Case and Ruling Comments on the 1964 Federal Tax Cases and Rulings

William P. Oberndorfer

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Case and Ruling Comments on the 1964 Federal Tax Cases and Rulings*

WILLIAM P. OBERNDORFER
Attorney, Norfolk, Virginia

Member of the firm of Kaufman, Oberndorfer, Spainhour and Hall

DEATH AND WORSE

We will start, by considering a clause in a will, that has been drawn to utilize the marital deduction benefits of section 2056.¹ The clause establishes a pecuniary bequest (either fixed or formula) to the deceased's widow under which the executor (1) is authorized or directed to satisfy the bequest in kind and (2) is directed to make any distribution at Federal estate tax values. To illustrate, suppose the widow is entitled to a bequest equal to $250,000, and there are only two assets in the estate, each having a Federal estate tax value of $250,000. Two years after death, when the distribution to the widow is made, asset A is still worth $250,000, but asset B has depreciated to a value of $100,000. As stated, the executor has the power to distribute asset B to the widow and, theoretically, to claim a $250,000 marital deduction. Revenue Procedure 64-19,² which is required study for every lawyer, states that, in the foregoing situation, the IRS will not allow the marital deduction. Where a will is executed prior to October 1, 1964 it may not have to be redrafted—due to a savings provision. However, wills drafted after October 1, 1964 must meet one of the two tests prescribed in Revenue Procedure 64-19.

Section 2056(b)(5),³ allows the marital deduction for life estates, whether or not in trust if, among other things, the surviving spouse is entitled for life to all the income from the entire interest (or all the income from a specific portion thereof), payable at least annually, with power in the surviving spouse to appoint the entire interest, or such specific portion in favor of herself or her estate. The power must be exercisable in all events.

In viewing the 1964 cases, it appears that a great deal of uncertainty still exists, as to the correct method of drafting a marital trust to achieve

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*This section of the Tax Conference Record has been included in the William and Mary Law Review, Vol. 6, beginning at page 203, as a convenience to readers of this Review.

2. REV. RUL. 64-15, 1964 INT. REV. BULL. No. 30. Due to a time limitation, Mr. Oberndorfer could not give a more detailed discussion of Revenue Procedure 64-19.
3. CODE § 2056 (b) (5).
maximum tax benefits under the present Code and regulations. Thus, in *Pierpont*, where the bequest was undeniably intended to qualify for the marital deduction, a trust remainder was to go “in such manner and proportions as my . . . wife may designate and appoint.” The Fourth Circuit, construing Maryland law and ignoring a non-adversary decision of a Maryland court, found that the widow lacked the power to appoint to her estate, and denied the marital deduction.

To the same effect is *Stedman*, where a widow’s uncontrolled discretion to invade trust principal for her comfort and maintenance did not suffice; under Massachusetts law her power to invade was contingent on a good faith determination that principal was needed and, therefore, her power was not “exercisable in all events.” I assume Virginia will follow this Massachusetts case. Notwithstanding the loss of the marital deduction, when Mrs. Stedman dies, the property in her husband’s estate which is subject to her power of appointment may be taxed in her estate. Under Section 2041, she has a taxable general power of appointment. Her power to invade for her “comfort” is too broad—the power is not limited by an ascertainable standard relating to her health, education, support or maintenance. In *A. Strite Exr. v. McGinnes* the power was held taxable despite state law imposing a standard of good faith.

In another recent case, it was held that the commuted value of the dower right of a widow under Virginia law qualified for the marital deduction.

Now, let us turn our attention to a situation in which a testator has left his widow the residue of his estate, that equals 50% (of the gross estate) before deductions. In making this computation, a recent decision held that you must include assets passing outside the will. Thus, a larger marital deduction was allowed under this view.

The Third Circuit recently held in *Estate of M. L. Noel v. Commissioner*, that the proceeds of a flight insurance policy, that was purchased and owned by the beneficiary widow, were not includible in the gross estate of the deceased husband under Section 2042. Query as to the effect of the *Noel* decision on an ordinary life policy with a double indemnity benefit. Query whether flight insurance is protected from income taxation.

