Review of Recent Tax Decisions

Lewis D. Spencer
Member, Indiana Bar

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One of the greatest problems of the present day practitioner in the field of Federal taxation is keeping up with the great number of decisions and rulings handed down by the courts and the Bureau of Internal Revenue. Each week the Tax Court, the numerous Federal district courts, the Court of Claims, the circuit courts of appeal and the Supreme Court of the United States are handing down decisions which have an important effect on various tax questions; each week the different units of the Bureau of Internal Revenue are issuing rulings and regulations which have a direct bearing on tax problems. An idea of the vast number of tax cases decided each year in the United States may be obtained from an examination of the work of the Tax Court. During the nine month period from July, 1942, to March, 1943, the Judges of the Court held 1,901 hearings and disposed of 1,022 cases by decisions. During that same period petitions for review of the decision of the Tax Court by a circuit court of appeals were filed in 34.4% of the decided cases. With the courts handling such a large number of tax cases, many of which involve more than one issue, it is not surprising that keeping up with current developments nearly exhausts the endurance of the most seasoned Federal tax attorney.

In view of the size of the task involved in keeping up with current developments in the field of Federal taxation a lawyer may well pause to wonder why he should attempt to follow all the new decisions and rulings. Is the result worth the effort? The most obvious need for following new developments is found in connection with proceedings before the Bureau of Internal Revenue and cases in the courts. Also it is important to be up to date on tax matters when filling out income tax returns; otherwise items may be erroneously included as income and important deductions and credits may be lost to the client. Another reason for watching the changing tax scene closely is to find points upon which clients may obtain refunds. Finally in planning various transactions such as business deals, divorces and the like it is important to know the areas of uncertainty in the

* Of the Indiana Bar.
tax law and to steer clear of them. All of these very desirable ends require that the present day attorney be well informed on recent tax decisions.

In the time that we have in this meeting today it is obviously impossible to examine in detail all of the recent tax cases. I have selected a few for our discussion, which to me seem interesting and important. Perhaps some of you will have others which you will want to present for our consideration before the hour is over.

No review of recent tax decisions would be complete without an examination of the cases decided by the United States Supreme Court during the past year. In its 1943-1944 term the Supreme Court handed down sixteen opinions and one per curiam order involving the Federal revenue law. This year was no different from prior years in that most of the decisions were against the taxpayer. Thirteen of the cases decided by opinion during the term favored the Government.

The first case that I would like to bring to your attention today is one of the three cases decided in favor of the taxpayer, namely Commissioner v. Heininger. The question in that case was whether the taxpayer was entitled in his Federal income tax return to deduct lawyer's fees and related legal expenses as ordinary and necessary expenses incurred in carrying on his business. The facts in the Heininger case were briefly as follows: Taxpayer was a licensed dentist of Chicago, Illinois, engaged in making and selling false teeth. His was a mail order business. His products were ordered, delivered, and paid for by mail, and circulars and advertisements sent through the mail proclaimed the virtues of his goods in lavish terms. The Postmaster General found that some of the statements made in taxpayer's advertisements were misleading and issued a fraud order which prevented taxpayer from using the mails. The taxpayer contested this order in the courts but the Circuit Court of Appeals eventually sustained the Postmaster General and the Supreme Court denied certiorari. During the course of those proceedings taxpayer spent some $36,000 for lawyer's fees and other legal expenses. In his income tax returns he claimed a deduction for these litigation expenses,

which deduction was denied by the Commissioner. In order to obtain the deduction it was necessary for the taxpayer to show three things:

(1) that the expenses were directly connected with "carrying on" his business;
(2) that they were "ordinary" expenses; and
(3) that they were "necessary" expenses.

