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SELECTED SIGNIFICANT INCOME TAX DEVELOPMENTS IN 1965

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During the year 1965 there has been no significant increase or decrease, as compared to prior years, in the number of judicial or administrative developments in the federal income tax field. In the legislative area it was "quiet", there being no income tax legislation actually enacted. As in other years most of the court decisions and administrative rulings were run of the mill, involving familiar situations and concepts. But, as in other years too, there were legislative activities, court decisions, and administrative rulings which are of more than routine interest, deserving of special attention. It is from such activities, decisions and rulings that the selection has been made in this paper for discussion.¹

LEGISLATIVE DEVELOPMENTS

Although there were no income tax statutes enacted² there was considerable legislative activity affecting the entire federal tax structure. The major enactments were the Excise Tax Reduction Act of 1965,³ Social Security Amendments of 1965,⁴ Railroad Retirement Tax Act Amendments of 1965,⁵ and Interest Equalization Tax Extension Act of 1965,⁶ each of substantial significance.⁷

Interestingly enough significant legislative activity in the income tax field consists of one enacted statute (dealing with enrollment, inter alia, of taxpayers' representatives before the Treasury Department)⁸ and

1. The selection of *significant* tax developments is in large measure subjectively determined. Those discussed in this paper, are, of course, not claimed to be all-inclusive. See, e.g. Emory & Goldstein, "Federal Income Taxation", *1965 Annual Survey of American Law* 209

2. Neither was there any estate or gift tax legislation.

3. P.L. 89-44, 79 Stat. 136.

4. P.L. 89-97, 79 Stat. 286.

5. P.L. 89-212, 79 Stat. 858.

6. P.L. 89-243, 79 Stat. 954.

7. Although these four acts are of large importance, they are, of course, outside the scope of this paper.

8. P.L. 89-332, 79 Stat. 1281, terminating the special enrollment of attorneys at law and certified public accountants to represent taxpayers before the Treasury Department. See TIR-781, November 23, 1965, announcing interim procedures under P.L. 89-332. As to attorneys at law and certified public accountants, those already enrolled to practice may continue to represent taxpayers before the Internal Revenue Service and those not so enrolled may represent a taxpayer by filing a declaration that they are in good standing as lawyers or certified public accountants, as the case may be. The Act has no application to persons other than attorneys at law and certified public accountants and does not abolish the power of attorney requirement.

three proposals. The first proposal is designed to encourage more foreign⁹ investment in the United States by easing some of the existing tax burdens on nonresident aliens, foreign corporations, and estates of nonresident aliens. The second,¹⁰ introduced at the request of the American Bar Association for study, contains a potpourri of proposed miscellaneous income, estate and gift tax amendments (substantive and procedural) which span a wide gamut. The third¹¹ is a study by a Congressional Committee suggesting the legislative reversal of Rev. Rul. 64-224¹² which permitted deduction of amounts paid in satisfaction of treble damage claims under Section 4 of the Clayton Act. As of this writing none of the foregoing proposals have been translated into actual legislation.¹³

Lastly, during 1965 Senator Harry F. Byrd, Chairman of the Senate Finance Committee retired from Congress, his post being taken over by Senator Long of Louisiana, who has been, and presumably will continue to be, more favorably inclined toward the Treasury views on tax legislation than his predecessor, Senator Byrd. This change in committee leadership conceivably can be of substantial significance in the make-up of the tax laws during the next several years.

JUDICIAL DEVELOPMENTS

Supreme Court

During 1965 there was a flurry of activity in the Supreme Court, unusual in that there were nine important federal tax decisions—twice the number usually handed down at a term. In *United States v. First National City Bank*¹⁴ the Court upheld an injunction issued by a District court in New York City to enjoin the First National City Bank of New York City from transferring any funds owing to Omar, S.A., a Uruguayan corporation (alleged to owe federal income tax) whether such funds were in the United States or in a branch of the bank in Montevideo, Uruguay, pending trial on the merits of the tax claim. This decision, over a vigorous dissent by Justices Harlan and Goldberg, expanded the concept of

9. H.R. 11297 (89th Cong. 1st Sess.), Foreign Investors Tax Act of 1965, re-introduced as H.R. 13103, Foreign Investors Tax Act of 1966.

10. H.R. 11450 (89th Cong. 1st Sess.).

11. Study by Staff of Joint Committee on Internal Revenue Taxation of Income Tax Treatment of Treble Damage Payments under Antitrust Laws (November 1, 1965).

12. C.B. 1964-2, 52.

13. See, however, H.R. 12752 (89th Cong. 2d Sess.) Tax Adjustment Bill of 1966 which is scheduled for enactment.

14. 379 U.S. 378, 85 S. Ct. 528. See also *United States v. Speers*, 86 S. Ct. 411, holding that a federal tax lien unrecorded as of the time of bankruptcy was invalid as against trustee in bankruptcy.

how far a District Court can “freeze” property under its control, whether such property be within or without the United States—an expansion which presumably the Treasury will not be slow to exploit in the enforcement of collection of taxes.

