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The Aftermath of Certain Key Federal Tax Cases Decided by the Courts in 1966

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The Office of the Chief Counsel for the Internal Revenue Service[1] contributes to the development of the Federal tax laws by the exercise of its *legislative, interpretative,* and *litigating* functions. These three functions are illustrated by the aftermath of four recent Supreme Court cases in which the Government was on the losing side—*Commissioner v. Brown, Fribourg Navigation Co., Inc. v. Commissioner, Malat v. Riddell,* and *Commissioner v. Tellier.*[2]

Each time a decision adverse to the Government is handed down by the Supreme Court, the Internal Revenue Service, acting in conjunction with the Tax Division of the Justice Department and the Office of the Tax Legislative Counsel of the Treasury Department, must analyze the opinion of the Court and decide upon a course of action to be taken. The Service must determine—

What is the scope of the decision?

Is the scope of the decision clear?

If the scope of the decision is not clear, should a Technical Information Release or other announcement be issued setting forth the Service's interpretation of the decision?

Should legislation be sought, and, if so, what form should it take?

Should the regulations be amended?

Should published revenue rulings be modified?

Is further litigation necessary to delineate the state of law in the area?

The role of the Chief Counsel's Office in resolving these questions and

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1. For a general discussion of the Office of the Chief Counsel for the Internal Revenue Service see Treusch, *Chief Counsel's Office: A Dynamic View of Its Organization and Procedures: The "Hows" and Something of the "Whys"*, 12th Annual So. Calif, Tax Institute 19 (1960); Spiegel, *Current Operations in the Chief Counsel's Office,* 38 Taxes 905 (Dec. 1960); Cohen, *The Chief Counsel's Office,* 42 Taxes 191 (Mar. 1964); Cohen, *Current Developments in the Chief Counsel's Office,* 42 Taxes 663 (Oct. 1964); Rogovin, *Current Developments in the Chief Counsel's Office,* Bulletin of Section of Taxation, A.B.A. 36 (Oct. 1965).

2. 380 U.S. 563 (1965); 383 U.S. 272 (1966); 383 U.S. 569 (1966); 383 U.S. 687 (1966).

in carrying out a course of action is graphically illustrated by the Office's activities in the wake of *Clay Brown, Fribourg, Malat,* and *Tellier.* The purpose of this article is not to examine the substantive ramifications of these decisions, but instead to review them in order to demonstrate that each case prompted a different response by the Government and that each case called for the performance by the Chief Counsel's Office of one of its three basic functions.

Legislative Function

The *Clay Brown* case illustrates the *legislative function* of the Chief Counsel's Office. In *Clay Brown,* a charitable organization claiming tax exemption[3] acquired the stock of a lumber company by agreeing to pay the former stockholders of the lumber company a stated percentage of its future earnings until the sales price had been paid. The tax-exempt organization made no commitment for payment of the sales price other than from the assets of the lumber business or the earnings produced by the business. The sales contract provided that simultaneously with the transfer of the stock of the lumber company the tax-exempt organization would liquidate the lumber company and lease its assets to a new corporation owned by the selling stockholders' attorneys for a period of 5 years. Clay Brown, the principal stockholder, was given a management contract to operate the lumber business.

The lease provided that the new corporation, owned by the seller's attorneys, would pay 80 percent of its earnings, computed before an allowance for depreciation, to the tax-exempt organization as rent. Since the earnings derived by the new corporation largely were offset by the so-called rental payments to the exempt organization, the new corporation paid little or no tax. On the other hand, the tax-exempt organization did not include the so-called rental payments in its income because of its tax exemption. Although a tax is imposed by the Internal Revenue Code of 1954 on the unrelated business income of charitable organizations,[4] there is an exception for rents from leases of real property for 5 years or less.[5]

The issue in the *Clay Brown* case was whether the selling stockholders' gain on the sales transaction was capital gain or whether the payments to them out of the earnings of the lumber business represented operating profits taxable at ordinary income rates.[6] The Government contended that a sale had not taken place since the risks of the transaction had remained

3. The possible tax consequences to a charitable organization of engaging in bootstrap transactions were stated in Rev. Rul. 54-420, C.B. 1954-2, 128.