There was no doubt that the expenses were directly connected with taxpayer's business. On the remaining two points, however, the Government argued that dentists in the mail order business do not ordinarily and necessarily attempt to sell false teeth by fraudulent representations as to their quality; that the taxpayer was found by the Postmaster General to have attempted to sell his products in this manner; and that therefore the litigation expenses which he would not have incurred but for this attempt, cannot themselves be deemed ordinary and necessary. The Court, however, took the view that when taxpayer employed a lawyer to defend his business from threatened destruction, it was the response ordinarily to be expected and that the expenses incurred in defending the business were appropriate and helpful and therefore "necessary." It accordingly held that the taxpayer's legal expenses in contesting the fraud order of the Postmaster General were deductible as ordinary and necessary business expenses under Section 23(a). If the Court had decided in favor of the Government it is possible that the Commissioner would have been able to disallow a deduction for legal expenses incurred by any company which was unsuccessful in defending a suit against the Government. For this reason it seems to me that this case is particularly important.

In determining the deductibility of legal fees and similar expenses it is also necessary to consider the new section added by the Revenue Act of 1942.\(^2\) Section 23(a)(2) of the Internal Revenue Code now provides for an additional deduction as follows:

In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.

An interesting case involving the application of this section to attorney's fees is *Helvering v. Stormfeltz.* In the *Stormfeltz* case the taxpayer had recovered a judgment of almost $230,000 against his guardian for converting the taxpayer's money to his own use. About $94,000 or 41% of this amount represented principal and the balance represented interest owed by the guardian for use of taxpayer's money. Taxpayer in the suit against his guardian paid approximately $100,000 for attorney's fees and legal expenses; in his income tax return he claimed a deduction in this amount under the new section 23(a)(2). Insofar as taxpayer's recovery from his guardian consisted of interest, it was income and the expense of its collection was clearly deductible under the statute. So far as the recovery was of capital, authority for the deduction for the expense of its recovery must be found, if at all, in that part of the statute permitting deduction of expenses paid "for the management, conservation, or maintenance of property held for the production of income." The court decided that the legal expenses incurred in obtaining that part of the recovery attributable to capital were not deductible for two reasons: (1) the property recovered by the taxpayer was not held for the production of income because taxpayer did not seek to fasten a claim upon any specific property but instead brought an action at law to recover damages; and (2) the taxpayer's legal expenses were analogous to expenditures for the purpose of protecting title to property; such expenses although involving conservation of property are not ordinary and necessary expenses but are capital expenditures. From the *Heininger* and *Stormfeltz* cases which we have just finished considering it is apparent that legal expenses may be deductible on the litigant's income tax return for any one of several reasons. Whether such expenses are deductible may be an important consideration before the taxpayer undertakes expensive litigation as well as when he makes out his income tax return.

Leaving the problem of deductions for a moment and turning to questions concerning the receipt of taxable income we find the controversy now raging around the taxability of life insurance proceeds payable in installments. The Commissioner of Internal Revenue contends that the proceeds of

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life insurance paid in installments result in taxable income to the beneficiary where the option to receive payments in installments was exercised by the beneficiary. The amount taxable would then be the excess of the amount received in installments over the amount which would have been received if the lump sum were paid immediately on death. The Tax Court in *Katharine C. Pierce* decided, however, that no taxable income results regardless of who exercises the option. This case is now on appeal to the Circuit Court of Appeals for the Second Circuit. The rule is well established that installments received by a beneficiary pursuant to an election of a settlement option made by the insured prior to the maturity of the policy are entirely exempt from Federal income taxation. The Commissioner argued in the *Pierce* case, however, that a different result should be reached when the beneficiary exercised the option because the beneficiary thus entered into a new contract with the insurance company under which the beneficiary invested his funds and received interest thereon. This argument was rejected by the Tax Court; it is quite possible, however, that it will prevail in the Circuit Court. In any event there is an area of uncertainty here at present, and whenever it is practical the insured should exercise the installment option in the policy. Then there is no doubt that the entire installment is not subject to the Federal income tax.