The Supreme Court also had occasion to pass on the scope of the “lesser offense” defense in a criminal tax proceeding;¹⁵ the taxability as ordinary income of gains realized by purchasers of notes (originally issued at discount) on sale of such notes prior to maturity;¹⁶ depreciation basis of steamships purchased from the Government;¹⁷ taxable investment income on life insurance companies;¹⁸ statute of limitations on tax evasion charges;¹⁹ and coal depletion.²⁰

In April, 1965, the Supreme Court upheld, by a 6 to 3 vote, capital gain treatment in a boot-strap operation involving the sale of property to charity with a lease-back to the sellers.²¹ Brown and others owned substantially all the stock in a corporation which owned and operated sawmills and related lumber activities. In 1952 they agreed to sell their stock to a charity for \$1,300,000 with a \$5,000 down payment, the balance to be spread over ten years payable out of earnings. It was agreed that contemporaneously with the stock transfer the charity would liquidate the company and lease its assets for five years to a new corporation (formed and wholly owned by Brown and others) which was to pay to the charity 80% of its operating profit (without depreciation or taxes) and 90% of such payment would then be paid over by the charity to Brown and others. The charity had no personal obligation to pay the note except from rental income. Brown was to have a management contract with the new corporation and the right to name any successor managers. Two years later Brown resigned as general manager and in 1957 the new corporation terminated its operations after suffering severe financial reverses. Brown and his group did not repossess the property under their mortgage but agreed that the property should be sold by the charity with the latter retaining 10% of the proceeds. The property was sold

15. *Sansone v. United States*, 380 U.S. 343, 85 S. Ct. 1004.

16. *United States v. Midland-Ross Corporation*, 381 U.S. 54, 85 S. Ct. 1308; *Dixon v. United States*, 381 U.S. 68, 85 S. Ct. 1301, which in effect laid at rest *Caulkins v. Comm.*, 1 T.C. 656, acq. CB 1944, p.5, aff'd 144 F. 2d 482 (CA 6, 1944), acq. withdrawn CB 1955-1, 7. In the *Dixon* case the taxpayer's claim that he relied on *Caulkins* fell on deaf ears.

17. *Waterman Steamship Corp. v. United States*, 381 U.S. 252, 85 S. Ct. 1389.

18. *United States v. Atlas Life Insurance Company*, 381 U.S. 233, 85 S. Ct. 1379.

19. *Jaben v. United States*, 381 U.S. 214, 85 S. Ct. 1365.

20. *Paragon Jewel Coal Co. v. Commissioner*, 380 U.S. 624, 85 S. Ct. 1207.

21. *Commissioner v. Clay Brown*, 380 U.S. 563, 85 S. Ct. 1162.

by the charity for \$300,000. Brown and his group received \$900,000 on the \$1,300,000 note. The Supreme Court upheld Brown's contention that this transaction gave rise to capital gain and not ordinary income—but not without vigorous dissent by three Justices.

The *Clay Brown* decision has precipitated not inconsiderable comment²² and has provoked the Joint Committee on Internal Revenue Taxation, in conjunction with the Treasury Department, to study that decision with the view to developing "corrective legislative proposals".²³ It is not likely that, in view of the Congressional study, there will be many persons rushing to set up boot-strap transactions similar to the one utilized in the *Brown* case. Too much success in one case often means no more "success" for others prospectively.

In an estate tax case²⁴ the Supreme Court held that airplane flight insurance purchased "on the spur" at an airport was includible in the gross estate of the applicant where three hours later the applicant perished in the crash of the airplane on the flight covered by the flight insurance purchased at the counter. The Court held that the proceeds of the accidental death policy were "insurance proceeds" and that the decedent had not completely divested himself of ownership even though his wife was beneficiary, she had paid the premiums, and he had told the counter clerk to give the policies "to my wife. They are hers now, I no longer have anything to do with them." The importance of the decision is that counter flight insurance is no different from life or other accidental death insurance for estate tax purposes, but that the applicant could divest

22. E.g., O'Neill, "Sales of Business to Charities—The Brown Case and its Aftermath," 43 TAXES 507 (1965); see also, Oliver, "Income Tax Aspects of Gifts and Leasebacks of Business Property," 51 Cornell L. Q. 21 (1965). Dauber, Jewell and Hall, Comment on Brown case, 23 Journal of Taxation, 2 (1965); Eliasberg, "Boot-strap Sales," 23 Journal of Taxation, 42 (1965).

