for meals and lodging *) while away from home in the pursuit of a trade or business * * *.” The interpretation of this provision, particularly the phrase “while away from home,” has given rise to much litigation, and was the subject of two Supreme Court cases decided in 1967.

In the first of these cases, Commissioner v. Howe A. Stidger, decided March 20, 1967, the Court considered the question of what constitutes the tax home of the military man whose assigned post of duty is at one location and whose family residence is at another.

Prior to October 1956, Stidger, a Captain in the Marine Corps, was assigned to a base in California, and he lived nearby with his wife and children. However, in October 1957, he was transferred to a base in Japan to serve a standard 15-month tour of duty. Since military personnel were not allowed to bring their dependents to Japan, Captain Stidger left his wife and children at his residence in California, where they stayed the entire time while he was in Japan.

On his 1958 tax return, Captain Stidger deducted the cost of his meals while in Japan. The Internal Revenue Service, however, took the position that his duty base in Japan represented his principal place of business and thus his tax home. Therefore, it disallowed his meal costs.

18. 387 U.S. at 225.
while there on the ground that he was not traveling away from home. The Tax Court upheld the Service, but the Court of Appeals for the Ninth Circuit reversed, holding that the word "home," as used in the statute, has to be given its usual meaning as the place of residence of the taxpayer and his family, and not his place of business. In so holding, the Ninth Circuit created a direct conflict with a 1948 decision of the Fourth Circuit. The Supreme Court granted certiorari.

The Supreme Court noted at the outset that its decision of the case had to rest squarely on a determination of where was the taxpayer's tax home. In the two prior cases involving travel expense deductions which the Court had decided, questions of location of tax home had been argued to the Court, but it had decided the cases on different grounds. The first such case was Commissioner v. Flowers, decided in 1946, involving a lawyer who worked in one city but for reasons of personal preference lived in another. The Court simply held that because the taxpayer lived in a city distant from where he worked for personal reasons, his travel expenses were not ordinary and necessary expenses. Therefore, it never reached the question of whether he was traveling away from home. The other travel expense case the Supreme Court had considered before Stidger was Peurifoy v. Commissioner, decided in 1958. There it simply affirmed, per curiam, a holding of the Court of Appeals for the Fourth Circuit that certain employment of the taxpayers involved was indefinite rather than temporary in nature, thereby making their places of employment their tax home. The Supreme Court placed its affirmance on the ground that the Fourth Circuit's finding of indefinite rather than temporary employment represented a fair assessment of the record. Therefore, the Supreme Court did not examine the merits of the case, and it did not consider the question of the meaning of the word "home" as used in the statute.

Since military dependents were not permitted in Japan, Captain Stidger's choice to maintain his family residence at a place other than where he worked was not made for personal reasons, as had been true in the Flowers case. There was therefore no question that Stidger's traveling expenses were "ordinary and necessary" within the meaning of section 162. Thus, the Supreme Court for the first time squarely faced the issue of what constituted a taxpayer's tax home.

22. 355 F. 2d 294 (9th Cir. 1966).
In an opinion by Chief Justice Warren, with Justices Douglas, Black and Fortas dissenting, the Court held that Stidger's tax home was his duty station in Japan and not his family residence in California.

The Court considered first the Government's argument that the Internal Revenue Service's position that a taxpayer's "home" is located at his principal place of business has the effect of law because Congress has repeatedly reenacted the substance of section 162 of the Code with knowledge of the Service's interpretation. In support of this argument the Government pointed out that a provision allowing the deduction of travel expenses while away from home was first enacted in the Revenue Act of 1921.26 Rulings published in 1921 held in effect that "home" as used in the statute meant a taxpayer's principal place of business or employment, whether or not it coincided with his place of residence.27 The Service has adhered to that position, with certain refinements, ever since, in both published rulings and litigation. Congress has reenacted the travel expense provision, without change in substance, in every revenue act subsequent to 1921, and in the 1939 and 1954 Codes.