4. Section 511 of the Internal Revenue Code of 1954. Hereafter all section citations are to the Internal Revenue Code of 1954.

5. Section 512 (b) (3) and (4)

6. 380 U.S. at 568.

with the sellers and the exempt organization promised only to pay over a percentage of the lumber business' future earnings. However, the Supreme Court in rejecting this argument held that the transaction was a sale and that as a result the former stockholders were entitled to report their gain on the transaction at capital gain rates.[7] The majority, concurring, and dissenting opinions in the *Clay Brown* case referred to it as an area for Congressional action.[8]

As a result of the Supreme Court's decision, Chairman Mills and Representative Byrnes of the House Ways and Means Committee requested that a study of bootstrap transactions be conducted by the staff of the Joint Committee on Internal Revenue Taxation of the Congress and by the Treasury Department.[9] The Legislation and Regulations Division of the Chief Counsel's Office participated in this study as the Internal Revenue Service's representative. The Division engaged in research to determine the various types of bootstrap transactions and the parties thereto. In addition, it coordinated field surveys in order to determine the frequency and types of transactions that were actually being engaged in by taxpayers. The research and surveys were essential in order to determine the scope of any proposed legislation and the parties that should be affected by such legislation. The Treasury Department enlisted the help of outside tax consultants. Also, conferences were held with representatives of the Section of Taxation of the American Bar Association in order to obtain their views.

The study of bootstrap transactions with a view towards drafting corrective legislation raised several policy questions. First, should the legislation be aimed at the sellers, the buyer, or the rental corporation? Second, should the legislation affect only bootstrap transactions engaged in by tax-exempt organizations, and, if limited to tax-exempt organizations, should it further be limited to *Clay Brown*-type transactions?

As a result of this study, Congressmen Mills and Byrnes introduced identical bills in the 89th Congress which would impose a tax on the unrelated debt-financed income of tax-exempt organizations.[10] One of the elements of the plan in *Clay Brown* was the shelter from tax provided by the tax exemption of the purchasing tax-exempt organization. These bills would render the profits of the business taxable to the charity where the business is unrelated to the exempt purpose of the organization and the

7. 380 U.S. at 570. The Tax Court [37 T.C. 461 (1961)] held that the gain was taxable at capital gains rates. The decision was affirmed by the Court of Appeals [325 F. 2d 313 (9th Cir. 1963)].

8. 380 U.S. at 579, 580, and 588.

9. Committee on Ways and Means, Press Release, Aug. 27, 1965.

10. H.R. 15942 and H.R. 15943, 89th Cong., 2d Sess. (1966). See Committee on Ways and Means, Press Release, June 27, 1966.

income-producing property is purchased out of future earnings of the business or otherwise acquired with borrowed funds.[11] Enactment of this legislation, on which public hearings were held,[12] would greatly inhibit the use of the *Clay Brown*-type device. In anticipation that similar bills will be introduced in the 90th Congress, the Legislation and Regulations Division is now studying the bills introduced in the 89th Congress to determine whether they provide the intended solutions for all known problems. In addition, it is considering the testimony presented at the public hearings and all other comments and suggestions received by the Treasury Department.

Acting on behalf of the Commissioner, the Legislation and Regulations Division of the Chief Counsel's Office exercised its *legislative function* by participating in the Joint Committee's study and by assisting in the development and drafting of the two bills.

Interpretative Function

The *Fribourg* case illustrates the *interpretative function* of the Chief Counsel's Office. *Fribourg* involved the deductibility of depreciation in the year of sale. During the late 1950's, the Internal Revenue Service became concerned that in some instances taxpayers were securing excessive depreciation deductions by under estimating salvage value of depreciable assets. After an extensive study of the problem, it was concluded that where depreciable property was sold or exchanged at a gain, for the year of sale salvage value should be adjusted upward to reflect the sales price. Accordingly, the depreciation deduction for the year of sale would be limited to the amount, if any, by which the adjusted basis of the property at the beginning of the year exceeded the sales price. The position was announced to the public[13] and advanced in the courts.