23. Press Release by Chairman Wilbur D. Mills of the Committee on Ways and Means, October, 1965. 657 CCH Par. 6743. After setting forth the possible scope of the Brown decision, the release ended with the following caveat. "Because of the seriousness of the problem presented, the staffs have been requested to consider the desirability of recommending that any corrective legislative proposals in this area relating to arrangements with exempt organizations or, possibly, loss corporations in situations which are similar or analogous to that involved in the Brown case, *be made effective as of the date of this announcement.*" (Italics supplied).

The majority of the Supreme Court apparently was satisfied that there was an arm's-length transaction and that the property was sold to the charity for an amount not in excess of fair market value. The decision presumably would have been otherwise had the property been sold in excess of fair market value. But how much of an excess? Despite the reasoning of the Court's opinion, the decision, justifiably enough, does require corrective legislation at least for the future.

24. Commissioner v. Noel Estate, 380 U.S. 678, 85 S. Ct. 1238. See Maxfield, "Federal Estate and Gift Taxation." 1965 Annual Survey of American Laws 195.

himself of all ownership (which he did not do in the *Noel* case) so as to have the proceeds excluded from the gross estate.²⁵

For a number of years a troublesome problem of depreciation has vexed taxpayers and the Internal Revenue Service, namely, whether, in the year of sale of real estate a substantial profit, depreciation *for that year* is allowable as a deduction. In November 1965, the Supreme Court heard argument in the *Fribourg* case on taxpayer's appeal from a denial of straight-line depreciation for the year of sale of ships sold at a large profit.^{25a} On March 7, 1966 the Supreme Court, in a 6-3 decision, reversed the lower court and upheld the deduction of depreciation in the year of sale.^{25b} For all practical purposes, therefore, the attack of the Internal Revenue Service on such last-year depreciation in the case of real estate has come to an unsuccessful end.^{25c}

Courts of Appeal

In contradistinction to the Supreme Court, the various Courts of Appeal²⁶ have many more issues to decide which decisions, because of the fortuitousness of what cases are heard by the Supreme Court, become the "law of the land". During 1965 that profuseness of issues was not abated.

Out of the welter of several hundred decisions rendered by the Courts of Appeal²⁷ two dozen or more have been selected for notice.

In *Van Zandt v. Commissioner*²⁸ the taxpayer (a doctor) had created two trusts for his children, acting as trustee. He conveyed his office property to the trust with a lease-back to himself and paid rent which he deducted on his own return. He was denied the deduction because under the lease-back he had retained the reversion; he was merely shifting funds from one pocket to another. Yet in *Oakes*²⁹ rental payments could

25. Although the *Noel* decision involves only estate tax, the opinion does touch upon Congressional approval of administrative interpretation also applicable to income tax.

25a. *Fribourg Navigation Co., Inc. v. Commissioner* (CA 2, 1964) 335 F. 2d 15. At the time this paper was originally presented to the Tax Conference the Supreme Court had not rendered its decision.

25b. 86 S. Ct. 862 (1966).

25c. *Motor Lease v. U.S.* 86 S. Ct. 1076 (1966) involving sale of automobiles.

26. In *Choate v. Commissioner* (CCA 2, 1942) 129 F. 2d 684, 689, Judge Frank described a Court of Appeal as "merely a reflector serving as a judicial moon . . . , guided by the light of Supreme Court decisions" but added that "perhaps the figure [of speech] indicates too much abjectness. On occasions, sometimes unwittingly, lower courts in tax cases manifest some creativeness."

27. For present purposes District Court decisions have not been generally included.

28. (CA 5, 1965), 341 F. 2d 440, aff'g. 40 TC 824, *cert. den.* 86 S. Ct. 32.

29. 44 TC No. 48 (1965). See, Note 41 N.Y.L. Rev. 206 (1966).

be deducted under somewhat different circumstances. Dr. Oakes and his wife owned improved real estate on which he had his office. Some three years after acquisition of the property he created an eleven-year trust for his minor children and named a bank as trustee. He conveyed the property to the trust with a lease-back for reasonable rent. Two years later he assigned his future interest to his wife and named her as guardian. The rental payments after the assignment were held deductible ostensibly because of the independent trustee and of the assignment of the reversionary interest. *Van Zandt* was distinguished on those grounds. Where the dividing line—the undulating equator—is between *Van Zandt* and *Oakes* is not as simple as appears.

The *Spomar*³⁰ and *Kohatsu*³¹ cases stand as important warnings to taxpayers that an investigating revenue agent is under no legal duty to inform a taxpayer (not yet charged with any tax crime) that he has a constitutional right to refuse to answer questions or produce records. Hence evidence voluntarily produced or made available by a taxpayer under investigation is admissible against him, whether or not he was informed or knew of his constitutional right. These decisions highlight the advisability of having professional assistance even at the earliest stages of revenue agent audits in appropriate cases.