Moreover, the Internal Revenue Service's position that home means principal place of business was brought to the attention of Congress with particular force in 1936 when the Commissioner argued in a case before the Board of Tax Appeals that a Congressman's tax home was Washington, D. C., even if he maintained a permanent residence in the district from which he was elected. The Board of Tax Appeals, agreeing with the Commissioner, held that a Congressman could not deduct his meals and lodging expenses in Washington because while there he was not away from home.28

In 1952 Congress amended the Code in order to negate the effects of this decision. It added a provision stating that the home of a Member of Congress shall be considered his place of residence within the state or district he represents, but amounts expended by Congressmen for living expenses shall not be deductible in excess of $3,000 per year.29

The Government urged in Stidger that by taking this course of action in response to the holding of the Board of Tax Appeals, Congress implicitly gave approval to the Internal Revenue Service's general position that a taxpayer's "home" is located at his principal place of business. This is because Congress could have amended the travel expense section of the Code in such a way as to overturn that position entirely, but

26. Section 214(a)(1) of the Revenue Act of 1921, 42 Stat. 239.
27. O.D. 864, C.B. 4, 211 (1921); O.D. 1021, C.B. 5, 174 (1921).
29. Section 162(a).
instead of doing so, it merely enacted a very limited amendment bearing only upon the cases of the Congressmen themselves.

The Court in Stidger rested its decision in a large part upon reasoning relevant only to members of the military services. The Court held, first, that military statutes and regulations supported the Commissioner’s position that a military man’s tax home is his permanent duty station. It observed that a Marine Corps directive defined the length of standard tours of duty in terms of the commencement and termination dates of “permanent changes of station.” In addition, eligibility for certain statutory travel allowances turns upon whether an assignment constitutes a “change of permanent station” or whether the serviceman is “away from his designated post of duty,” and not, it should be noted, whether he is away from his permanent residence or legal domicile.

The Court went on to hold that the Service’s position as to the military man’s tax home found additional support in the fact that Congress traditionally has provided a special system of tax-free allowances for military personnel. In line with these allowances Stidger received per diem payments while he was away from his permanent duty station in Japan. His quarters at that station were provided to him free, and at the same time he received a tax-free quarters allowance, and also a tax-free subsistence allowance. Moreover, because his assignment to Japan was considered a change of permanent station, the Government would have paid the moving expenses of Stidger’s wife and children had they moved their residence from California to another part of the United States. The Court noted that the system of tax-free allowances gives military men complete and direct relief from the special living expenses imposed upon them by their vocation, whereas the income tax deduction under section 162 of the Code accords only incomplete and indirect relief to the civilian business traveler.

In addition to the foregoing observations, the Supreme Court took note that the Service had long maintained the position that the military man’s permanent post of duty was his tax home, and its position had previously been upheld in a Court of Appeals decision. The Court stated that Congress had thus long had knowledge of the Service’s interpretation of the statute, and had chosen to deal with the financial problems of military life by way of a special system of tax-free allowances for servicemen. The Court concluded that for these reasons it agreed with the Service’s position that the tax home of the serviceman is his permanent duty station, even if he is not able to bring his family there to live with him.

The Court thus upheld the Service’s definition of “home” as applied to the military taxpayer, thereby settling one of the controversial questions presented in the travel expense field.

The second travel expense problem which the Supreme Court considered in 1967 is that of determining when a taxpayer is away from his tax home. The Internal Revenue Service has long taken the position that an individual is not away from home unless he is away long enough so as to be required to obtain substantial sleep or rest.\(^1\) In most cases where the business traveler meets this requirement, he does so because his trip requires him to stay away from home overnight. The Service’s definition of “away from home” is therefore commonly known as the “overnight rule.”