Rev. Rul. 62-92 indicates that this position is based on the view that the longstanding regulatory provisions providing that the salvage value which was determined at the time of acquisition would not be disturbed

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11. The *Clay Brown* case left unresolved several problems which would not be solved by the proposed legislation and which call for the exercise of the *litigating function* of the Chief Counsel's Office. First, there is the question of whether the payments made by the leasing corporation are rent or a share of the profits; if the latter, there obviously would be no rental deduction. Second, if the payments are not rent, the exception from the unrelated business tax for rental payments is not applicable. Finally, to what extent may charitable organizations engage in *Clay Brown*-type transactions and still retain their tax exemption. Some of these questions are presently being litigated.

12. See, Hearings before the Committee on Ways and Means on H.R. 15942, and H.R. 15943, 89th Cong., 2d Sess. (Aug. 29, 1966).

13. Technical Information Release 384, June 7, 1962; Rev. Rul. 62-92, C.B. 1962-1, 29.

applied only to assets still in the hands of the taxpayer. It was reasoned that the regulatory provisions were designed to eliminate "needless and endless controversies" over estimated salvage value, but upon sale or exchange of an asset, it is reasonable and proper to take the ultimate facts into consideration in determining the depreciation deduction for the year of disposition. This position with respect to adjustment of salvage value was accepted by some lower courts,[14] and rejected by others.[15]

In *Fribourg* the Government's position was accepted by both the Tax Court and the Court of Appeals for the Second Circuit.[16] *Fribourg* involved the sale of a used liberty ship for an amount in excess of its estimated salvage value. Prior to the taxpayer's acquisition of the ship, it had obtained a letter ruling with respect to the useful life of the asset and its salvage value. Due to abnormal market conditions occasioned by hostilities in the Suez Canal area, the taxpayer was able to sell the ship after about two years of service for an amount substantially in excess of the estimated salvage value.[17] For the year of sale the Service disallowed the entire depreciation deduction with respect to the ship since the amount realized from the sale of the ship exceeded its adjusted basis at the beginning of the year, and, therefore, the use of the ship during the year of sale "cost the taxpayer nothing."

Due to the importance of the question, the heavy litigation, and conflicts between the courts of appeals on the issue, the Supreme Court granted certiorari.[18] The Court decided in favor of the taxpayer holding that the depreciation deduction was erroneously disallowed.[19]

Almost immediately after the Supreme Court decision, questions began to arise with respect to the scope of the decision. In certain quarters there

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14. *Cohn v. United States,* 259 F. 2d 371 (6th Cir. 1958); *Motorlease Corporation v. United States,* 334 F. 2d 617 (2nd Cir. 1964), *reversing* 215 F. Supp. 356 (D. Conn. 1963); *Killebrew v. United States,* 234 F. Supp. 481 (E.D. Tenn. 1964).

15. *E.g., United States v. S & A Co.,* 218 F. Supp. 677 (D. Minn. 1963), *aff'd* 338 F. 2d 629 (8th Cir. 1964), *cert. denied* 383 U.S. 942 (1966); *Occidental Loan Co. v. United States,* 235 F. Supp. 519 (S.D. Calif. 1964); *Macabe Co.,* 42 T.C. 1105 (1964); *Harry Trotz,* 43 T. C. 127 (1964), *rev'd on other grounds* 361 F. 2d 927 (10th Cir. 1966); *Holder Driv-Ur-Self, Inc.,* 43 T.C. 202 (1964) (Nonacq. C.B. 1965-2, 7).

16. T.C. Memo. 1962-290; 335 F. 2d 15 (2nd Cir. 1964).

17. The estimated salvage value and useful life of the vessel were 3 years and $54,000. The actual sale price of the ship was $695,500. Shortly after the sale, similar vessels were again being scrapped for amounts nearly identical to the originally estimated salvage value of the ship.