A troublesome question in the area of income tax deductions is that relating to payments which are made in violation or some public policy (local or national) or the deductibility of which would be against public policy implicit in federal tax law.³² The outstanding decision in 1965 is *Tellier*³³ which upheld a deduction for legal expenses incurred by taxpayer, a securities underwriter, in *unsuccessfully* defending against criminal fraud charges. The Court of Appeals, in a landmark decision, reversed its distinctions established more than thirty years ago.³⁴ In March,

30. *United States v. Spomar* (CA 7, 1965), 339 F. 2d 941.

31. *Kohatsu v. United States* (CA 9, 1965), 351 F. 2d 808.

32. See, *United Draperies, Inc. v. Comm.* (CA 8, 1965) 340 F. 2d 936, *cert. den.*, 382 U.S. 813; 86 S. Ct. 30 holding that gifts or rebates to employees of good customers were not deductible as business expenses and *Dukehart-Hughes Tractor Co. v. U. S.* (Ct. Cl. 1965) 341 F. 2d 613, holding that "gifts" to Iowa state employees were deductible. Also, deductions were allowed in *Sterling Distributors v. Paterson* (D. C. Ala., 1965) 236 F. Supp. 479 for rebates or free beer given in violation of Alabama statutes and in *Marigold Foods, Inc. v. United States* (D. C. Minn. 1965) 65-2 USTC Par. 9667 for depreciation on dairy property operating in violation of state law. Tyler, "Disallowance of Deductions on Public Policy Grounds" 20 Tax L. Rev. 665 (1965).

33. *Tellier v. Commissioner* (CA 2, 1965) 342 F. 2d 690.

34. The distinction was that deduction would be allowed for legal or related expenses incurred in *successfully* defending a criminal charge incident to the operation of a business but no deduction where the defense was *unsuccessful*. *Burroughs Bldg. Material Co. v. Commissioner* (CCA 2, 1931) 47 F. 2d 178.

1966 the Supreme Court affirmed.³⁵ The concept or role of public policy in tax controversies has now taken on a new aspect.

It has been customary for the Internal Revenue Service to wield a big stick where the funds of a close corporation are used for the personal benefit of a principal stockholder. The corporation is not allowed any deduction and the stockholder is deemed to have received a dividend or ordinary income to the full amount. In *DiZenzo*³⁶ it was held that where the government claimed corporate expenditures were dividends, the Court held that if that be the claim then the amount of earnings or profits is of vital importance in determining how much of the expenditure is a dividend under Section 316 of the Code, taxable as ordinary income. This decision is an important limitation on the big stick treatment.

The issuance of advance rulings by the Internal Revenue Service has not infrequently raised the issue of the extent to which such rulings can be relied upon by persons similarly situated or closely related to the recipient of a ruling. In *Bornstein*³⁷ the taxpayer could not sustain an estoppel against the Commissioner on the ground that he relied on a ruling given to another related person similarly situated in a "collapsible corporation" transaction. Many a tax plan can founder on misplaced reliance on rulings given others inasmuch as no one knows just when the Internal Revenue Service may choose to abandon a position taken in any given type of ruling.

The Court of Appeals for the Second Circuit has held in two cases that a divorce may be considered as valid for federal income tax purposes in determining taxability of alimony even though such divorce was not valid under the law of New York in which the parties were resident.³⁸ These decisions, if not overturned,³⁹ will be a mixed blessing tax-wise to persons participating in "quickie" divorces, depending upon whether the issue is taxability or deductibility of alimony payments.

35. 86 S. Ct. 1118. Compare *Knetsch v. United States* (Ct. Cl., 1965) 348 F. (2d) 932, cert. den. 86 S. Ct. 1221, disallowing deductions for out-of-pocket costs incurred in tax-saving annuity purchase plans which went "sour" taxwise with *Perry A. Nichols* 43 TC 842 which permitted theft loss deduction for amounts paid to promoters of abortive tax-saving scheme! See also *DeCastro*, "Liberal Trend in Allowing Deductions for Legal Fees" 20 Tax L.R. 615 (1965); *Krane*, "Deductibility of Legal and Accounting Fees". 44 TAXES 7 (1966).

36. *DiZenzo v. Commissioner* (CA 2, 1965) 348 F. (2d) 122. See *Teschner*, "Hidden Dividends—Paper Tiger of Constructive Corporate Distribution" 43 TAXES 644 (1965).

37. *Alfred B. Bornstein v. United States* (Ct. Cl., 1965) 345 F. (2d) 558.

38. *Borax v. Commissioner* (CA 2, 1965) 349 F. (2d) 666, involving a Mexican divorce; *Wondsel v. Commissioner* (CA 2, 1965) 350 F. (2d) 339, involving a Florida divorce.

