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Recent Decisions

RECENT DECISIONS

Corporations — Voting Trusts and Subchapter S

Petitioners, owners of all of the outstanding stock of the A & N Furniture and Appliance Company, an Ohio corporation, elected in 1958 to have the income of the corporation taxed to them as individuals in accordance with subchapter S of the Internal Revenue Code.[1] In 1961 they entered into a voting trust agreement pursuant to section 1701.49 of the Ohio Revised Code. The trustee was given the irrevocable right to vote all of the shares of each shareholder for a period of ten years. Under section 1372(a) of the Internal Revenue Code, the shareholders listed certain deductions on their personal income tax returns that were actually losses that the corporation suffered. The Commissioner refused to allow these deductions on the ground that the voting trust created by the shareholders prevented A & N from qualifying as a small business corporation under section 1371(a). *Held*: A small corporation which has chosen to be treated as a proprietorship for tax purposes under subchapter S (sections 1371-1377) of the Internal Revenue Code, does not forfeit that election by creating a voting trust with all the stockholders participating. *A & N Furniture & Appliance Co. v. United States*, 271 F. Supp. 40 (S.D. Ohio 1967).

Congress enacted subchapter S to allow small businesses to select the form of organization desired, without having to take into account major differences in tax consequences. In order to qualify under subchapter S a small business must not (1) have more than ten shareholders, (2) have as a shareholder a person who is not an individual, (3) have a non-resident alien as a shareholder, and (4) have more than one class of stock. The government based its argument that the voting trust disqualified the company on two grounds. First, the claim was made that the voting trust created a separate class of stock in violation of section 1371(a)(4). Second, the contention was made that the voting trust was, in effect, a shareholder other than an individual and this violated section 1371(a)(2).[2]

The court rejected both of the government's contentions. The argument that the voting trust agreement created a separate class of stock was refuted on the ground that the regulation was not intended to apply to voting trusts, but rather to a corporation which issues two classes of stock. The court stated:

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[1] INT. REV. CODE of 1954, §§ 1371-77. The pertinent part of § 1371 reads:

> (a) Small Business Corporation. For purposes of this subchapter, the term 'small business corporation' means a domestic corporation which is not a member of an affiliated group . . . and which does not—
> (1) have more than 10 shareholders;
> (2) have as a shareholder a person . . . who is not an individual;
> . . . .
> (4) have more than one class of stock.

[2] 271 F. Supp. 40, 42 (S.D. Ohio 1967).

> It is clear that Congress was not at all concerned with the respective voting power of each shareholder in a small corporation. They were only concerned that the businesses taking the Subchapter S election be those small businesses which Congress intended to benefit, and that no accounting complications result, and although the regulation (1.1371-1(g)) speaks of 'voting rights,' it appears clear to this court that it is directed toward the issuance of two classes of stock, and accounting difficulties resulting therefrom, rather than voting power per se.[3]

The government's second contention that the voting trust created a "shareholder" other than a person under section 1371(a)(2) was dismissed by the court on the basis that there was no reason why a voting trust should be considered a shareholder.[4] Therefore, in accord with the purpose of subchapter S to allow small businesses to operate in whatever form they see fit, without having to take into account prohibitive tax consequences, a voting trust was not held sufficient reason to disallow a small corporation the use of subchapter S.[5]

G.E.S.

Family Law — Contraception as Grounds for Divorce

Plaintiff sought a divorce on grounds of extreme cruelty, alleging that for two years, beginning with the inception of the marriage, her husband insisted she take contraceptive pills as a condition precedent to his engaging in marital relations. The husband constantly supervised the pill-taking ritual. The plaintiff acquiesced in her husband's demands in the short-lived hope that he would change his mind. *Held, judgment nisi entered*: A husband's insistence that his wife take contraceptive pills as a condition precedent to engaging in marital relations constitutes grounds for a divorce predicated upon extreme cruelty. *Goldstein v. Goldstein*, 97 N.J. Super. 537, 235 A.2d 498 (Ch. 1967).