Decisions of the lower courts have been sharply divided over the issue of whether the overnight rule is a valid interpretation of the statute. The Tax Court consistently upheld the rule between 1944 and 1966 in numerous cases dealing with meal expenses. However, in 1962 the Eighth Circuit rejected the rule in *Hanson v. Commissioner*, stating that it is “merely an arbitrary line drawing having no basis in the statute,” and that “these cases must be decided according to their own set of facts.”\(^2\) In 1966 the Tax Court followed the Eighth Circuit’s decision, announcing in *William A. Bagley v. Commissioner* that it would no longer follow the overnight rule as an absolute guide in all cases.\(^3\) The First Circuit, however, reversed the Tax Court’s decision in *Bagley*, holding that the language in section 162 refers to travel in a substantial sense, and not to one-day round trips. It stated that it could think of no sharper or better place to draw the line in defining “away from home” than does the overnight rule, and that it would therefore accept the rule.\(^4\) Mr. Bagley, a consulting engineer, maintained his office at his home in Milford, New Hampshire. During 1960 and 1961 he was employed from time to time by various power companies in the New England area on a per diem basis. On many of these days he left home early, ate breakfast on the way, ate lunch at work, and stopped to dine on the drive back. His employers’ places of business were from 30 to 75 miles away and he normally reached home about 10 p.m. The First Circuit determined that Mr. Bagley could not deduct the cost of these meals.

Meanwhile the Sixth Circuit had rejected the overnight rules in *Cor-

\(^3\) 46 T.C. 176 (1966).
\(^4\) 374 F. 2d at 207.
There a wholesale food salesman made daily round trips on behalf of his employer to various towns and cities around the town where he resided. He generally left his residence at 5 a.m. and returned around 5:30 p.m., covering about 150 to 175 miles per day. The question presented is whether the cost of his breakfasts and lunches while on the road constitute deductible traveling expenses or non-deductible personal or living expenses. The Government determined that his meal expenses were not deductible because his trips were of less than overnight duration, and he was therefore not away from his tax home. The Sixth Circuit held that the Commissioner's "overnight" or "sleep or rest" rule bore no rational relationship to the business necessity of the meal expenses.

Thus, the Eighth and Sixth Circuits, having rejected the rule, were arrayed against the First Circuit, which had upheld it. In the 1966 term of the Supreme Court, certiorari was applied for in both Bagley and Correll. Certiorari was granted in Correll, and the case was decided on December 11, 1967.36

In an opinion by Justice Stewart, with Justices Douglas, Black and Fortas dissenting, and Justice Marshall not participating, the overnight rule was upheld by the Court. The Court stated that the overnight rule provides a means of interpreting the travel expense statute so as to achieve ease and certainty of application, and substantial fairness to taxpayers.

The rule affords ease and certainty of application by providing a definite and objective standard for deciding cases. Without the rule, the question of whether a particular taxpayer was "away from home" on a given day would presumably have to be decided on a case-by-case basis, and much uncertainty and wasteful litigation would result. As the First Circuit put it in the Bagley case, "every meal-purchasing taxpayer" would have "to take pot luck in the courts."37

The overnight rule achieves substantial fairness to taxpayers by putting all one-day travelers on a similar tax footing. Without the rule, a taxpayer who leaves his home city on a one-day trip would be allowed to deduct the cost of his lunch and other meals consumed on the trip, whereas a taxpayer who merely commutes or travels within a city is not allowed to deduct the cost of his lunch or any other meals which he purchases.

The Court further held that the overnight rule was not inconsistent

35. 369 F. 2d 87 (6th Cir. 1966).
36. ___ U.S. ___ (1967); 68-1 USTC 9101.
37. 374 F. 2d at 207.
with the wording of the travel expense statute. Observing that the language of the statute—"meals and lodging . . . away from home"—is obviously not self-defining, it stated that the use of the words "meals and lodging," as a unit, suggests—at least arguably—that Congress contemplated a deduction for the cost of meals only where the travel in question involves lodging as well as meals. Since only the taxpayer who must stop for sleep or rest on his business trip incurs significantly higher living expenses as a direct result of his business travel, Congress might well have thought that only taxpayers in this category should be allowed to deduct their living costs while on the road.