39. *Certiorari* has been denied in both cases, 86 S. Ct. (1966). In the *Borax* case there was also the issue as to whether a second marriage would be recognized supporting the validity of a joint return filed by the taxpayer and second wife.

Regulations of the Commissioner prescribing actuarial tables for valuing future or present interest are generally sustained for income, estate or gift tax purposes. In extraordinary situations, however, it is open to taxpayers to claim and sustain valuations based on actual facts. Thus, in *Hall Estate*⁴⁰ a reversionary interest for estate tax purposes was valued not on the basis of mortality tables, but on the actual physical condition of the decedent. In every case where the taxpayer seeks to avoid the use of the tables in the regulations, the burden is upon him to justify such avoidance.

For many years the Internal Revenue Service maintained an almost inflexible view that a taxpayer could validly elect the installment method of reporting gain only in the first possible income tax return *when it was filed*. This view has been materially shaken by two decisions⁴¹ which permitted the taxpayer in each instance to claim and obtain the benefit of the installment method at a later time when what he did or did not do at the time of filing the initial return was not inconsistent with an election to use the installment method. The Internal Revenue Service has announced that it will revise its regulations governing the election of the installment method for reporting gain,⁴² thus abandoning its heretofore strict view of the validity of an election to use the installment method.

Other interesting decisions involved nondeductibility of loss on sales between related persons in a family corporation⁴³, tax effects of reincorporation under Sections 337, 331, and 368(a) of the Internal Revenue Code,⁴⁴ duty of an attorney to disclose identity of person making a deposit on account of taxes,⁴⁵ taxability of excess value on gift of maturing endowment policy to charity,⁴⁶ nature of gain on sale of contract

40. *William S. Hall, et al. v. United States* (CA 7, 1965)—F. (2d)—, 65-2 USTC Par. 12,359; 16 AFTR (2d) 6206. See also *Estate of J. Tucker v. United States* (D.C. Tex. 1965)—F. Supp.—, 65-2 USTC Par. 12, 360, 16 AFTR (2d) 6199, for a similar departure from use of actuarial tables in valuing claim of divorced wife.

41. *Mamula v. Commissioner* (CA 9, 1965) 346 F. (2d) 1016 and *Bookwalter v. Mayer* (CA 8, 1965) 345 F. (2d) 476. In *Mamula* the taxpayer, in good faith, originally elected a method which was clearly nonallowable. In the *Mayer* case, the taxpayer, in good faith, did not report the sale in the year it was made because no payment was received in that year; later in a timely amended return for that year, the taxpayer claimed the installment method which claim was sustained by the Court of Appeals.

42. In TIR 756, 657 CCH Std. Fed. Tax Rep. Par. 6700 the Internal Revenue Service announced that pending issuance of revised regulations it would follow the *Mayer* and a number of other cases decided in 1962, 1963 and 1964 liberalizing the election of the installment method. See also *F. E. McGillick* 42 TC 1059 (1965)

43. *McCarthy v. Conley* (CA 2, 1965) 341 F. (2d) 948.

44. *Pridemark, Inc. v. Commissioner* (CA 4, 1965) 345 F. (2d) 35.

45. *Tillotson v. Boughner* (CA 7, 1965) 350 F. (2d) 663; *Schulze v. Rayunec* (CA 7, 1965) 350 F. (2d) 666.

46. *Friedman v. Commissioner* (CA 6, 1965) 346 F. (2d) 506.

rights including release of employment claims,⁴⁷ loss of good will and effect of expectation of recovery on year in which loss is deductible,⁴⁸ spin-offs,⁴⁹ necessity for definiteness in a deficiency notice under Section 269 of the Code,⁵⁰ and disallowance of depreciation for television network contracts.^{50a}

Tax Court

Some of the perennial troublesome tax problems incident to transfers of business from one corporate entity to another were given an airing in *Hyman N. Berghash*⁵¹. The taxpayer was sole owner of X Corporation stock engaged in the drug business. X sold certain of its operating assets to Y Corporation, the stock of which was owned equally by taxpayer and an unrelated investor. X was then liquidated and dissolved. The Tax Court held there was no reorganization either under Section 368(a)(1)-(D) or (F) of the Code; distributions to taxpayer did not constitute dividends and the gain realized by X was not taxable because of Section 337.

In *Ralph Bellamy*⁵² an attempted capital gain transaction on the sale of rights in television films was held to result in ordinary income.⁵³

The Tax Court considers⁵⁴ husband and wife who have filed a joint income tax return as separate taxpayers for purposes of sending out deficiency notice so that the Commissioner can either send a joint notice or separate notices. Thus, if the husband and wife are separated, the Commissioner is not precluded from accepting a waiver of restrictions from one spouse and sending a statutory notice of deficiency to the other.

