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Recent Cases

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RECENT CASES

Corporations—Equity—Specific Performauce of Stock Option Granted Because of Tax Advantage Feature of Option

After being informed by defendant Kentucky Fried Chicken Corporation that his employment had been terminated,[1] plaintiff gave the corporation written notice of his desire to exercise the stock option included in his employment agreement[2] and tendered a check for the option price of the stock, which defendant refused. Plaintiff then filed suit, seeking damages for breach of the employment contract and specific performance of the stock option feature. Defendant argued that the subsequently executed "Stock Option Agreement" had expired before the attempted exercise of the option and that it was separable from the original employment contract.[3] The Chancery Court, Davidson County, Tennessee, found the employment and stock option agreements to be parts of a single contract and granted the relief prayed for. On appeal to the Court of Appeals of Tennessee,[4] *held*, affirmed. Specific performance of a stock option

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1. Plaintiff received on May 17, 1967, a letter from defendant, dated May 15, 1967, which stated that his employment was "terminated as of this date." However, defendant offered to employ the plaintiff "for thirty days from date to advise us" on certain matters. Plaintiff continued his employment for the thirty-day period pursuant to the letter.

2. Plaintiff's employment agreement was embodied in a letter of June 13, 1966, which stated, in part, "For the fiscal year ending September 30, 1967, we guarantee you a salary and bonus combination to be not less than $20,000 total. . . . There will be made available to you fifteen hundred (1500) shares of stock to be acquired over a three (3) year period, acquired in the manner most advantageous to you based on Internal Revenue Service and Securities and Exchange Commission regulations." On January 10, 1967, plaintiff executed a "Stoek Option Agreement" which granted to him the option of purchasing 1500 shares of the common stock of defendant corporation at thirty dollars ($30) per share. By the terms of the agreement, the option would terminate "either (i) after the expiration of two (2) years from the date the option is granted, or (ii) after the termination of employment for any reason whatever other than death or disability. . . ."

3. Defendant contended that the plaintiff had given notice of his exercise of the option after his discharge from regular employment. Defendant justified this argument by a term of the "Qualified Stock Option Plan" that "No option will be exercisable . . . after the termination of employment for any reason whatever other than death or disability. . . ." Defendant argued in the alternative that plaintiff had given notice after the termination of his thirty-day special employment which the defendant stated had begun on the date the letter was mailed, May 15, not on the date of the letter's receipt, May 17.

4. Defendant did not appeal the award of damages to the plaintiff. Plaintiff appealed part of the decree which ordered him to pay 6% interest on the purchase price of the stock from the date of the tender of the check until the date of the stock purchase. The Court of Appeals modified this part of the decree and held that the plaintiff should pay interest on the check from the date the suit was filed.

agreement will be decreed where monetary damages are impossible to estimate due to the nature of the tax saving advantages of the agreement. *Kentucky Fried Chicken Corp. v. Thuermer*, Execution No. 11, 188 (Tenn. Ct. App., August 30, 1968).[5]

A "qualified stock option" plan, as defined by the Internal Revenue Code, allows an employee to purchase stock in his company with favorable tax consequences. In a normal stock option plan, the employer grants to the employee an option for a specified period to purchase a specified number of shares of stock at a price equal to the market price of the stock at the date the option is granted.[6] If the plan is a "non-qualified" plan, the difference between the option price and the value of the stock at the time the option is exercised is taxed to the employee as ordinary income in the year of the exercise of the option.[7] But if it is a "qualified" plan, all gain realized from a sale of the stock will be taxed at the long-term capital gain rate.[8] Generally, specific performance of a contract to purchase securities will be decreed only if damages are clearly inadequate.[9] However, the courts have not been permitted to consider tax benefits in determining the inadequacy of damages because of the general rule that tax advantages could not properly be considered in affixing damages in a suit on a contract.[10] Specific performance has been decreed when the securities had no market value,[11] when the market value was not fixed[12] or readily ascertainable,[13] when the securities were not readily

5. The opinion and briefs are on file with the Clerk of the Court of Appeals, Supreme Court Building, Nashville, Tennessee, 37219.