In the United States wilful refusal to consummate the marriage is nowhere an express ground for annulment or divorce, nor is refusal to copulate without contraceptives. Nevertheless, if a husband or wife, contrary to his partner's wishes, insists upon precautionary measures as a prerequisite to coitus, the latter spouse may not be without remedy. Possible recourse may be obtained through an annulment for fraud, a divorce for desertion, or a divorce for cruelty.[1]

In most states a consummated marriage can be annulled on the ground of fraud if it "goes to the essentials" of the marriage relationship.[2] A number of cases have held that the requisite fraud exists where one party has expressly and falsely promised before marriage that he would have chil-

[3] *Id.* at 45.
[4] *Id.* at 46.
[5] *Id.* at 43.

[1] *See* Annot., 4 A.L.R.2d 227 (1949).
[2] G. CLARK, DOMESTIC RELATIONS § 15 (1954). An unconsummated marriage may be annulled for any fraud which would be sufficient to annul an ordinary contract. 4 AM. JUR. 2D *Annulment of Marriage* § 13 (1962).

dren afterward.[3] In several cases the courts have carried the reasoning one step further and have granted an annulment on the ground of fraud where the promise to have children was merely implied.[4]

Although the general rule with respect to divorce is that a refusal to have children does not of itself constitute desertion, one jurisdiction,[5] New Jersey, has ruled that a refusal, persisted in for the statutory period, to have sexual intercourse without the use of contraceptive devices, constitutes desertion.[6] This rule represents an extension of the doctrine that a wilful refusal to have any sexual contact constitutes desertion if continued for the statutory period. The latter rule, which is recognized by a substantial minority of jurisdictions,[7] has been justified primarily on the ground that a platonic marriage cannot accomplish a major purpose of wedlock, namely the procreation of children.[8] Apparently, New Jersey would equate copulation accompanied by contraception for the statutory period with a total lack of copulation, for both "deprive the marriage of . . . its most important object . . . [progeny]."[9]

The avoidance of procreation of children by one spouse over the objections of the other, or the refusal of one spouse to engage in sexual intercourse unless contraception is practiced, does not, as a rule, authorize the granting of a divorce on the ground of extreme cruelty.[10] However, with the decision in the instant case, New Jersey has apparently extended its parochial view of contraception to include the granting of a divorce predicated upon extreme cruelty. The ineptly written decision[11] seems to recognize the existence of a fraudulent intent on the part of the husband in that his wife was under the delusion her mate possessed paternal instincts. The significance of this factual finding in relation to the court's ultimate decision is obscure, and until a more prolific opinion is rendered by a New Jersey court, an understanding of the status of this area of divorce law will remain impregnable.

F.W.B.

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[3] *See* Stegienko v. Stegienko, 295 Mich. 530, 295 N.W. 252 (1940); Coppo v. Coppo, 163 Misc. 249, 297 N.Y.S. 744 (Sup. Ct. 1937).

[4] *See, e.g.*, Pisciotta v. Buccino, 22 N.J. Super. 114, 91 A.2d 629 (Super. Ct. 1952); Lembo v. Lembo, 193 Misc. 1055, 86 N.Y.S.2d 206 (Sup. Ct. 1949). It should be noted that waiver is a defense to both express and implied fraud. Annot., 4 A.L.R.2d 227, 233 (1949).

[5] Harrington v. Harrington, 38 Del. 333, 192 A. 555 (Super. Ct. 1937).

[6] Kreyling v. Kreyling, 20 N.J. Misc. 52, 23 A.2d 800 (Ch. 1942). The *Kreyling* rule has been restricted slightly by the subsequent case of Kirk v. Kirk, 39 N.J. Super. 341, 120 A.2d 854 (Super. Ct. 1956), which held that the plaintiff must prove by clear and convincing evidence that he strongly objected to the defendant's conduct throughout the statutory desertion period. In the *Kirk* case the petitioner was denied a divorce for failing to meet this requirement.

[7] 27A C.J.S. *Divorce* § 36(3) (1959).

[8] Kreyling v. Kreyling, 20 N.J. Misc. 52, 23 A.2d 800 (Ch. 1942); Raymond v. Raymond, 79 A. 430 (N.J. Ch. 1909).

[9] Kreyling v. Kreyling, 20 N.J. Misc. 52, 23 A.2d 800, 803-04 (Ch. 1942).