The prolonged continuation of an estate can have some surprising tax effects. In *Old Virginia Brick Co.*,⁵⁵ an estate was kept in existence long beyond the time it had a *raison d'être* for being continued. The Tax Court held the executors were in fact trustees under a testamentary trust so that an election they made as stockholders of the taxpayer corporation to treat it as a Sub-chapter S corporation was invalid!

In *Hitchon Estate*⁵⁶ the principal stockholder of a family corporation

47. *Turzillo v. Commissioner* (CA 9, 1965) 346 F. (2d) 884.

48. *Parmelee Transportation Co. v. United States* (Ct. Cl. 1965) 351 F. (2d) 619.

49. *Lockwood v. Commissioner* (CA 8, 1965) 350 F. (2d) 712.

50. *Luke v. Commissioner* (CA 7, 1965) 351 F. (2d) 568.

50a. *Commissioner v. Indiana Broadcasting Corp.* (CA 7, 1965) 350 F. (2d) 580, cert. den. 86 S. Ct. 645.

51. 43 TC 743. See also *Frank Verito*, 43 TC 429 and *Guy A. VanHeusden* 44 TC 491.

52. 43 TC 487.

53. Cf. *Commissioner v. Ferrer* (CA 2) 304 F. (2d) 125.

54. *Marie A. Dolan* 44 TC 420.

55. 44 TC—#69.

56. 45 TC—#6

turned in nearly all of his stock to the corporation, receiving nothing in return. The other stockholders were his sons. Sometime after the transfer the corporation was liquidated. In determining the gain realized by the sons, the Tax Court held that although the gift was ostensibly to the corporation, the father actually made a gift to each of his sons so that the basis of stock originally owned by the sons should be increased by the transferor's basis of the stock turned in to the corporation. A most interesting dichotomy of form and substance!

How to arrive at the value of property for tax purposes has been and still is somewhat of a puzzle. In *Phillip Kaplan*⁵⁷, *Daniel McGuire*⁵⁸, and *Maurice Rivkin*⁵⁹, the Tax Court had to wrestle with what constitutes fair market value as affected by auction sale results⁶⁰. The opinions in the *Kaplan* and *McGuire* cases make for hilarious reading—a welcome respite from so many dull performances in tax opinions.

ADMINISTRATIVE DEVELOPMENTS

In Rev. Rul. 65-30⁶¹ the Internal Revenue Service has ruled that even though a corporation which is eligible to avail itself of the tax benefits under Section 337 fails to furnish the information required under the Regulations, the stockholders will not *ipso facto* be denied their benefits under such section.

In three revenue rulings⁶² the Service has set forth several examples of what do or do not constitute “rents” under Section 1372(e)(5) of the Code for Subchapter S purposes. The examples include (a) short-term leasing of motor vehicles, leasing of barricades during construction of motor carts, of dress suits, of construction crane, and (b) storage charges for grain, cotton, and refrigerated products.

A significant pronouncement appears in Rev. Rul. 65-192⁶³ concerning the guides to be followed in valuing closely held corporate stock for income, estate and gift tax purposes. In setting forth these guides the Service has explicitly stated that the “formula approach” which it adopted 45 years ago⁶⁴ has no application in determining fair market values of corporate stocks or business interests unless it was imperative to value intangible assets of the corporation or intangible assets included in the

57. 43 TC 663.

58. 44 TC—#75.

59. TC Memo.—1965-99.

60. “Auction Sales Price of Property”, Note, 23 *Journal of Taxation* 284 (1965); Note 51 *Cornell L.Q.* 613 (1966).

61. CB 1965-1, 155.

62. Rev. Rul. 65-40, CB 1965-1, 429; Rev. Rul. 65-83, CB 1965-1, 430; and Rev. Rul. 65-91, CB 1965-1, 431.

63. CB 1965-2.

64. ARM 34, CB 2, 31 (1920); ARM 68, CB 3, 43 (1920).

business interest. The ruling also extends the principles set forth in Rev. Rul. 59-60⁶⁵ for valuing closely held corporate stock for estate and gift tax purposes to income tax controversies. In so doing Rev. Rul. 65-192 may go a long way to harmonize what could be divergent and confusing criteria depending upon the tax involved.