6. INT. REV. CODE of 1954, §§ 421(a), 422(a); Treas. Reg. § 1.421-8 (1966).

7. INT. REV. CODE of 1954, § 421(b).

8. INT. REV. CODE of 1954, §§ 421(a), 422(a)-(b); Treas. Reg. § 1.422-1 (1966).

9. Blatt v. Boardwalk Securities Corp., 114 N.J.L. 477, 176 A. 688 (Ct. Err. & App. 1935). To obtain such a decree of transfer, the plaintiff must show he attempted to exercise the option according to its terms while it was in force. *See also* Treas. Reg. § 1.421-7(h)(l) (1966). For an example of failure to exercise an option within alloted time, see O'Brien v. United Home Life Ins. Co., 250 F.2d 483 (6th Cir. 1958).

10. Paris v. Remington Rand, 101 F.2d 64 (2d Cir. 1939) (rejection of award to cover resulting income taxes on the base amount of damages); McLaughlin v. Union-Leader Corp., 100 N.H. 367, 127 A.2d. 269 (1956), *cert. denied*, 353 U.S. 909 (1957) (resulting taxes are not a proper element of damages); Dixie Feed & Seed Co. v. Byrd, 52 Tenn. App. 619, 376 S.W.2d 745 (1963), *cert. denied*, 379 U.S. 878 (1964) (jury cannot be charged as to the possible tax treatment to the plaintiff of an award for personal injuries).

11. Arentsen v. Sherman Towel Service Corp., 352 Ill. 327, 185 N.E. 822 (1933) (stock not on the market and thus without market value).

12. Baruch v. W.B. Haggerty, Inc., 137 Fla. 799, 188 So. 797 (1939) (stock had no fixed or par value since the corporation was owned by one man).

13. Aldrich v. Geahry, 360 Pa. 376, 61 A.2d 843 (1948) (closely held stock, not available in the market and without quoted or ascertainable market value).

available,[14] and when there was a particular reason necessitating such a remedy.[15] On the other hand, specific performance has been denied in the absence of the above factors.[16]

The instant court held that plaintiff had a valid, enforceable contract granting to him an option to purchase stock at any time before September 30, 1967, the time during which the plaintiff had a right to be employed under his employment agreement.[17] Although the "Stock Option Agreement" expired with the termination of employment, the court held that this agreement was merely "partial performance" of the original employment contract and not an "isolated transaction." The court then held that monetary damages were inadequate. Refusing to apply the general rule that tax benefits could not be considered in assessing damages and finding all the authorities cited by the defendant "not in point," Judge Todd declared that the plaintiff made the contract precisely for these tax advantages and that if they were not considered, it would deny the plaintiff the benefit of his bargain, leaving him without a remedy.[18] Once it was decided that the anticipated tax savings were to be considered, the court concluded that specific performance was justified because damages were then impossible to ascertain.[19]

In refusing to follow the general rule that tax advantages may

14. Haglin v. Ashley, 212 Minn. 445, 4 N.W.2d 109 (1942). In this instance the stock of a casket company was held by very few people. It had never been listed on the stock exchange and had no established market value.

15. Baruch v. W.B. Haggerty, Inc., 137 Fla. 799, 188 So. 797 (1939). A recent New York case, Lutzker v. Walter E. Heller & Co., 172 F. Supp. 77 (S.D.N.Y. 1959), granted specific performance but the court did not give reasons for its decision.