4. 64-2 USTC CCH ¶ 12,262 (4th Cir. 1964).
7. 330 F. 2d 234 (3rd Cir. 1964).
8. 64-2 USTC CCH ¶ 12,255 (4th Cir. 1964).
10. 322 F. 2d 950 (3rd Cir. 1964).
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REAL ESTATE AND RELATED AREAS

When property is involuntarily converted and replaced, the replacement property must be "similar or related in service or use" to avoid gain on the involuntary conversion. For some time IRS insisted that the replacement property must have a close "functional" similarity to the property converted; the end uses must be similar. If an investor, such as a lessor, owned a commercial building which he leased to a mercantile establishment, he would have to replace it with a similar type building which could also be leased to a mercantile establishment. Merely replacing it with property from which he could derive rental income would not suffice. The appellate courts had held contrary to IRS, and finally, in Revenue Ruling 64-237 the IRS adopted a position in accord with the courts. Henceforth, the important factor will be the similarity of the services or uses which the original and replacement properties have to the particular taxpayer.

In Sexton, the taxpayer was allowed to depreciate land on which he operated a garbage dump. He made an excavation and estimated the value of the land when ultimately filled. Depreciation was allowed on the investment of the empty space, based upon the quantity exhausted by the filling with garbage each year. The five dissenting Tax Court judges were unwilling to depreciate the elimination of air from a hole in the ground.

One of the year's most stirring developments was the Tax Court's limiting of the now-famous Cohn rule. For background, suppose you owned a building or other depreciable property costing you $100,000. The useful life is 25 years, and you estimated no salvage value. You held the building for 15 years, taking $60,000 depreciation, leaving you with an adjusted basis of $40,000. You then took a half year's depreciation of $2,000. Under the Cohn case, decided in 1958, the depreciation would be disallowed. The Sixth Circuit held that the sales price ($40,000 in our hypothetical case) is the actual salvage value of the property sold, and in the year of sale, a taxpayer cannot depreciate his property to a point where its adjusted basis (also $40,000 in our hypothetical case) will go below its salvage value.

In McCabe Co., the Tax Court held contra. An office building was

12. Id., § 1033(a).
sold at a price in excess of its depreciated basis. Depreciation was allowed for the year of sale. The building was sold substantially prior to the expiration of its useful life, and the Tax Court held that the amount received did not constitute or otherwise determine salvage value. The IRS failed to take into account the distinction between the concept of depreciation, or the gradual exhaustion of property, and the concept of appreciation or the increase in value as a result of changes in market conditions. The property had simply appreciated in value. The sales price reflected the market value of the property, but this had no relation to its salvage value. Section 1250, the post-1963 depreciation recapture section, does not emasculate these decisions, and the dispute might well end in the Supreme Court.

In *Glienke v. U.S.* and *Voss v. U.S.* taxpayers were allowed capital gains treatment on the sales of subdivided real estate. In each case, the land had been placed in the hands of a real estate agent who completely controlled the development and sale. He subdivided, hired attorneys and set the sales prices. The owners knew nothing about developing land, and neither exercised nor attempted to exercise any control over the projects. The real estate agent was not acting as an agent of the owners, but for his own account, as an independent contractor.

However, in *W. E. Anderson*, a farmer who had purchased farm land and sold it as acreage to a developer, was held to realize ordinary income. The facts here were against the taxpayer. He acquired the farm with the intent of developing it and financed costs, such as sewers and utilities, prior to conveying to the developer.

Section 453(b) permits income from the sale of real property to be computed on the installment basis, subject to the regulations. The regulations merely state that the taxpayer must elect the installment basis on the return for the year in which the sale occurred. Recent decisions supported the thesis that the election need not necessarily be made on a timely filed return. In *C’de Baca*, the taxpayer successfully elected on a return filed late due to his negligence; in *McGillick Co.*, the return was filed late because the taxpayer erroneously believed he did not have to file one; and in *Reaver*, the taxpayer successfully elected on an amended return after failing to do so on the original one. However, in *Peter Mamula*, the taxpayer reported a gain from the sale of real property at a price in excess of its depreciated basis. Depreciation was allowed for the year of sale. The building was sold substantially prior to the expiration of its useful life, and the Tax Court held that the amount received did not constitute or otherwise determine salvage value. The IRS failed to take into account the distinction between the concept of depreciation, or the gradual exhaustion of property, and the concept of appreciation or the increase in value as a result of changes in market conditions. The property had simply appreciated in value. The sales price reflected the market value of the property, but this had no relation to its salvage value. Section 1250, the post-1963 depreciation recapture section, does not emasculate these decisions, and the dispute might well end in the Supreme Court.