An acquiescence by the Commissioner to an adverse decision of the Tax Court is a curious administrative phenomenon.⁶⁶ In Rev. Rul. 65-259⁶⁷ the Commissioner withdrew his acquiescence issued 21 years earlier in *Minnesota Mortuaries*.⁶⁸ Henceforth, rental income derived from a corporate lessee, anyone of whose shareholders (directly or indirectly) owns one-fourth or more in value of the stock of the lessor corporation, will be treated as income from the use of corporation property described in Section 543(a)(6) of the Code for personal holding company purposes. To protect taxpayers who relied on the acquiescence, Rev. Rul. 259 will be applied only to taxable years beginning July 1, 1965 and thereafter.⁶⁹

SPECIAL PROBLEMS

*Unreasonable Accumulations of Surplus*⁷⁰

In 1965 there was much litigation activity in this area, presumably because of the increased activity of the Service in asserting Section 531 liability. As usual the Commissioner has been sustained more often⁷¹ than

65. CB 1959-1, 237.

66. See Rogovin, "The Four R's: Regulations, Rulings, Reliance and Retroactivity", 43 TAXES 756. The Commissioner does not "acquiesce" or "non-acquiesce" to any decision of a District Court, Court of Appeals, Court of Claims, or Supreme Court. The practice of acquiescence or non-acquiescence started when the Board of Tax Appeals was created in 1924.

67. CB 1965-2.

68. 4 TC 280 (1944). The withdrawal was occasioned belatedly by 320 East 47th Street Corp. v. Commissioner (CA 2, 1957) 243 (2d) 894.

69. The question arises: if in 1957 the Court of Appeals correctly held such rental income to be income from use of corporate property, are not some taxpayers being given an exceptional "break" for the years 1957 to 1965?

70. See generally Nelson, "Recent Trends Regarding Unreasonable Accumulations of Surplus", 43 TAXES 857 (1965).

71. See, e.g., *Motor Fuel Carriers, Inc. v. United States* (D.C. Fla., 1965) 244 F. Supp. 380; *Fenco, Inc. v. United States* (CA 4, 1965) 348 F. (2d) 456; *Young Motor Co., Inc. v. Commissioner* (CA 1, 1965) 339 F. (2d) 481; *United States v. McNally Pittsburgh Mfg. Corp.* (CA 10, 1965) 342 F. (2d) 198; *Carlen Realty Co. v. Tomlinson* (CA 5, 1965) 345 F. (2d) 998; *Havens & Martin v. United States* (D.C. Va., 1965) 15 AFTR (2d) 1140, 65-1 USTC par. 9417; *Dickman Lumber Company v. United States* (D.C. Wash.) 15 AFTR (2d) 027, 65-1 USTC par. 9133; *Ted Bates, Inc.* TCM 1965-251; *Perfection Foods, Inc.*, TCM 1965-15; *Bardahl Mfg. Corp.*, TCM 1965-200; *Otmar Realty Estate Corp.*, TCM 1965-189; *Charles Turner*, TCM 1965-101, *Sears Oil Co.*, TCM 1965-39; *Apollo Industries, Inc.*, 44 TC 1; *Goodall Estate*, TCM 1965-154.

not⁷² because of the generality and vagueness in the reasons and justification given by many taxpayers for not distributing dividends. Thus, taxpayers generally fail in their proof of the reasonableness of their needs.

In *Viona-Lione*⁷³ the Tax Court stated that where the accumulation is not unreasonable the burden is still on the corporation to establish that there was no avoidance of income tax on shareholders but such fact "is repugnant to the existence of a purpose to avoid tax and, although not conclusive, is substantial evidence that such a purpose did not exist". Yet in *Scripps Newspapers*⁷⁴ where the accumulated earnings were not unreasonable there was no need to determine whether the corporation was "availed of" to avoid tax on shareholders because of the credit under Section 535(c) (1). And in *Bremerton Sun Publishing Co.*⁷⁵ where there was an unreasonable accumulation there was proof that the corporation was not availed of to avoid tax.⁷⁶

*Net Operating Loss Carryovers*⁷⁷

Net operating loss carryovers were considered in several decisions and in a statement of policy by the Internal Revenue Service. In three decisions involving pre-1954 losses the taxpayers were unsuccessful. In *Allied Central Stores*⁷⁸ the taxpayer was a constituent corporation in a pre-June 22, 1954 merger. It was denied a carryover of pre-merger losses (even though the merger occurred in a fiscal year ended January 31, 1954) to post-merger 1955 and 1957 income. In *Fawick Corporation*⁷⁹ and *Foremost Dairies*⁸⁰ taxpayers were denied carryover losses under the 1939 Code because the losses were being offset against a business activity different from that which gave rise to the loss.⁸¹ In *H. F. Ramsey*⁸² the Tax Court held that a change in ownership did not preclude a carryover of loss under Section 382 of the 1954 Code but applied Section 269 of the

72. See, e.g., *Viona-Lione, Inc.*, TCM 1965-96; *Bremerton Sun Publishing Co.*, 44 TC 566; *Carolina Rubber Hose Corp.*, TCM 1965-229; *Donruss Co. v. United States* (D.C. Tenn., 1965) 15 AFTR (2d) 896, 65-1 USTC par. 9292; *Scripps Newspapers*, 44 TC 453; *Freedom Newspapers*, TCM 1965-248; *Oman Construction Co.*, TCM 1965-325.