[10] *See, e.g.*, Thomas v. Thomas, 219 Ala. 196, 121 So. 710 (1929); Lohmuller v. Lohmuller, 135 S.W. 751 (Tex. Civ. App. 1911). However, there are some factual situations in which refusal of one spouse to engage in completed normal sexual intercourse has been held to constitute cruelty. *E.g.*, Longtin v. Longtin, 22 N.Y.S.2d 827 (Sup. Ct. 1940).

[11] The ambiguous wording of the court resulted in an incorrect set of headnotes accompanying the opinion.

Labor Law — Federal Rule 65(d)'s Requirement of Specificity

Petitioner, a union representing Philadelphia longshoremen, had entered into a collective bargaining agreement in 1959 with the respondent, an association of employers in the port of Philadelphia. A dispute arose over the meaning of provisions for compensating longshoremen who are told upon reporting for duty that they will not be needed until the afternoon. The union contended that these "set-back" provisions meant that longshoremen whose employment was postponed due to inclement weather were entitled to four hours pay. The association argued that the provisions guaranteed the longshoremen no more than one hour's pay under such circumstances. In order to resolve this disagreement, the parties followed the grievance procedure set out by their contract and submitted the matter to an arbitrator for a final determination. The arbitrator ruled that the association's contention was correct. However, one month later certain union members refused to unload a ship unless their employer would guarantee four hours pay for having set back their starting time from 8 a.m. to 1 p.m. The association instituted proceedings in the district court to enforce the original arbitrator's decision. After a temporary settlement between the parties the problem arose again and the association requested an order by the court to require the union to comply with the arbitrator's award. The district court entered a decree requiring the union "to comply with and to abide by the said Award." When the court indicated that such a decree would be issued, counsel for the union asked the court for clarification as to the actual meaning of the order, but the district judge refused to explain the meaning of the order.

Later, further set-back disputes occurred and the district court issued a rule to show cause why the union and its officer should not be held in contempt for violating the order. At the contempt hearing the judge refused again to explain his order and adjudged the union in civil contempt. The court of appeals affirmed the original decree of the district court[1] and its contempt order.[2] The United States Supreme Court *reversed*: Rule 65(d) of the Federal Rules of Civil Procedure requires that a federal court issuing an order granting an injunction or a restraining order clearly set forth the reasons for its issuance. Therefore, the parties who must obey them will know what the court intends to require and what it means to prohibit. *International Longshoremen's Association, Local 1291 v. Philadelphia Marine Trade Association*, 389 U.S. 64 (1967).

In reaching its decision the court stated that rule 65(d) was designed to prevent the type of confusion that clouded the command of the district court. Rule 65(d) provides:

> Every order granting an injunction and every restraining order shall set forth the reasons for its issuance; shall be specific in terms; shall describe in reasonable detail, and not by reference to the complaint or other document, the act

[1] 365 F.2d 295 (3d Cir. 1966).
[2] 243 F. Supp. 140 (E.D. Pa. 1965), *aff'd*, 368 F.2d 932 (3d Cir. 1966).

> or acts sought to be restrained; and is binding only upon the parties to the action, their officers, agents, servants, employees, and attorneys, and upon those persons in active concert or participation with them who receive actual notice of the order by personal service or otherwise.

The Court felt that the order in question "clearly failed to comply with that rule, for it did not state in 'specific . . . terms' the acts that it required or prohibited."[3] The Court went on to point out that the judicial contempt power is a "potent weapon" and can be dangerous when founded upon an order which is too vague to be understood. To avoid this, Congress enacted rule 65(d) to require a federal court to frame its orders so that the parties will understand just what is intended. Since the district court's decree was not in accord with this principle, it was struck down. In closing the court stated: "The most fundamental postulates of our legal order forbid the imposition of a penalty for disobeying a command that defies comprehension."[4]

G.E.S.