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estate on the deferred payment method. This method was found improper and taxpayer then sought to use the installment method. He lost on the ground that he elected a method of reporting inconsistent with the installment method, and he did not state in his return, as required by the regulations, that his computation of income was being reported on the installment method.

In *Hindes v. U.S.*, the taxpayers created a dummy corporation to which they sold a ranch on the installment basis. The corporation sold the ranch for cash. Taxpayers were denied the use of the installment sales basis on the ground that the corporation was a mere conduit and the sale was direct to the purchaser.

In Revenue Ruling 64-205, taxpayers were allowed a contribution deduction of the fair market value of a restrictive easement on their property. They deeded the easement to the U.S., to enable the government to preserve a scenic view afforded certain public properties. The basis of the remaining property was required to be reduced by the part of the total basis allowable to the easement.

Section 337, provides that if a corporation adopts a plan of complete liquidation, and within the 12-month period beginning on the date of the adoption of the plan, the corporation is completely liquidated, no gain is recognized by the corporation from the sale or exchange of property within the 12-month period. This section is frequently used by real estate corporations.

Suppose property is destroyed by a fire, and insurance proceeds are received. Revenue Ruling 64-100, revoking an earlier ruling, holds that for purposes of section 337, the involuntary conversion constitutes a sale or exchange. At first blush the ruling seems liberal, but it really is not. To qualify under the ruling, the plan of liquidation must be adopted before the fire occurs. Accordingly, the benefits of the ruling will be confined to the more “arson-minded” taxpayer. Others, such as *Keller & Goetz, Inc.*, will be “burned.” In that case, the District Court held, that a gain on the condemnation of real estate was realized in 1955 when the property was condemned, rather than in 1957 when the award was paid. Since the taxpayer had no opportunity to adopt a plan of liquidation before condemnation, the conditions of section 337 could not be met.

When must a plan of liquidation be adopted? Obviously, it is not desirable to adopt a plan before the sales contract is executed, because the contract may never be executed. On the other hand, if the plan is adopted after the contract is executed, the IRS might contend that the

27. 326 F. 2d 150 (5th Cir. 1964).
28. INT. REV. BULL. 64-30, 6.
29. CODE § 337.
30. INT. REV. BULL. 64-13, 8.
31. 64-2 USTC CCH ¶ 9797 (D. N.Y. 1964).
contract is one of sale rather than one to sell and that the sale was made prior to the adoption of the plan.

In Alameda Realty Corp., the stockholders, husband and wife, negotiated unsuccessfully for the sale of their stock. They then caused the corporation to execute a contract. The contract was apparently in the customary form. At all times, on and before the contract date, the stockholders intended to terminate the corporation's activities and distribute the sales proceeds to themselves, but no written or formal plan of liquidation was adopted. The Tax Court held that the facts showed such a plan existed, and therefore section 337 was applicable.

In Jeanese, Inc. v. U.S., the taxpayer could not avail itself of section 337 because the real estate involved constituted inventory that was not sold to one person in one transaction. The California District Court described the contract as one to sell and not a contract of sale. The buyer had not paid the per lot cash price, had not obtained a construction loan, and did not have a purchase-money note and deed of trust. This case could actually help a taxpayer, who adopted his plan after signing such a contract.

More a real estate than a corporate case is Commissioner v. Zongker. A corporation purchased 100 acres, intending to sell 474 lots and retain 16 acres for commercial development. After it sold 200 lots and realized 34% of the anticipated income, the stockholders sold their stock to the same group of purchasers. It was held that the corporation had realized "a substantial part of the taxable income to be derived" from the property and therefore did not meet the definition of a collapsible corporation. The term "substantial part", as used in section 341, relates to the income realized prior to the sale, rather than to the amount of income that remains to be realized.

Corporations

Under section 351, no gain or loss is recognized, if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange, such person or persons are in control of the corporation (own at least 80% of the stock). Revenue Ruling 64-56 states that technical "know-how" falls within the definition of "property" which can be transferred under section 351. Ancillary and subsidiary services may be performed in connection with the transfer.