Another interesting, though probably less significant, case involving the receipt of taxable income is *Malcolm McDermott*. In that case taxpayer had received $3,000 as the winner of the Ross Essay Prize given by the American Bar Association as trustee under the will of Erskine M. Ross. The will of Mr. Ross provided that the income from a $100,000 trust should be awarded annually as a single prize in an essay contest. The taxpayer did not include the prize amount received by him in his income tax return, maintaining that it was a gift to him. The Commissioner contended that the $3,000 was compensation and therefore taxable income. The Tax Court decided in favor of the Commissioner but adopted a third theory. It held that the taxpayer under the terms of the Ross will was the ascertained income beneficiary of the trust for 1939 and that the moneys received by him were so

distributed to him as the beneficiary of the trust. This decision has been criticized on the ground that an easier and more plausible way of deciding the case would have been to characterize the prize as compensation in accordance with the Commissioner’s contention.

The next case which I wish to bring to your attention involves the deductibility of living expenses while on a temporary job away from home. Ina Claire, the moving picture actress, and her husband were both domiciled in San Francisco at the time of their marriage in March, 1939. From May, 1939, to September, 1939, she lived in Hollywood or vicinity while participating in the making of a motion picture for which she was under contract. Upon completion of the picture, she returned to San Francisco and remained with her husband. When she filed her Federal income tax return she deducted as traveling expenses, amounts expended by her for food, rent and similar items while away from home during such period of her employment. The Tax Court held that taxpayer was not away from home in the pursuit of a trade or business during the time that she was fulfilling her professional engagements as an actress in Hollywood because Hollywood was her home during this period. The Circuit Court of Appeals, however, disagreed with the Tax Court, and on July 17, 1944, handed down its opinion in favor of the taxpayer. The Circuit Court reasoned that the word "home" in the statute was not intended to have any unusual or novel meaning. It therefore refused to follow the view of the Tax Court that a person’s home was his “place of business, place of employment, or the post or station at which he is employed.” In the case of Coburn v. Commissioner, the Circuit Court of Appeals for the Second Circuit upheld a deduction for business expenses under similar circumstances. The taxpayer in the Coburn case was also employed by the Hollywood motion picture studios. In the year in question he spent 263 days in Hollywood making a picture but the Court nevertheless decided that his home was in New York, where he maintained an apartment, and that his Hollywood expenses were thus deductible. It would seem that the principle of these cases is equally applicable to persons who have taken temporary war jobs away from their families.

and to others whose work has taken them away from home. They should now consider the possibility of securing refunds.

Another interesting case involving deductions is Ralph J. Green. The facts in that proceeding were as follows: Upon settlement of his father's estate in 1931, taxpayer, as distributee, received one-half of the residuary estate. Several years later the Commissioner of Internal Revenue determined a deficiency in estate tax against the estate, which taxpayer paid with interest in 1939. The question presented was whether taxpayer was entitled to deduct the interest on his Federal income tax return. The Commissioner contended that taxpayer paid interest upon the indebtedness of the estate as a volunteer and that he was not paying interest upon his own indebtedness. The taxpayer argued that he was a transferee of assets in the estate and was therefore liable for payment of the deficiency in estate tax together with interest thereon. The Tax Court decided in favor of the taxpayer and held that the taxpayer was entitled to deduct on his income tax return all interest accruing after the distribution of the estate. The same problem frequently arises in connection with corporate transactions. Consider, for example, the case of Koppers Company. The taxpayer, a corporation, received in liquidation, all of the assets of two Canadian and nine Delaware corporations in which it was the sole stockholder and for which subsidiaries it had assumed as transferee all deficiencies in tax. The question was, what amount of interest on said taxes, if any, paid by the taxpayer as a transferee, was interest on its obligations as distinguished from interest on the obligations of its transferees. The Tax Court reasoned that when the subsidiaries distributed their assets to the taxpayer each transferor owed the government its tax deficiency together with interest thereon from the dates of determination. The taxpayer took the assets subject to those debts. The interest accruing after the date of acquisition of the assets by the taxpayer was, therefore, interest upon the obligations of the taxpayer. The Court accordingly concluded that the interest on the deficiencies for the period after the taxpayer received the assets was interest paid by the taxpayer, and, as such, was deductible.