18. 379 U.S. 998 (1965).

19. 383 U.S. 272 (1966). On March 21, 1966, the Supreme Court granted certiorari and, in a per curiam opinion based on *Fribourg,* reversed the United States Court of Appeals for the Second Circuit in *Motorlease Corporation.* 383 U.S. 573 (1966).

appeared to be a belief that *Fribourg* permitted a depreciation deduction for the year of sale in all cases. The Interpretative Division, working in conjunction with the Office of the Assistant Commissioner (Technical), devoted many man hours in analyzing and interpreting the Supreme Court opinion and the decisions cited in the opinion. As a result of this intensive study, it was concluded that the scope of the decision was much more limited than some persons had originally believed.

In the *Fribourg* factual situation both the salvage value and the useful life of the asset had been estimated with reasonable accuracy at the time the ship was put in service. The Service had ruled on these points and did not later question the original ruling. The Supreme Court emphasized that, in *Fribourg*, the reason for the sale prior to the expiration of the estimated useful life and at an amount in excess of the estimated salvage value was an "unexpected and short-lived, but spectacular" change in market conditions. The Court indicated that the Service had confounded two concepts—depreciation of an asset through wear and tear or gradual expiration of useful life, and fluctuation in the market value of an asset through changes in price levels. It was apparent from the decision that the Supreme Court did not in every case preclude adjustment of estimated salvage value in the year of sale, but limited its decision to situations where the original estimates were admittedly reasonable and later proved to be accurate.[20] The Service, therefore, concluded that the salvage value of an asset could be adjusted and the depreciation for the year of sale accordingly disallowed, in whole or part, where the taxpayer failed to assign a salvage value to property or where the salvage value assigned was inadequate.

At the time of the *Fribourg* decision a number of cases containing similar issues were pending. The Tax Court and Refund Litigation Divisions and the various field offices of the Chief Counsel's Office were, of course, obliged to review these cases and, taking into account the Service's interpretation of the opinion, decide which issues were controlled by *Fribourg* and should, accordingly, be conceded.[21] In a similar manner,

20. The Court stated:

"It is, of course, undisputed that the Commissioner may require redetermination of useful life or salvage value when it becomes apparent that either of these factors has been miscalculated. The fact of sale of an asset at an amount greater than its depreciated basis may be evidence of such a miscalculation. * * * But the fact alone of sale above adjusted basis does not establish an error in allocation. * * *

"* * * Since the original estimates here were admittedly reasonable and proved to be accurate, there is no ground for disallowance of depreciation." 383 U.S. at p. 277.

21. See *Catherine F. Dinkins*, 45 T.C. 593 (1966) (which was decided after *Fribourg*) in which the service argued that part of the depreciation deduction

the Service has had to take account of *Fribourg* in its handling of cases which are in a pre-litigation stage.

The Interpretative Division of the Chief Counsel's Office, exercising its *interpretative function,* assisted in determining the scope of the decision and is now participating, in conjunction with the Income Tax Division of the Office of the Assistant Commissioner (Technical), in an intensive study to determine the necessity of revoking or modifying any published rulings which may be construed as being in conflict with the *Fribourg* decision.

LITIGATING FUNCTION

The *Malat* case illustrates the *litigating function* of the Chief Counsel's Office. In *Malat,* the Supreme Court dealt with the problem of whether certain real estate was a capital asset or whether it came within the exception for "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business".[22] *Malat* concerned a sale of real estate by a taxpayer who was in the business of selling real estate. Previously, the Government had argued with success that the legislative purpose of section 1221 required that a sale by a taxpayer in the ordinary course of his trade or business should result in ordinary income if a "substantial" or "essential" reason for the holding of the property was for sale.[23] The Supreme Court, however, in *Malat* rejected that argument and concluded that the *"principal"* purpose or purpose *"of first importance"*

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claimed in the year property was sold was not allowable because of an inaccurate estimate of useful life and salvage value and another portion was not allowable because it would reduce the adjusted basis of the property below the sales price. The Tax Court held for the Government to the extent that the disallowance was based on the redetermination of useful life and salvage value, but held that the Supreme Court decision in *Fribourg* governed the depreciation which was disallowed merely because it would reduce the adjusted basis below the actual sale price.