32. 42 T.C. No. 21 (May 1964).
34. 334 F. 2d 44 (10th Cir. 1964).
35. Code § 341.
36. Id., § 351.
In *Estate of Heinz Schmidt,* a taxpayer incorporated his proprietorship under section 351. The Tax Court required him to include, in his personal income, the balance in his reserve account for bad debts. Since there was no longer a need for the reserve, the amount therein had to be restored to income. This was not tantamount to taxing the gain on the transfer of assets, protected by section 351, but was considered merely a restoration to income under a system of accounting.

In cases where section 351 is inapplicable, or where it is applicable but part of the gain realized is also recognized, the taxpayer must be aware of section 1239. Under the latter section, where there is a sale of depreciable property between a corporation and an individual who owns more than 80% of the stock in the corporation, the gain is taxed as ordinary income.

In *Harry Trotz,* the taxpayer sold his construction business assets, to a new corporation in which he owned only 79% of the stock. The other 21% was owned by an employee, to whom Trotz had advanced the purchase price, and in turn, the employee pledged his stock to Trotz and gave Trotz an option to buy it at book value. The Tax Court held that Trotz had virtually complete control, and for tax purposes, was the owner of more than 80% of the stock. Accordingly, the gain on the depreciable assets was taxed as ordinary income.

A number of loss corporation cases were decided, mostly adverse to the taxpayers. Usually, they involved factual issues under section 269, which disallows the loss carryover if the principal purpose in the acquisition of the loss corporation is the avoidance of the Federal income tax laws. Typical of such cases, but not otherwise significant, was *Herbert Luke.*

In *Euclid-Tennessee, Inc.* the Tax Court did not have to decide the section 269 issue. It denied a loss carryover because, after the merger, the taxpayer did not meet the requirement prescribed by section 382 of carrying on substantially the same trade or business that generated the loss. The losses were incurred in a beer business, which had been abandoned for 2½ years, during which time, the taxpayer did nothing except rent the real estate used in the beer business. The taxpayer had been formed for the purpose of dealing in beer, not real estate. To the same general effect is *Frederick Steel Co.,* also involving beer.

Reversing the Tax Court in an important decision, the Sixth Circuit,

38. 42 T.C. No. 90 (Sept. 1964).
40. 43 T.C. No. 13 (Nov. 1964).
41. Code §269.
43. 41 T.C. No. 74 (March 1964).
44. Code §382.
in *Zanesville Investment Co.*, held that section 269 did not bar the netting, on consolidated returns, of post-acquisition losses of one corporation against post-acquisition income of another. Section 269 was intended to bar the use of someone else's loss or a built-in but unrealized loss, that is, a loss economically accrued prior to the affiliation. Section 269 was not designed to prevent the use of actual cash losses incurred both economically and tax-wise after the affiliation.

Under section 302, the redemption of a taxpayer's stock in a corporation is, under some circumstances, treated as a dividend from the corporation to the shareholders, while under other circumstances, the shareholder derives a capital gain or possibly no gain. Dividend treatment is avoided, if the taxpayer’s entire interest in the corporation is terminated by the redemption. For the purpose of determining whether the taxpayer's entire interest has been redeemed, stock owned by certain members of his family may be deemed constructively owned by, or attributed to, the taxpayer. The family attribution rules, do not apply if the taxpayer does not acquire an interest in the corporation for 10 years and agrees to notify the Commissioner if he does. In *Pearce v. U.S.*, the taxpayer was allowed capital gains treatment on a stock redemption, even though the taxpayer inadvertently failed to file the agreement until his return was audited. Dividend treatment under section 302 may be avoided if the facts are such that the distribution by the corporation is not essentially equivalent to a dividend. In *Boyd v. U.S.*, a jury found for the taxpayer on this issue. This case contains exhaustive instructions which may serve as models.

In *The Humacid Company*, the taxpayer held corporate notes which he gave to a charity after they had appreciated in value. The corporation then bought the notes from the charity. The Tax Court, permitted the taxpayer a charitable contribution deduction for the value of the notes and refused to tax him on income from the bail-out by the corporation from the charity, even though he contemplated it at the time of the contribution. However, the same taxpayer was taxed on the income derived from a similar bail-out of other notes, which he sold to a third party who was held to be a mere conduit.