73. TCM 1965-96.

74. 44 TC 453.

75. 44 TC 566.

76. Contra, *Bardahl Mfg. Corp.*, supra, *Charles Turner*, supra.

77. See Wimmer, "Operating Loss Carryovers: Recent Developments", 43 TAXES 869 (1965).

78. *Allied Central Stores, Inc. v. Commissioner* (CA 2, 1965) 339 F. (2d) 503.

79. *Fawick Corporation v. Commissioner* (CA 6, 1965) 342 F. (2d) 823.

80. *Foremost Dairies, Inc. v. Commissioner* (CA 5, 1965) 341 F. (2d) 580.

81. *Libson Shops v. Koehler*, 353 US 382 (1957).

82. *H. F. Ramsey, Inc.*, 43 TC 500.

1954 Code to bar the deduction because there was a patent purpose to avoid tax by the shift of control.

The decision which has created a stir is *Maxwell Hardware*.⁸³ Taxpayer corporation suffered substantial losses in the hardware business. It entered into an arrangement with two partners (engaged in the real estate business) to develop a sub-division. Thereafter the hardware business was discontinued. The partners furnished funds through the purchase of nonvoting preferred stock equivalent to 40% of the value of the common stock. Reversing the Tax Court⁸⁴ the Court of Appeals for the Ninth Circuit permitted the hardware losses to be offset against the profits of the subdivision activity. The Court held that Sections 269, 482, and 382(a) of the 1954 Code were not bars to the allowance. And in an unequivocal statement the Court said "*Libson Shops*, decided under the 1939 Act, is no longer law. It has been superseded by the 1954 Internal Revenue Code which, in Section 382, dealt specifically and differently with the concept of continuity of business enterprise upon which the *Libson Shops* decision was based."

How does the Internal Revenue Service react to the *Maxwell Hardware* decision? On October 13, 1965, the Service replied⁸⁵ in part as follows:

"It is the position of the Revenue Service that in cases similar to *Maxwell Hardware*, Sections 269 and 382, as well as Section 482, are applicable in dealing with the carryover of losses. The Revenue Service believes that the foregoing statutory provisions must be construed to effectuate congressional intent in combating 'trafficking in loss carryovers'. Moreover, the Service also believes that the loss carryover in cases similar to *Maxwell Hardware* should be denied under the rationale of the *Libson Shops* decision since to permit a loss carryover in such cases would run counter to the legislative objectives of the carryover privilege.

"The cornerstone of the *Libson Shops* decision was a searching examination of the purposes of the carryover privilege * * * this * * * analysis was not made obsolete by the enactment in 1954 of provisions limiting or denying loss carryovers in certain situations involving abuses that were specifically brought to the attention of Congress. It is the view of the Service that the basic approach of

83. *Maxwell Hardware Company v. Commissioner* (CA 9, 1965) 343 F. (2d) 713. For a trenchant critique, see Comment, "The Loss Carryover Deduction and Changes in Corporate Structure", 66 *Col. L.R.* 338 (1966).

84. 41 TC 386.

85. TIR 773, 657 CCH Std. Fed. Tax Reports par. 675.

the Supreme Court in *Libson Shops* retains vitality under the 1954 Code in interpreting the application of Section 172.”⁸⁶

The Revenue Service thus appears to be “fighting mad” about the Maxwell Hardware decision and bids fair to continue to maintain the vitality of *Libson Shops* for some time to come.⁸⁷

86. The release also announced that the Service would “apply *Libson Shops* in any loss carryover case under the 1954 Code, not contemplated by the announcement in Revenue Ruling 58-603, CB 1958-2, 147, where there has been both a 50 percent or more shift in the benefits of a loss carryover (whether direct or indirect and including transactions having the effect of shifting the benefit of the loss by shifting assets, stock, profit interests or other valuable rights) and a change in business as defined in section 382(a) and the regulations thereunder. The Service will not rely on *Libson Shops* under the 1954 Code in any loss carryover case where there has been less than a 50 percent change in the beneficial ownership of the loss or where there has been no change in business as defined in section 382(a) and the regulations thereunder. However, the Service will continue to rely on sections 269 and 482, where appropriate, in dealing with the carryover of losses. Revenue Ruling 63-40, C. B. 1963-1, 46 will be modified to the extent inconsistent herewith.

“The Revenue Service stated that certiorari was not requested in *Maxwell Hardware* due to the absence of a direct conflict between the circuits. The decision will not be followed as a precedent in the disposition of similar cases.”

87. Scheff, Comment on TIR 773, 23 *Journal of Taxation* 326 (1965).