22. Section 1221 states, in part, that * * * "the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

"(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business * * *"

23. See *Rollingwood Corp. v. Commissioner,* 190 F. 2d 263 (9th Cir. 1951); *Greene-Haldeman v. Commissioner,* 282 F. 2d 884 (9th Cir. 1960); *American Can Co. v. Commissioner,* 317 F. 2d 604 (2nd Cir. 1963), *cert. denied* 375 U.S. 993 (1964); *S.E.C. Corp. v. U.S.* 140 F. Supp. 717 (S.D. N.Y. 1956), aff'd per curiam, 241 F. 2d 416 (2nd Cir. 1957), *cert. denied* 354 U.S. 909 (1957);

Harrah v. Commissioner, 30 T.C. 1236 (1958). *Contra, Municipal Bond Corp. v. Commissioner,* 341 F. 2d 683 (8th Cir. 1965); *Bennett v. Commissioner,* 186 F. 2d 407 (5th Cir. 1951).

must be for sale. The extent to which the Court broadened the definition of a capital asset is quite unclear.

In *Malat,* the taxpayer was a participant in a joint venture which had been organized for the purpose of purchasing a parcel of land.[24] The joint venture apparently had three different purposes in mind with respect to the property. One of the possibilities was construction of a garden type apartment development on the entire parcel. However, because the mortgage market was unfavorable the development was not constructed. The partners also considered constructing apartment buildings on the inner portion of the parcel, retaining the outer portion for commercial use. However, this required rezoning of the outer portion which could not be obtained. The taxpayer testified that the partners thought when they purchased the property that they had made a good purchase and if they could not obtain acceptable construction financing or rezoning, they could always sell the property. Finally, the inner portion of the parcel, after being subdivided and improved, was sold. The partners recognized ordinary income. The partners still explored the possibility of commercial development of the outside portion. However, after a disagreement arose among the partners, some of the partners, including the taxpayer, decided to terminate the joint venture. Accordingly, part of the property was sold to a new partnership, consisting of those partners who wished to retain their interest in the property, and the rest of the property was sold to a real estate developer. The Government argued that the real estate was held primarily for sale in the ordinary course of that business. The Government cited many court opinions which, when faced with a dual purpose holding, concluded that if an "essential" or "substantial" purpose was to sell, then the property was held "primarily for sale".[25] Taxpayers contended that they had intended to develop the property for rental and that the eventual sale was only a termination of the investment because development was not feasible.

The District Court applied the rule stated by the 9th Circuit in *Rollingwood Corp. v. Commissioner*[26] that a taxpayer who intends to rent or sell

24. The facts as presented are in accord with the findings of the District Court on remand from the Supreme Court [66-2 USTC ¶9564 (S.D. Cal.] and generally in accord with the statements of the Court of Appeals [347 F. 2d 23 (9th Cir. 1965)] and the Supreme Court. There being some confusion among the joint venturers regarding the intended use of the land, the various statements of the facts are not in all respects identical.

25. *Supra* note 23.

26. 64-1 USTC §9432 (S.D. Cal.) In *Rollingwood,* 190 F. 2d 263 (9th Cir. 1951), the taxpayer corporation was organized in 1943 by an individual, who was in the business of constructing homes and subdividing and selling real estate, to construct and manage a war housing project. In conformity with the policy of the United States to provide low cost rental housing, these houses

real estate depending on which course appears to be most profitable must recognize ordinary income if the real estate is sold. The *Rollingwood* case stated that only an "essential" reason for the holding need be for sale. The Court of Appeals for the 9th Circuit affirmed. The Supreme Court reversed and remanded holding that the wrong test was applied. The Court stated that the word "primarily" should be interpreted in its every day sense. This interpretation, the Court said, is consistent with the legislative purpose to distinguish between the realization of appreciation in value accrued over a period of time, and profits and losses arising from the everyday operation of a business.[27]