16. Irving Trust Co. v. Deutsch, 2 F. Supp. 971 (S.D.N.Y. 1932), *modified on other grounds*, 73 F.2d 1212 (2nd Cir. 1934), *cert. denied sub. nom.*, Biddle v. Irving Trust Co., 294 U.S. 708 (1935), *rehearing denied*, 294 U.S. 733 (1935), *cert. denied*, Deutsch v. Irving Trust Co., 294 U.S. 708 (1935) (stock commonly bought and sold on the market); Toles v. Duplex Power Co., 202 Mich. 224, 168 N.W. 495 (1918) (readily ascertainable value); *and* Nason v. Barrett, 140 Minn. 366, 168 N.W. 581 (1918) (fixed value, readily obtainable). *But see* Lutzker v. Walter E. Heller & Co., 172 F. Supp. 77 (S.D.N.Y. 1959) (specific performance granted; no reasons given).

17. Kentucky Fried Chicken Corp. v. Thuermer, Execution No. 11,188 (Tenn. Ct. App. Aug. 30, 1968) at 5-6. The court rejected defendant's contention that the right to purchase stock arose only from the "Stock Option Agreement" and the "Qualified Stock Option Plan," a right which was waived before notice of exercise of option by discharge from regular employment or by the end of the thirty-day special employment period. *Id.*

18. *Id.* at 8-9. The court noted, in dicta, that if the rule prohibiting the consideration of tax savings was valid, it would be a "harsh rule" which would justify the application of the equitable doctrine of specific performance. *Id.*

19. *Id.* at 7, 9. The variables involved in computing such damages would include: when the stock will ultimately be sold by the plaintiff, what the plaintiff's income will be at that time, and what tax rates and regulations will be in effect at the time of sale.

not properly be considered in calculating damages, the court properly recognized the importance of taxes in present-day financial planning. Courts first formulated the general rule at a time when taxes were not as great a factor in financial matters as they now are. However, at present, tax considerations are often determinative of the form and substance of a given transaction. This is true with regard to stock options, especially "qualified" options. The stock option is part of the employee's compensation, and consequently the employee agrees to work for a lower salary. Clearly, the plaintiff contemplated the tax advantages of the stock option when he negotiated his employment contract, which granted to him both a salary and the right to buy stock "in a manner most advantageous to [him] based on the Internal Revenue Service . . . regulations." To dismiss a consideration of the tax advantages would greatly emasculate the attractiveness of "qualified" stock option plans. The instant decision, then, is correct in bringing the rule of damages in line with modern business practice.

Furthermore, this holding is justified because it grants to the plaintiff that for which he bargained. The "qualified stock option," with its attendant tax benefits, was the basis of the employment contract. Plaintiff had bargained for the right to ride the market for a three-year period with the hope that the price of the corporation's stock would soar, enabling him to purchase at an advantageous price and eventually realize a considerable capital gain upon sale. Finally, specific performance was proper because damages would be difficult to compute due to the uncertainty as to when plaintiff would sell the stock, the uncertainty of the price of the stock upon sale, the fluctuating tax rates, and the fluctuation of plaintiff's income, which might place him in a different tax bracket each year, causing varying tax treatment throughout the years. The plaintiff, however, could have been awarded damages in the amount of the value of the stock at the time of the final settlement of the suit, and could then decide whether or not to purchase the shares of stock to which he was entitled. This would, in effect, replace one bargain with another, and the second agreement may be less attractive. This finding would create a new option which would have to be exercised immediately after the suit, thus depriving the plaintiff of the opportunity to follow the market during the period when the option was granted. Considering the time consumed in present-day litigation, the plaintiff would be deprived of a remedy until some future date, at which time the stock might have declined in value. The court's decision was therefore sound although the plaintiff could have been made economically whole at some future date.