7. Ralph J. Green, 3 T. C. 74 (1944).
Finally, before leaving the Federal income tax and proceeding to recent estate tax cases, we should stop a moment to consider the status of the long standing battle between the Commissioners and the taxpayers over the taxation of trust income. I refer to the problems arising out of *Helvering v. Clifford.* In the *Clifford* case the taxpayer as grantor transferred property in trust to himself as trustee for a period of five years. His wife was named as beneficiary in the trust instrument, which also provided that the trust property was to revert to the grantor at the end of the five year period or sooner if the grantor's wife predeceased him. All the income from ordinary cash dividends was to be held for the exclusive benefit of the beneficiary; all other income was to be added to the corpus. The government contended and the Supreme Court agreed with the government that the effect of this trust instrument was merely to reallocate temporarily the grantor's income within the family group. The Supreme Court therefore held that the income was taxable to the grantor at his high surtax rates and not to the beneficiary or trustee at lower tax rates. Since the *Clifford* decision was handed down there has been a flood of litigation in the courts over its application. An article in the December, 1941, issue of The Yale Law Journal lists 58 cases in which this point was involved and in the two and one-half years since that time a large number of additional cases have been concerned with the application of the *Clifford* case to the taxation of trust income. It therefore seems pertinent to consider here how this battle between the Commissioner and the taxpayer is progressing today. Four factors are generally considered to be pertinent in ascertaining the application of the *Clifford* case to the taxation of trust income:

1. The length of the trust term. In the *Clifford* case the trust was to last for five years, or less if either the grantor or his wife died; at the termination of the trust the property was to revert to the grantor.

2. Identity of the trustee. In the *Clifford* case the grantor designated himself as trustee.

3. The identity of the beneficiaries. In the *Clifford* case the sole beneficiary was the grantor's wife; the income was thus kept in the family circle.

4. The control retained by the grantor. In the *Clifford* case the grantor as trustee retained exclusive control;
he had power to pay out or to accumulate the income; and he had power to manage the trust property practically without restriction.

The big question in applying the doctrine of the Clifford case has been whether all four of these items must be present to make the trust income taxable to the grantor, and if all four points need not be present, which points or combination of points is sufficient.

The trend of the recent decisions on this problem seems to me to be in favor of the taxpayers. It is not possible here to review all of these recent decisions. I do, however, want to call your attention to the case of Armstrong v. Commissioner. The big difference between the Clifford case and the Armstrong case was in the first of the four points previously mentioned, namely, the length of the trust term. In the Armstrong case the trust was for twelve years and at the end of the twelve year period the trust property did not revert to the grantor but went to his adult daughter. On the remaining three points the Armstrong trust was somewhat similar to the Clifford trust: (1) The grantor of the trust was also the trustee. (2) the beneficiaries were members of the grantor's family. (3) The trust instrument gave the grantor absolute power over the trust estate. Nevertheless the Circuit Court of Appeals decided in favor of the taxpayer and held that the income of the trust was not taxable to the grantor. The significance of this case to me is that under it a father can still give property to a child and yet designate himself as the trustee with absolute control and management for the benefit of the estate without having the income taxed to himself at high rates.

I turn now from recent tax cases involving the Federal income tax to recent decisions dealing with the Federal estate tax. The first case I have selected is a comparatively unimportant memorandum decision of the Tax Court: Estate of Henry Ti. Sloane, decided on June 8, 1944. The reason I would like to talk about the Sloane case is not because it in itself is so revolutionary or important but because it deals with a question that frequently arises in actual practice. This question is the proper method of valuing stock in corporations and similar business interests. The regulations of the