The *Malat* decision dealt with standards to be applied to the basic factual determination of whether property is held primarily for sale in the ordinary course of a trade or business. This is an area where the Service does not ordinarily issue rulings but where many disputes arise after the property is sold.[28] After the *Malat* decision was handed down the Chief Counsel's Office R.I.R.A. data[29] indicated that, under section 1221 alone,

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were advertised for rent and were all rented. The houses were rented for an average time of 22 months, but by 1947, almost all of the 700 houses constructed had been sold. The Tax Court held—that the houses were held by the corporation primarily for sale to customers in the ordinary course of its trade or business and the Court of Appeals affirmed. The Court of Appeals found that the issue was whether the property was held primarily for sale or primarily for rent. The Court stated that a definition of "primarily" as "essentially" or "substantially" was more consistent with the purpose of Congress, which was to tax at ordinary income tax rates gain on the sale of property bought and sold for a profit, but at capital gains rates gain on the sale of investment property. Accordingly, since an "essential" or "substantial" reason for the construction and holding of the houses in this case was for their sale, the Court held that the profits on the sales should be taxed as ordinary income.

27. The pertinent part of the opinion states that—

"As we have often said, 'the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses.' * * * Departure from a literal reading of statutory language may, on occasion, be indicated by relevant internal evidence of the statute itself and necessary in order to effect the legislative purpose. * * * But this is not such an occasion. The purpose of the statutory provision with which we deal is to differentiate between the 'profits and losses arising from the everyday operation of a business' on the one hand * * * and 'the realization of appreciation in value accrued over a substantial period of time' on the other. * * * A literal reading of the statute is consistent with this legislative purpose. We hold that, as used in §1221(1), 'primarily' means 'of first importance' or 'principally'." 383 U.S. at 571-572.

28. Rev. Proc. 64-31, C.B. 1964-2, 947.

29. The Reports and Information Retrieval Activity, among other things, gathers data relating to the workload of the Chief Counsel's Office. See Link, *RIRA—A Legal Information System in the Internal Revenue Service,* 43 Taxes 231 (1965).

159 groups of cases pending involved this issue. Accordingly, a study group was established to consider the impact of the decision on existing precedents and the many pending cases. Representatives of the Justice Department and the Chief Counsel's Office made a thorough review of the law in this area. Moreover, the language involved appears in many other Code sections.[30] The immediate impact of the decision was to broaden the circumstances under which a dealer in real property could obtain capital gains on a sale of that type of property.

However, more disturbing was the fact that the Supreme Court's opinion left many unanswered questions. After a review of the decision, it became apparent that the scope and meaning of the Court's decision could only be determined in the course of further litigation.[31] A function of the Refund Litigation and Tax Court Divisions of the Chief Counsel's Office is to assure that a uniform litigation position is adopted. With respect to routine cases, we knew that our position in all the pending cases would be uniform and consistent. However, it was intended that special attention be given to the particularly troublesome cases.

Since *Malat,* a number of decisions have been rendered amplifying the rule that the Supreme Court laid down. For example, in *S. O. Bynum,*[32] a Tax Court case, the property involved was part of a farm leased by the taxpayers in 1936 and purchased in 1942. The taxpayers lived on the farm and maintained a nursery and landscape business on it. In late 1959, because they were under pressure to amortize or reduce a mortgage on the land, the taxpayers began to subdivide and improve a portion of the farm. In 1960 and 1961, the activities conducted by them in connection with the sale of the subdivided lots were so substantial as to constitute a trade or business. The opinion, which was reviewed by the entire Tax Court, noted that, unlike *Malat* which involved a dual purpose holding,

30. *E.g.,* sections 337, 341, 1231, and 1236.