In *Commissioner v. Brown*, the taxpayer instead of giving his stock to charity, sold it to a charity on the installment basis, taking a note for the sale price. Based upon a complex, carefully planned scheme, the purchase price was to be paid solely out of 90% of the earnings of the business. The taxpayer and other employees continued in the em-

46. 64-2 USTC CCH ¶ 9700 (6th Cir. 1964).
47. Code § 302.
49. 64-2 USTC CCH ¶ 9651 (D. N.J. 1964).
ploy of the business at their former salaries. Contrary to the Commissioner’s contention that there really was not a sale, the Ninth Circuit held, that the sale was genuine and that the taxpayer realized capital gains on the installment basis.

Holding invalid the Commissioner’s regulations to the contrary, the Coady case in 1961, and the Marett case in 1963, held that section 355 applies to a spin-off division of a single business. Its benefits are not confined to the spin-off of one of two separate and distinct businesses. In Revenue Ruling 64-147, the IRS ruled that it would follow these decisions and that it was considering a modification of the regulations. But the TIR was issued after Patricia W. Burke was tried and briefed, but before decision by the Tax Court. Following issuance of the TIR, the taxpayer and Regional Counsel brought the ruling to the attention of the Tax Court Judge and the case was submitted only for a factual determination of whether a branch was a separate business, and if so, whether there was a valid business reason for separation.

Section 355 applies only if the spin-off business has been actively conducted throughout a 5-year period, ending on the date of the distribution of the stock. In the last mentioned case—the Burke case—the stock of a subsidiary, operating a branch in a different city from the parent, was distributed to the stockholders of the parent. At that time the subsidiary had been incorporated only for a year. But prior to incorporation, the branch store operated as an unincorporated branch for 2 years, and prior to that, a salesman operated in the City. Favoring the taxpayer, the Tax Court computed the 5 years by tacking all three periods together.

Similarly, in W. E. Gabriel Fabrication Co., it was held that the time during which a predecessor proprietorship operated a business counted toward the 5-year period. As long as the business had been operated 5 years prior to the stock distribution, it did not have to be operated that length of time by either the distributing corporation or the controlled corporation.

A problem is presented in a parent-subsidiary situation, in which the subsidiary is managed by the owners of ½ of the stock of the parent and the parent desires to distribute all of its stock in the subsidiary to its managers, thereby resolving a disagreement in management policy. However, the stock of the subsidiary is not as valuable as the ½ stock of the parent owned by the subsidiary’s managers. Accordingly, in order to equalize the values prior to the distribution, the parent contributes

52. 289 F. 2d 490 (6th Cir. 1961).
53. 325 F. 2d 29 (5th Cir. 1963).
56. 42 T.C. No. 81 (Sept. 1964).
57. 42 T.C. No. 53 (July 1964).
cash to the capital of the subsidiary, thereby making the subsidiary's stock more valuable. This procedure was approved in Revenue Ruling 64-102. It was not prohibited by section 355 as a device for the distribution of earnings, because if it had been taxable, it would have been taxable, not as a dividend, but as a capital gain on the complete termination of an interest under section 302.

As the sole stockholder of a corporation having large accumulated earnings, you completely liquidate the corporation, thereby receiving not only the accumulated earnings but also the operating assets. You then form a new corporation to which you transfer the operating assets, and continue on your "Merry" way. You assume that you will derive a long-term capital gain on the liquidation, thereby avoiding the necessity of "pocketing" your earnings through the dividend route. You've assumed incorrectly. This one-time favorite device has been rather effectively resisted by the Commissioner.

The Commissioner has usually relied on Sections 368, 354, and 356 to spell out a "D" reorganization accompanied by a distribution of cash "boot" which is taxable as an ordinary dividend. Taxpayers have sought to avoid those sections on various theories, one of which is that they are inapplicable unless "substantially all" the assets are transferred to the new corporation. In John C. Moffatt, the Tax Court held that the assets need not be limited to those shown on the transferor's balance sheet, and that the most valuable asset of an engineering consulting firm was its staff of trained personnel, all of whom joined the new corporation. In Pridemark, Inc., for want of a better theory, the Tax Court held, that instead of a complete liquidation, there was an "F" reorganization which is defined as "a mere change in the identity, form or place of organization."