Commissioner on this problem are helpful as far as they go. If the stock is listed on a stock exchange, the mean between the highest and lowest quoted selling prices on the valuation date is considered to be the stock's fair market value. If the stock is not listed on a stock exchange, actual private sales shortly before or after the valuation date are of great weight in determining the fair market value of the stock. If there are no actual sales, the fair market value of the stock may be indicated by bona fide bid and ask prices. So far so good. Frequently, however, it is necessary to value stock or an interest in a business which is not listed on a stock exchange, for which there are no actual sales near the correct valuation date, and for which there are no material bid and ask prices. This was the situation in the Sloane case, which involved the valuation for estate tax purposes of stock in closely held corporations. Here the regulations of the Commissioner do little more than state that all relevant factors should be considered. The principal business of one of these corporations was that of a New York City department store. The taxpayer in the Sloane case called two witnesses before the Tax Court, each of which used a different method of stock valuation. Mr. Weise, a member of the firm of Scudder, Stevens & Clark, investment counsellors, attempted to calculate what the market price of each of the stocks in question would be if there was an established market for each stock by making comparisons with concerns whose stocks were bought on a market. Judge Harron of the Tax Court did not approve of his method, which for the sake of convenience I will call the comparative method. The second witness for the taxpayer, Mr. Coffman of Standard & Poor's Corporation, used what is frequently referred to as the income capitalization method. He endeavored to arrive at a reasonable estimate of earnings and dividend paying capacity over a reasonable period in the future; he then capitalized those earnings at a reasonable rate of return to arrive at the fair market value of the business. In estimating the future earnings of the company he studied its balance sheets and its income statements and he took into consideration other pertinent facts relating to the business. For example, W. & J. Sloane had two divisions, a wholesale branch and a retail branch. The wholesale branch had operated at a profit for the period preceding the valuation date.
but the retail branch had operated at a loss. At a time near the valuation date the wholesale branch of the Sloane business was discontinued. In forecasting the future earnings of W. & J. Sloane, therefore, Mr. Coffman concluded that its expected earnings would be less after the valuation date than before the valuation date. This reduced the value of the stock when the smaller estimated earnings were capitalized. There are three comments which I would like to make about the Sloane case: First, the detailed opinion of Judge Harron is very helpful in suggesting items that are important in valuing a business. Second, Judge Harron's criticism of the comparative method used by Mr. Weise is probably not valid today because of a change made in the Internal Revenue Code by the Revenue Act of 1943. The Code now provides that in this type of case the value of stocks of corporations engaged in the same or a similar line of business which are listed on an exchange may be taken into consideration, in addition to all other factors. Finally, the Sloane case illustrates the large amount of estate taxes that can be saved by contesting a valuation case. The Commissioner in the Sloane case contended that the fair market value of the W. & J. Sloane common stock was $51.00 a share; the Tax Court determined a value of $1.30 a share. The Commissioner contended that the fair market value of the W. & J. Sloane preferred stock was $100 a share; the Tax Court determined a value of $5 a share. The same difference in values appears in the other stocks in question. The result was that the executors of the Sloane estate paid practically nothing on the two million dollar estate tax deficiency asserted by the Commissioner on this issue.

Another problem that has resulted in considerable litigation in the estate tax field centers around the tax consequences of a possibility of reverter. In Helvering v. Hallock, the decedent had created a trust in which he specified that the income was to be paid to his wife during her lifetime; upon her death the income and principal of the trust was to be paid to the decedent, if living, otherwise to his son and daughter. Decedent died before his wife without ever regaining the trust property. The Supreme Court held nevertheless that this was a transfer intended to take effect in possession or enjoyment at or after death within the mean-
ing of the tax statute, and the value of the trust property after deducting the value of the wife's life estate was included in the gross estate of decedent for Federal tax purposes. The big issue between the Commissioner and the taxpayers since the Hallock case has been whether anything should be included in decedent's gross estate when decedent's possibility of regaining the trust property was much less substantial than in the Hallock case. There the property would return to him if he survived his wife. Suppose that under the terms of the trust instrument the property would not return to him unless he survived his wife, several children, and one or two grandchildren. Is the trust property or any part of it still to be included in his gross estate? The Tax Court at first took the position that the trust property was includible in the gross estate of decedent even if the possibility of reverter was extremely remote as long as the reverter to the decedent was specifically provided for by the terms of the trust instrument. Only when the reverter to the grantor was by operation of law because the trust instrument was silent did the Tax Court decide that the trust property was not taxable. On March 31, 1944, the Circuit Court of Appeals for the Third Circuit decided the case of Lloyd v. Commissioner in which it specifically repudiated this test of the Tax Court. In the Lloyd case the trust instrument provided for the payment of income to a son for life, and gave the son a power of appointment over the trust income and principal. If the son failed to exercise the power of appointment, the trust principal was to be paid to the son's wife and his descendants. Only if the son did not exercise the power of appointment and died without leaving a wife or children surviving him was the trust property to revert to the decedent. The Court held that this possibility was too remote to require inclusion of the trust property in decedent's estate.