Taxation — Accumulated Earnings — Burden of Proof in Tax Court

Section 531 of the Internal Revenue Code of 1954 imposes a tax[1] on the accumulated taxable income[2] of every corporation "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders . . . by permitting earnings and profit to accumulate instead of being divided or distributed."[3] Exceptions are made in the case of personal holding companies,[4] foreign personal holding companies,[5] and tax exempt corporations as defined in subchapter F.[6] Section 533 of the Code[7] creates two presumptions: (1) the fact that earnings and profits are accumulated "beyond the reasonable needs of business"[8] is determinative of the purpose of tax avoidance with respect to shareholders unless the corporation proves the contrary by a preponderance of the evidence;[9] and (2) the fact that a corporation is "a mere holding or investment company"[10] is prima facie evidence of the purpose of tax avoidance with respect to its shareholders.[11] These presumptions are in addition to the presumption of correctness attaching to the Commissioner's determination of tax deficiency

[3] 389 U.S. 64, 76 (1967).
[4] *Id.*

[1] The tax is levied at the rate of 27½% of the first $100,000 of accumulated taxable income and 38½% of accumulated taxable income in excess of $100,000. INT. REV. CODE of 1954, § 531.
[2] *Id.* § 535.
[3] *Id.* § 532(a).
[4] *Id.* § 532(b)(1). *See also id.* § 542.
[5] *Id.* § 532(b)(2). *See also id.* § 552.
[6] *Id.* § 532(b)(3). *See also id.* subch. F.
[7] *Id.* § 533.
[8] *Id.* § 533(a).
[9] *Id.*
[10] *Id.* § 533(b).
[11] *Id.*

under procedural principles generally applicable to income tax litigation.[12]

In response to complaints of unfairness in the assessment of deficiencies in the area of accumulated earnings taxes, based on the government's poor record in litigation and the difficulty and expense to taxpayers in establishing that an accumulation was for the reasonable needs of business,[13] Congress enacted section 534 of the Internal Revenue Code of 1954. Section 534 provides a procedure whereby the taxpayer may shift the burden of proof on the issue of reasonable business needs to the Commissioner in a proceeding before the Tax Court. If a notice of deficiency is based in whole or in part on an allegation that earnings were accumulated beyond the reasonable needs of business, the burden of proof is on the Commissioner unless, before the notice is mailed, the taxpayer is notified that the proposed deficiency includes an accumulated earnings tax.[14] The taxpayer may shift the burden of proof back to the Commissioner[15] if, within sixty days after notification, it submits a statement of the grounds and supporting facts on which it relies to establish that the accumulation is not beyond the reasonable needs of business,[16] provided the statement recites the grounds with clarity and specificity and the supporting facts are substantial, material, definite, and clear, and wherever possible, disclose the dollar amount of funds retained for each business need.[17] Section 534 only shifts the burden of proof as to reasonable business needs so that the taxpayer still has the burden of establishing the non-existence of tax avoidance motivation for the accumulation. However, if the court finds that the accumulation was for a reasonable business need, this burden becomes insignificant under the credit provided for such accumulations by section 535(c)(2).[18]

In the past the relief Congress sought to provide by the enactment of section 534 has not been afforded to corporate taxpayers because the Tax Court would not rule in advance of trial on the adequacy of section 534 statements.[19] Uncertain therefore that the burden of proof had shifted to the Commissioner, tax counsel have continued to present all available evidence of reasonable business purpose. Perhaps the first time tax counsel has had the "abnormally strong nervous system"[20] required to rest a client's case entirely on the burden of proof issue and the failure of the Commissioner to discharge his burden under section 534 was in *Rhombar Co. v. Commissioner*, 386 F.2d 510 (2d Cir. 1967).

[12] TAX CT. R. PRAC. 32. *See also* J. MERTENS, FEDERAL INCOME TAXATION § 50.61 (rev. ed. 1965).

[13] H.R. REP. No. 133, 83d Cong., 2d Sess. 52 (1954); S. REP. No. 1622, 83d Cong., 2d Sess. 68 (1954).

[14] INT. REV. CODE of 1954, § 534(a)(1)(b).

[15] INT. REV. CODE of 1954, §§ 534(a)(2), 534(c).

[16] Treas. Reg. § 1.534-2(d)(2) (1959).

[17] Bremerton Sun Publishing Co., 44 T.C. 566 (1965); Ted Bates & Co., P-H Tax Ct. Mem. ¶ 65,251 (1965).

[18] INT. REV. CODE of 1954, § 535(c)(2).