31. The specific problems left unresolved by the *Malat* decision were numerous. For example, it was not clear what the result would be if a taxpayer who sold property had a number of motives for holding the property and only one was to hold for sale. Must the sale motive outweigh the sum of all the other motives or only be more significant than any other single motive? It also was not clear if the sale motive had to be only slightly more significant than the other motive or motives or if it had to be substantially more significant. It also was not clear whether a taxpayer who manufacturers products for sale or rent could treat profits with respect to its sales as capital gains. With respect to existing precedents, it was not clear what the effect of the decision would be on the change of purpose rule. That rule, generally stated, is that ordinary income is recognized when property is sold by a taxpayer who when he originally purchased the property did not intend to engage in the business of selling such property but who at a later date changed his intentions, engaged in such a business, and held the property for sale in that business.

32. 46 T.C. 295 (1966).

this case involved a change of purpose. The Tax Court went on to state that while "the taxpayers' purpose at the time of acquisition has evidentiary weight, . . . the end question is the purpose of the 'holding' at the time of the sale or sales." Accordingly, the taxpayers were required to report ordinary income in connection with these sales.[33] Other post-*Malat* cases also have applied the change of purpose rule although not always in the Service's favor.[34] In a concurring opinion in *Bynum,* Judge Tannenwald, with three other judges agreeing, further expounded on the basis of the Tax Court's decision. Among other things, he stated that the sale motive does not "have to be capable of a quantitative measurement of more than 50 percent" but it need only be *"primus inter pares"*.[35] A number of other decisions have been rendered by the Tax Court and the Court of Claims since *Malat.* They seem to indicate that perhaps the new test will not significantly change the outcome of cases involving dual purpose holdings.[36]

In the trial of these cases, the Tax Court and Refund Litigation Divisions, and the various field offices of the Chief Counsel's Office were faced with a situation where the law was unclear. It was the Office's responsibility to attempt to bring uniformity and clarity to this area. The litigating divisions, by assisting in the trial of the cases and by working together to develop a uniform policy, have contributed to the clearing up of some of the problems created by the *Malat* decision.

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33. It is interesting to note the concurring opinion of Judge Tanenwald in this connection. He states that in many change of purpose cases, part of the profit is attributable to appreciation in value during the period the property was held for investment, and part results from the operation of the business. Therefore, he suggests that "perhaps some method of allocation within an appropriate statutory framework is indicated." 46 T.C. at 302.

34. For example, in *Tibbals v. United States,* 362 F. 2d 266 (Ct. Cl. 1966), the Court of Claims held that two of three sales by taxpayer of subdivided land resulted in ordinary income but that the third sale resulted in capital gains.

However, the Court, after recognizing that a taxpayer's purpose can change and that the dominant purpose during the period prior to sale is critical, found that by the time the final sale was made taxpayer held the property as an investment and his financial interest was in "the realization of appreciation in value accrued over a substantial period of time." In *J. Thomas Requard,* T.C. Memo 1966-141, the Tax Court held that the gain realized from a transfer of an interest in a partnership and attributable to certain real estate which had appreciated substantially in value was ordinary income.

35. 46 T.C. at 302.

36. *See, e.g., Tibbals v. United States, supra* note 34; *Nadalin v. United States,* 66-2 USTC §9548 (Ct. Cl.); *J. Thomas Requard, supra* note 34; *Joan E. Heller Trust,* T.C. Memo. 1966-121; *William A. Scheuber,* T.C. Memo. 1966-107; *Municipal Bond Corp.,* 46 T.C. 219 (1966); and see Comment, 64 Mich. L. Rev. 1610, 1613 (1966).

SUMMARY OF THE THREE FUNCTIONS

The *Tellier* case, [37] because of the nature of the decision and its reversal of prior authority in the lower courts,[38] illustrates the three basic functions of the Chief Counsel's Office which contribute to the development of the Federal tax laws.