Under Subchapter S of the Internal Revenue Code, a so-called small business corporation may elect not to be taxed as a corporation. Instead it will be taxed under special rules resembling those applicable to partnerships. Among numerous limitations are those that the electing corporation cannot have more than one class of stock, and that the election will be terminated if the corporation has gross receipts, more than 20% of which, is derived from rents.

In Catalina Homes, Inc. stockholder advances were held to be a

59. Code § 368.
60. Id., § 354.
61. Id., § 356.
62. 42 T.C. No. 56 (July 1964).
63. 42 T.C. No. 50 (July 1964).
64. Code § 368(a) (1) (F).
65. Code § 1371 et seq.
second class of stock, thereby causing the taxpayer corporation to be disqualified under Subchapter S. The decision itself is not particularly troublesome except in this respect: It is generally desirable to distribute all the income of a Subchapter S corporation to its stockholders. However, if the corporation needs money for use in its business the stockholders may want to lend the income back to the corporation. Query, whether such loans will be treated as a second class of stock under the Catalina case? On a more liberal note, is Revenue Ruling 64-232,6 that allowed Subchapter S status to a corporation which leased items of personal property, and, in connection therewith, provided delivery, pickup, cleaning, repairing and storing services. The amounts received were not deemed to be rents.

Under Revenue Ruling 64-279,68 the Internal Revenue Service will consider requests for advance rulings relating to deferred compensation arrangements. Perhaps the best way to provide for widows of deceased corporate officers is through such an arrangement. In Loewy Drug Company,69 Interstate Drop Forge Co.,70 and in Schner-Block Co.,71 corporations were denied deductions for payments to widows. The payments were ordinary but not necessary. They were not prompted by business considerations; no benefit to the respective corporations was derived; no contention was made that the payments represented additional compensation for past services; and they were not made pursuant to a contract. In deciding how much compensation is to be paid for the services of our hypothetical executive, we may find that the amount of time he devoted to the business is not too relevant. In the interesting McWane72 case, the Fifth Circuit stated that it was well accepted in the business world, that an executive’s salary is not dependent upon the amount of time spent on the job. He may do some of his most creative work while relaxing at home.

In the Electric Regulator73 case, reversing the Tax Court, the Court of Appeals for the Second Circuit held, that the corporation was not liable under Section 531 et seq for the accumulated earnings penalty tax. Procedurally and substantively, both the Tax Court and the Court of Appeals decisions are required reading. The taxpayer won despite large cash balances and increased surpluses. According to the Court of Appeals, the Tax Court completely disregarded the basic proposition that, to the extent surplus has been translated into plant expansion, increased receivables, large inventories and other assets relating to its business, a

69. 64-2 USTC CCH ¶ 9718 (7th Cir. 1964).  
70. 64-1 USTC CCH ¶ 9182 (7th Cir. 1964).  
71. 329 F. 2d 875 (2nd Cir. 1964).  
72. 331 F. 2d 921 (5th Cir. 1964).  
73. 336 F. 2nd 339 (2nd Cir. 1964).
corporation may accumulate surplus with impunity. The earnings which had been converted into bricks, mortar, machinery, equipment and inventory were scarcely available for current expenses or expansion. The cash balances had to be reduced by all the current liabilities and, contrary to the commissioner's contention, could not be paid as dividends.

In Luhring Motor Co.,74 and in Gunderson Brothers Engineering Corp.,75 the taxpayers sold vehicles on a deferred payment basis, adding finance charges to the cash selling price. Instead of accruing the finance charges as income along with the accrual of the selling price, they accrued the finance charges monthly as the installments were collected. The Tax Court held this method to be correct under section 446.76 The finance charges being earned only over the lives of the contracts. The automobile dealer reserve cases and the prepaid income cases, all adverse to the taxpayers, were distinguished. In the Luhring case, even though there was no express provision in the contracts for the abatement of finance charges, the evidence made it clear that it was the taxpayer's custom, as well as that of other dealers in the Tidewater area, to abate unpaid finance charges in the event of contract cancellation or termination.

We therefore see that the 1964 decisions and rulings, while consistent with previous findings do provide us with substantial precedents.

74. 42 T.C. No. 53 (July 1964).
75. 42 T.C. No. 38 (June 1964).
76. Code § 446.