[19] Barrow Mfg. Co. v. Commissioner, 294 F.2d 79 (5th Cir. 1961); Raymond I. Smith, Inc. v. Commissioner, 292 F.2d 470 (9th Cir. 1961); Shaw-Walker Co., 39 T.C. 293 (1962); I.A. Dress Co., 32 T.C. 93 (1959), *aff'd*, 273 F.2d 543 (2d Cir. 1960); Pelton Steel Casting Co., 28 T.C. 153, 174 (1956), *aff'd*, 251 F.2d 278 (7th Cir.), *cert. denied*, 356 U.S. 958 (1958).

[20] B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 6.08, at 234 (1966).

Rhombar Co., a closely held corporation owned almost entirely by the H. M. Rothschild family, operated a furniture business under the trade name of John Stuart, Inc. In 1952 it sold all its business assets, including the right to use the Stuart trade name, to John Widdicomb Co., Inc., another closely held corporation in which the Rothschilds had a controlling interest after the sale. Thereafter, Widdicomb operated Rhombar's former business under the Stuart name and Rhombar accumulated its income, derived entirely from dividends, interest and capital gains from the sale of securities and from the installment payments received from Widdicomb. Consequently, surplus increased from $1,167,648 on January 31, 1954, to $2,382,494 on January 31, 1963, while dividends were limited to $700 per year.

The Commissioner assessed deficiencies for the fiscal years ending January 31, 1960, 1961, and 1963, under the accumulated earnings tax provisions. Pursuant to section 534 Rhombar filed a thirteen-page statement detailing its efforts to acquire another furniture business and alleging that the reasonable needs of business required it to maintain a reserve equal at least to its entire net worth to a minimum of $3,500,000 in order to finance an acquisition program of purchasing interests in furniture manufacturing businesses and facilities. In the Tax Court, Rhombar contended that this statement shifted the burden of proof to the Commissioner and offered no evidence. The Tax Court upheld the deficiency assessment on the ground that the corporation was a "mere holding or investment company" within the terms of section 533(b).[21] On appeal the Second Circuit affirmed, holding that a taxpayer's statement, if sufficient, will shift the burden of proof of unreasonable accumulations to the Commissioner under section 533(a), but the taxpayer still has the burden of proving it was not a mere holding or investment company under section 533(b). Therefore a failure to introduce any evidence to rebut the statutory presumption will result in a decision for the Commissioner.[22]

A deficiency determination based on the accumulated earnings tax provisions properly raises both the issues of unreasonable accumulations and the status of the taxpayer corporation as a mere holding or investment company.[23] Since section 533 creates two alternative presumptions, tax counsel must be prepared to rebut either or both by a preponderance of the evidence. Thus reliance on section 534 statements will not be sufficient in many cases. Should the Commissioner rely on the provisions of section 533(b), the deficiency could be sustained unless the taxpayer introduces sufficient evidence to discharge his burden of proof. In this respect the question of reasonable business purpose and the shifting burden of proof under section 534 would never be reached.[24]

Most corporate taxpayers should not be unduly burdened by the necessity of proving they engaged in activities other than "holding property

[21] INT. REV. CODE of 1954, § 533(b).

[22] Rhombar Co. v. Commissioner, 386 F.2d 510 (2d Cir. 1967).

[23] Stanton Corp., 44 B.T.A. 56 (1941), *aff'd*, 138 F.2d 512 (2d Cir. 1943); *cf.* Helvering v. Gowran, 302 U.S. 238 (1937); Brook v. Commissioner, 360 F.2d 1011 (2d Cir. 1966).

[24] This in essence is the precise situation in *Rhombar*. *See* 47 T.C. at 90.

and collecting the income therefrom or investing therein."[25] Once this burden is satisfied and a proper statement has been filed under section 534, the burden of establishing the absence of a reasonable business purpose for the accumulations in question should be on the Commissioner.

A recent Tax Court case clarifies the status of section 534 statements. In *Chatham Corporation*[26] the court set forth the proper procedure for obtaining pre-trial rulings on the sufficiency of section 534 statements to shift the burden of proving that accumulations are beyond the reasonable needs of the business. Past practice has been to submit a motion as to the sufficiency of the statement to the judge of the motions calendar in advance of trial.[27] In *Chatham* the motion was submitted to the trial judge before whom the case was to be tried when the case was called for trial. The court ruled on the motion in advance of the hearing on the merits and apparently indicated that it will continue to so do if the same procedure is followed by counsel in future cases.[28] Thus the necessity of counsel with an extremely strong nervous system and the dangers of relying solely on section 534 statements in the absence of pre-trial rulings have been eliminated. With *Chatham* it appears that the relief Congress sought to provide taxpayers in enacting section 534 may at last become available.