The Court noted that in any event it was clear that when Congress enacted section 162(a) (2) as part of the 1954 Code, it had notice that the Commissioner had interpreted its statutory predecessor in accordance with the overnight rule. The various committee reports and hearings show that the rule was brought to the attention of, and was understood by, the committees involved. The Court held that the case thus came within the well-settled principle that Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law.

The Court stated that while alternatives to the overnight rule were available, and improvements could be imagined, the Court's role was only to assure that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner. It concluded that the rule had not been shown deficient on that score and was therefore valid.

As a result of the Correll decision, the uncertainty which existed for many years concerning the validity of the overnight rule is at an end, and the sharp conflict which the rule engendered among the courts has been put to rest. There can be little doubt that Correll is a landmark decision in the travel expense area, and will do much toward bringing order and coherence to a field of tax law which in the past has been the scene of much confusion.

Turning to section 482 of the Internal Revenue Code of 1954, an important decision involving pricing arrangements based upon valid business reasons was rendered by the United States Court of Claims on

38. Section 482 provides that in any case of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, etc., between or among such organizations, etc., if he determines that such distribution, etc., is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations.
February 17, 1967, in the case of *Eli Lilly and Company v. United States.* The taxpayer, an Indiana corporation, is a long-established and well-known manufacturer of ethical drugs and also engages in extensive research and development of new drugs for manufacture. It sells its products to domestic customers within the United States. Prior to 1943 the taxpayer exported its products; however, in 1943 the taxpayer decided to handle its export business through subsidiary corporations. It formed Eli Lilly International Corporation and Eli Lilly Pan-American Corporation, both of which are wholly owned Indiana corporations. Pan-American obtained a ruling from the Internal Revenue Service in early 1944 that it qualified as a Western Hemisphere Trade Corporation. The advantage of this ruling was that Pan-American was taxable at the maximum rate of 38 percent, whereas Eli Lilly and International were taxable at the rate of 52 percent. In 1944 Eli Lilly adopted a pricing policy on its sales to International and Pan-American designed to motivate these subsidiaries to increase their volume of export sales. It sold to its subsidiaries at a very substantial discount off domestic prices, increasing the discount with the volume of sales. In 1946 the taxpayer decided to change its sales flow. Thereafter, instead of selling directly to both International and Pan-American, the taxpayer sold all merchandise for export to International. International, in turn, sold either to its customers in the Eastern Hemisphere or to Pan-American. Pan-American, in turn, sold to its customers in the Western Hemisphere.

In 1952 the taxpayer again decided to change its pricing policy. In that year prices were demoralized in the antibiotic field and streptomycin was being purchased by taxpayer and sold at a loss because of its difficulties in manufacturing that product. Also, the taxpayer had a continuing tax problem under section 45 of the Internal Revenue Code of 1939 (the predecessor of section 482 of the 1954 Code), since the then existing pricing arrangement, arising from the settlement of the Internal Revenue Service's proposed assessment under section 45 of the 1939 Code for the years 1944 through 1948, allegedly placed the taxpayer at a substantial disadvantage tax-wise with respect to the rest of the industry. The new pricing arrangements were intended to approximate the taxpayer's manufacturing costs, plus third-party royalties and allocated operating expenses. Thus, the taxpayer established a pricing policy in 1952 which differed from the policy which it had used in 1944 through 1948. The pricing arrangement which had been in effect for the period 1944

40. "Ethical" drugs, generally speaking, are those which can be purchased by the consumer only on prescription.
through 1948 had been a discount off domestic prices, the discount increasing as the subsidiaries' volume of sales increased. The pricing policy established in 1952 was a cost-oriented price which, in effect, allocated all the profits to the taxpayer's subsidiaries. Under this new pricing policy all goods transferred to International were priced at approximately manufacturing cost. However, International's pricing policies for goods purchased by it from the taxpayer differed with respect to goods destined for its customers in the Eastern Hemisphere as compared to those destined for Pan-American. International sold to its customers in the Eastern Hemisphere at approximately the same price as Eli Lilly sold to its domestic customers. However, International sold to Pan-American at a price designed only to recover International's cost, plus allocable administrative and selling expenses attributable to sales to Pan-American. As in the case of sales by Eli Lilly to International, no provision was made for any substantial profit to International on its sales to Pan-American. In short, by its pricing policy the taxpayer shifted its own profits to its tax-favored subsidiary—Pan American.