In *Tellier,* contrary to numerous decisions and published rulings in the past,[39] the Court held deductible legal fees incurred in the unsuccessful defense of a criminal prosecution arising out of the conduct of the taxpayer's business. The Supreme Court's opinion extended, however, beyond this specific holding into a discussion of the entire "frustration of public policy" area.[40]

The Chief Counsel's Office exercised its *interpretative function* by revising previously taken public positions with respect to the deductibility of legal fees in criminal matters. The office exercised its *litigating function* by examining its current litigating position with respect to other kinds of cases usually considered to fall within the "public policy" area. In addition, a bill was introduced in the second session of the 89th Congress which deals with certain aspects of the question of the denial of deductions from gross income because of the frustration of clearly defined public policy.[41] The bill was introduced as a result of a study conducted by the Staff of the Joint Committee on Internal Revenue Taxation of the Congress, which, in turn, was prompted by the Service's 1964 ruling concerning the deduction of treble damage payments.[42]

The initial interpretative response is manifest in Revenue Ruling 66-330[43] which revokes and modifies previous rulings[44] all of which dealt in

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37. *Commissioner v. Tellier,* 383 U.S. 687 (1966), *aff'ing* 342 F. 2d 690 (2nd Cir. 1965).

38. *Tellier v. Commissioner,* 22 T.C. Memo 1062 (1963).

39. See, *inter alia, Burroughs Bldg. Material Co. v. Commissioner,* 47 F. 2d 178 (2nd Cir. 1931); *Gould Paper Co. v. Commissioner,* 72 F. 2d 698 (2nd Cir. 1934); *C. W. Thomas,* 16 T.C. 1417 (1951); *Thomas A. Joseph,* 26 T.C. 562 (1956); *Acker v. Commissioner,* 258 F. 2d 568 (6th Cir. 1958); *Peckham v. Commissioner,* 327 F. 2d 855 (4th Cir. 1964); Rev. Rul 64-224, 1964-2 C.B. 52.

40. Much has been written on this subject. See, for example, Note, *Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning with the Internal Revenue Code,* 72 Yale L. J. 108 (1962); Lindsay, *Tax Deductions and Public Policy,* 41 Taxes 711 (1963); Diamond, *The Relevance (or Irrelevance) of Public Policy in Disallowance of Income Tax Deductions,* 44 Taxes 803 (1966).

41. S. 3650, 89th Cong., 2d Session (1966).

42. Staff of Joint Committee on Internal Revenue Taxation, Study of Income Tax Treatment of Treble Damage Payments Under the Antitrust Laws (Nov. 1, 1965); Rev. Rul. 64-224, C.B. 1964-2, 52.

43. I.R.B. 1966-45, 5.

44. I. T. 2303, V-2 C.B. 38 (1926); Rev. Rul. 62-175, C.B. 1962-2, 50; Rev. Rul. 64-224, C.B. 1964-2, 52.

one way or another with the issue of the deductibility of legal fees in criminal matters. This response to what is the clear holding of the *Tellier* case was of course compelled by the decision itself. However, the language of the opinion with respect to other matters in the public policy area is not nearly so clear and compelling. Accordingly, the *interpretative function* of the Chief Counsel's Office must additionally be exercised in exploring and coordinating the thrust of the opinion into other related areas, such as fines and penalties, bribes and kickbacks, treble damages under the anti-trust laws, and indeed in all of the areas which in the last 40 years have involved the issue of frustration of public policy when taxpayers have made business-related payments. This exercise of our *interpretative function* is, of course, not limited to reevaluation of past published ruling positions. It necessarily also involves determinations with respect to pending litigation. At this very moment, we are involved in this task.

We must act upon the assumption that bills similar to the bill introduced in the 89th Congress will be introduced in the 90th Congress. This means that the Legislation and Regulations Division must exercise the *legislative function* by engaging in an examination of any legislation which is proposed in order that it may be ready, when the occasion arises, to effectively represent the Service. In this activity, of course, the operation of the Chief Counsel's Office must be coordinated with the similar activity in the Office of the Tax Legislative Counsel.

The exercise of the three basic functions of the Chief Counsel's Office—*legislative, interpretative,* and *litigating*—will ultimately result in a comprehensive Service position.