S.C.S.

Taxation — Traveling Expense — Sleep or Rest Rule

Taxpayer was a traveling salesman for a wholesale grocery company in Tennessee. He customarily left home early in the morning, ate breakfast and lunch on the road, and returned home in time for dinner. He deducted the cost of his breakfast and lunch as traveling expenses incurred in the pursuit of business while away from home under section 162(a)(2) of the Internal Revenue Code of 1954.[1] Since the daily trips required neither sleep nor rest, the Commissioner disallowed the deductions. The taxpayer sued in district court and received a favorable jury verdict. The Sixth Circuit affirmed, holding that the Commissioner's sleep or rest rule is not "a valid regulation under the present statute."[2] *Held*, *reversed*: A taxpayer may not deduct the cost of meals while away from home unless the trip required either sleep or rest, regardless of how many cities a given trip may have touched, how many miles it may have covered, or how many hours it may have consumed. *United States v. Correll*, 389 U.S. 299 (1967).

Section 162(a)(2) allows a deduction for traveling expenses (including amounts expended for meals and lodging) while away from home in the

[25] Treas. Reg. § 1.533-1(c) (1959). Discharging this burden is doubly important to corporate taxpayers in view of § 535(c)(3) limiting the accumulated earnings credit of mere holding and investment companies to $100,000. INT. REV. CODE of 1954, § 535(c)(3); Treas. Reg. § 1.535-3(c) (1959).

[26] Chatham Corp., 48 T.C. 145 (1967).

[27] *Id.* at 146.

[28] *Id.*

[1] INT. REV. CODE of 1954, § 162(a)(2).

[2] 369 F.2d 87, 90 (6th Cir. 1966).

pursuit of a trade or business.[3] The question often raised is whether the Code requires both meals and lodging as a prerequisite to deduction or whether the deduction of meals is independent from overnight lodging. The Commissioner has consistently contended that "the fundamental test for determining whether the taxpayer incurred the meal expenses 'while away from home' has been whether or not his business travel was of such nature that it required him to seek lodging or at least sufficient time to sleep or rest."[4] The question of whether "meals and lodging" is to be read in the conjunctive has produced varied results in the courts of appeals. The First Circuit, in *Commissioner v. Bagley*,[5] upheld the Commissioner's sleep or rest rule, while the Eighth Circuit rejected it in *Hanson v. Commissioner*[6] and *United States v. Morelan*.[7]

The Supreme Court in *Correll* has settled the conflict among the circuits by upholding the Commissioner's sleep or rest rule. It is now apparent that the day traveler, the man who leaves his home in the morning and returns in the evening without a stopover for sleep or rest, is put on a similar tax footing with intracity travelers and commuters, who cannot deduct the cost of meals they eat on the road.[8] The Court noted that Congress has delegated to the Commissioner the task of prescribing "all needful rules and regulations for the enforcement" of the Internal Revenue Code,[9] and that the role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner.[10] The Court also noted the rule to be consistent with expressed legislative intent.[11]

As the dissent pointed out, due to the increased availability of high speed travel it is possible for a man to be in Los Angeles for breakfast, New York for lunch and back in Los Angeles for dinner. To say that this man cannot deduct the cost of his meal because he was not away from home overnight seems questionable. Yet as the Court noted, no one has come up with a better solution.

J.J.K.

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[3] INT. REV. CODE of 1954, § 162(a)(2).
[4] Hanson v. Commissioner, 298 F.2d 391, 396 (8th Cir. 1962).
[5] 374 F.2d 204 (1st Cir. 1967).
[6] 298 F.2d 391 (8th Cir. 1962).
[7] 356 F.2d 199 (8th Cir. 1966).
[8] *See* Commissioner v. Flowers, 326 U.S. 465 (1946).
[9] INT. REV. CODE of 1954, § 7805(a).
[10] 389 U.S. at 307.
[11] *Id.* at 305.