Lilly contended that the legal standard to be applied in employing section 482 is that of a fair and reasonable price and that the prices it charged International for goods sold to it met this standard and therefore no reallocation was necessary. The Government contended that section 482 authorizes the Commissioner to reallocate income wherever necessary to reflect the true income of controlled corporations—whether the failure to reflect true income resulted from inadvertence, tax avoidance, design, or from sound internal business reasons, such as inter-company bookkeeping, incentives, or capitalization—and that the standard established in the Income Tax Regulations for the application of section 482 is that dealing which would have taken place at arm's length between independent taxpayers if circumstances were otherwise unchanged.

The Court of Claims determined that Eli Lilly failed to prove that the Internal Revenue Service arrived at an unreasonable result. The court noted that after the reallocation under section 482 Pan-American's share of the profits was still high and ranged from 62.07 percent to 74.56 percent, and thus the lion's share of the profits from Western Hemisphere sales remained in Pan-American even after the reallocation. The court applied the provision of section 1.482-1 of the regulations and stated that if International were an "uncontrolled" purchaser from Eli Lilly, it would not have been able to buy the products at the prices paid by it in this case. The court concluded that Eli Lilly failed to meet its admittedly difficult burden of proving what it would have charged a volume pur-

41. Section 1.482-1(b) (1).
chaser, such as International, if it were an "uncontrolled" purchaser. The court stated that in a refund suit the taxpayer in order to prevail must go further than proving arbitrary action by the Commissioner. That, in addition, the taxpayer must provide the correct amount of the tax and resulting overpayment.

The court noted that the existence of valid and sound business purposes for inter-company arrangements does not devitalize section 482, noting that the shift resulted in a failure to clearly reflect Eli Lilly's income from manufacturing, and that this is enough to warrant an allocation under section 482.

As to the arm's length standard, the court cited from *Oil Base, Inc. v. Commissioner*, to the effect that "where * * * the extent of the income in question is largely determined by the terms of business transactions entered into between two controlled corporations it is not unreasonable to construe 'true' taxable income as that which would have resulted if the transactions had taken place upon such terms as would have applied had the dealings been at arm's length between unrelated parties," and concluded that even if the arm's-length standard is not the sole criterion, it is certainly the most significant yardstick.

Lilly further contended that section 482 should not be applied to an inter-company pricing arrangement so as to deny any of the benefits intended to be conferred by the Code on Western Hemisphere Trade Corporations. The court concluded that section 482 is available to the Government even though the resulting reallocation may have an effect on some benefits conferred by another section of the Code, and thus the Commissioner was authorized to apply the provisions of section 482 despite the resulting impact on some of the benefits conferred by the Western Hemisphere Trade Corporation provisions of the Code.

An important decision in the realm of exempt organizations was rendered by the Court of Appeals for the First Circuit on June 21, 1967, in the case of *Crosby Valve and Gage Company v. Commissioner*. In this case the issue presented was whether the assignment of a corporation's equity in certain bonds to an exempt organization, which owned all of the stock of the taxpayer-corporation, constituted a charitable contribution so as to entitle the taxpayer to a deduction under section 170 of the Internal Revenue Code of 1954.

The taxpayer is a Massachusetts corporation, all of whose stock is owned by the Stone Charitable Foundation, Inc., an organization de-

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42. 362 F. 2d 212 (9th Cir. 1966).
43. *supra*, note 42 at 214.
44. 380 F. 2d 146 (1st Cir. 1967).
scribed in section 501(c) (3). The taxpayer purchased certain bonds, which were financed in part by bank loans, held the bonds for 30 days or more, and then contributed them to the Foundation subject to the bank loans. Charitable deductions were claimed by the taxpayer-corporation on its returns filed for the fiscal years 1954, 1955 and 1956, and were based on the contributions of the taxpayer's equity in the bonds assigned to the Foundation.