This same problem also comes up in connection with the proceeds of life insurance policies. In many cases the insured retained a possibility of reverter for his estate in the event he survived the beneficiaries. On August 11, 1944, the Circuit Court of Appeals for the Second Circuit in Goldstone v. United States decided in favor of the government.

where the proceeds of a life insurance policy were payable to decedent's wife, or, in the case of her prior death, to his two daughters, or if none of the named beneficiaries survived him, to his executors or administrators. The taxpayer advanced a rather unique argument based upon the power of the life beneficiary to surrender the policy for its cash value. The taxpayer argued that the life beneficiary could thus cut off the possibility of reverter to the decedent's executors and that any title that the executors had to the proceeds was a new title based upon the action or failure to act of the life beneficiary and not upon the terms of the policy giving them a possibility of reverter. In cases before the Tax Court executors had previously succeeded with this argument, *(Estate of James W. Henry, Docket No. 109513, Memo. Dec. January 16, 1943; Estate of Berthold Goldsmith, Sr., Docket No. 3134, Memo. Dec. May 29, 1944)* but the judges of the Circuit Court of Appeals stated that the argument did not convince them. The problems involving possibilities of reverter have now reached the Circuit Courts of Appeal but it is quite possible that they will again have to be passed upon by the United States Supreme Court before they are completely solved.

This concludes the discussion of the cases that I have selected out of the recent tax decisions. You will observe that the taxpayers were successful in quite a few of them. These decisions and others have caused some tax-minded people to wonder if the courts are becoming pro-taxpayer. Perhaps this is the beginning of a trend by the courts back to their pre-1934 attitude in favor of the taxpayer.

**EXAMINATIONS OF ABSTRACTS OF TITLE**

The Section on Property and Taxation considered at its meeting on September 1, 1944, under the leadership of Chester H. Zechiel, the question of simplifying the process of examining abstracts of title. A most active discussion followed in which Messrs. Ahlgren, Bamberger, Clarke, Coleman, Fox, Hamby, Kothe, and Myers participated. It was the consensus of the group that at the present time there was no satisfactory solution to the three principal problems involved in abstracting: the growing size of abstracts, the increased
costs, and the wastage of attorneys' time in continuous re-
examination of abstracts.

It was pointed out that in some counties there were few,
if any, delays in procuring a satisfactory abstract, that ex-
amination was faster than procurement of title insurance,
and that where lawyers were willing to cooperate among
themselves and with real estate men and abstractors, the
problem was not serious. Others pointed out that abstracting
was an important source of income for young lawyers, and
that unless a much more satisfactory plan than title insur-
ance or the Torrens System could be devised, it would be un-
desirable to incur this loss of revenue.

An extensive discussion followed on the use of plats in
urban communities and voluntary agreement among lawyers
to waive formal and inconsequential defects.

It was agreed by all that the meeting was most bene-
ificial and that the Section should continue the study of the
problem for further reporting at subsequent meetings.

The Section then considered a letter presented by Herman
W. Kothe, Esq. and one by C. W. Reed, Esq. dealing with a
proposed Rule 71-A of the United States Supreme Court Rules.

MR. COLEMAN: Mr. President, I move that this body
resolve that it is the sense of this body that proposed Rule
71-A would be detrimental to the interests of owners, and
lien-holders of real estate, and should not be adopted by the
Supreme Court of the United States, and that a copy of this
resolution be forwarded to the Clerk of the Supreme Court
of the United States.

The motion was seconded by Mr. Bamberger.

Upon the suggestion of the chairman, it was agreed
that the resolution be passed on by the Board of Governors.
Mr. Bamberger also suggested that the resolution make
provision for presenting the question to the American Bar
Association. This amendment was also accepted and the
motion was carried. It was then agreed that Mr. Coleman
should present the resolution to the State Bar Association
for its approval.