The Government contended that the assignments of the taxpayer's equity in the bonds to the Foundation were not charitable contributions such as would entitle the taxpayer to deductions under section 170, but were in fact dividends to its parent. This contention was based on the fact that the Foundation owns all of the stock of the taxpayer and completely controls its operations, and that such control precludes the assignments from qualifying as gifts. The Tax Court held for the Government concluding that the transfers did not proceed from a detached and disinterested generosity, but were the result primarily of the control which the Foundation had over the taxpayer and the legal duty which the taxpayer had to carry out the will of its sole stockholder. The Tax Court cited and relied upon the Supreme Court decision in Commissioner v. Duberstein. The Tax Court stated that their conclusion was consistent with the legislative purpose of the sections of the Code relating to the taxation of unrelated business income of certain exempt organizations.

The taxpayer appealed and in an opinion by Circuit Judge Coffin the First Circuit agreed with the conclusion reached by the Tax Court, but registered disagreement with the Tax Court's emphasis upon a purely charitable motive as a prerequisite for a deductible charitable contribution. The court stated that were the deductibility of a contribution under section 170(c) to depend on "detached and disinterested generosity, an important area of tax law would become a mare's nest of uncertainty woven of judicial value judgments irrelevent to eleemosynary reality." The court stated that in the case of a contribution to a charitable organization, the law's policy finds charity in the purposes and works of the qualifying organization, not in the subjective intent of the contributor. However, the First Circuit affirmed the Tax Court's decision on the alternative ground, that being, that there is no reason for a difference in tax treatment merely because the income was earned by a wholly owned subsidiary rather than directly by the tax-exempt organization. The First Circuit relied on the statutory treatment of the taxation

45. 46 T.C. 641 (1966).
47. Sections 511 to 515, I.R.C. 1954.
48. supra, note 44 at 146.
of unrelated business income of certain charitable organizations. It stated that whether the charity operates a business directly or through a subsidiary, the economic and competitive implications of allowing a deduction for income that in fact is retained by the charity would be the same, and thus the transfer must be treated as a nondeductible dividend under section 316.

The decision in *Crosby Valve* was followed by the Court of Appeals for the First Circuit in the case of *United States v. Knapp Brothers Shoe Manufacturing Corporation,*49 decided November 2, 1967. In this case three individuals interested in New York University, an exempt organization, formed the taxpayer-corporation. The certificate of incorporation provided that “no stockholder shall at any time be entitled to dividends on his shares; . . . [or] to any of the profits or assets . . .” The sole distributee of both income and property was NYU. Upon its formation the taxpayer acquired all of the assets of Knapp Brothers, Inc., a successful shoe manufacturer. The business continued to be profitable and during the years 1957 through 1960 the taxpayer made substantial payments to NYU. The question presented was whether these payments constituted charitable contribution. The court stated that the question was whether the taxpayer could escape the ambit of the *Crosby Valve* case.

The taxpayer contended that NYU was neither “owner” nor “shareholder” and that the *Crosby Valve* rationale was therefore inapplicable, asserting that the owners of taxpayer were the voting trustees, who, under the voting trust instruments, are vested with both legal and beneficial ownership of the Stock. The court disagreed, stating that it is NYU which possesses the real beneficial interest and that the stockholders neither have, nor can have, any interest or purpose apart from the ultimate interest of NYU.

The taxpayer next contended that NYU may never receive any funds from it, the stockholders may retain all profits in the company, and the company, instead of succeeding, may go bankrupt. The court answered this contention by stating that the possibility that no one will benefit from the operations of the taxpayer does not alter the fact that if any profits do become payable, they are payable to NYU.

In conclusion, the court remarked that good citizenship and charitable giving are good business, but charity that begins at home, however amiable, is not within that concept.

49. 384 F. 2d 692 (1st Cir. 1967).