Property—Landlord-Tenant—Rabbinical Court Establishes Far-Reaching Standard of Landlords' Obligations to Tenants

Tenants in the South End of Boston, represented by the South End Tenants Council, appeared before the Rabbinical Court of Justice (Beth-Din Zedeck) of the Associated Synagogues of Massachusetts and requested the court to adjudicate disputes arising over the condition of properties owned by their landlords, the Mindick family. The representatives of the Tenants Council alleged that the Mindick family owned and operated approximately 60 buildings in such fashion as to make the dwellings unsanitary and hazardous for habitation[1] and sought arbitration, alleging that normal channels of relief through governmental agencies involved complex procedures, with attendant delays and costly litigation. After being summoned[2] to the closed court sessions, the landowners contended that they were not responsible for general conditions in that section of the city, that they were doing their utmost to keep the buildings in proper condition, and that tenant-caused damage made continuous repair a heavy financial burden.[3] The Rabbinical Court obtained an agreement from both sides of the dispute to select arbiters, who would meet and investigate all the charges in the dispute.[4] Following guidelines suggested by the court, the arbitration ended in a final agreement on August 5, 1968, which established a new pattern in the relationship between landlord and tenant. The central bases of that relationship were: (1) the readiness of the landlord to comply with legal requirements regarding the condition of his property; (2) the

1. The Tenants Council alleged that the buildings were rat and roach-infested, and that the abnormal conditions prevailing in the buildings had led to lawlessness, prostitution and dope peddling. The tenants also claimed that they were harassed for making complaints and that there was constant rent-gouging by the landlord. The Council presented a list of eleven real estate corporations controlled by the Mindick family.

2. A Jew can be cited for contempt of court if he refuses to participate in such proceedings or to abide by the court's rulings. Rabbi Samuel I. Korff, the administrator of the Rabbinical Court, said that he did not believe "anyone of the Jewish faith would treat lightly a contempt of court order." Such an action takes away many of his religious privileges and subjects him to some disdain among devout Jews. Wall Street Journal, Sept. 9, 1968, at 1, col. 4. According to Robert L. Spangenberg, director of the Boston Legal Assistance Project, "[i]t was because of the sanctions available to the Rabbinical Court for those of the Jewish faith that both parties agreed to submit their grievances to the Court." OEO, 3 *Law in Action* 1 (August, 1968).

3. The landlords also alleged that many tenants fail to pay the rent and that collections are virtually impossible to make and must be recorded as a loss.

4. Each party was to select one arbiter. The two arbiters so chosen were to select a third arbiter. This group became the Board of Arbitration.

acceptance by the landlord of special burdens occasioned by the location of his properties; (3) his willingness to make some resources available for non-required improvements; (4) the existence of a strong tenants' organization; and (5) the availability of appropriate supporting social services better enabling tenants to maintain landlord's properties. *In re Mindick,* Rabbinical Court of Justice (Beth-Din Zedeck) (Associated Synagogues of Mass. 1968).

Traditionally, the low-income slum tenant has had little protection from apartment house owners who refuse to maintain their dwellings in a sanitary or habitable condition. Property law imposed no duty on a landlord to repair even the most dangerously dilapidated structures. The tenant had no right to demand that the property should meet any particular standard, and if he rented the property, he was consequently subject to the rule of caveat emptor.[5] After the property was rented, the landlord was still under no obligation to keep the rented premises in repair, or to prevent further deterioration of the building itself.[6] Only the defense of constructive eviction was available to the tenant, which would then absolve him of the obligation to pay rent under certain circumstances once he quit the premises.[7] Legislatures soon found that traditional property concepts were ill-suited to cope effectively with the acute problem of urban tenement districts. A definition of "tenement house" was formulated in New York at the relatively early date of 1867.[8] By the year 1900, New York City had 82,652 tenement houses that provided living space for 65 per cent of its population.[9] The Tenement House Law of 1901,[10] applicable to only New York and Buffalo, marked the beginning of

5. 2 R. POWELL, REAL PROPERTY § 233, at 300 (1967); 1 H. TIFFANY, REAL PROPERTY § 99 (3d ed. 1939).

6. 2 R. POWELL, REAL PROPERTY § 233, at 300 (1967); 1 H. TIFFANY, REAL PROPERTY § 103 (3d ed. 1939).

7. If a breach of the covenant of quiet enjoyment occurs, the lessee is provided with the defense of constructive eviction which is a complete bar to any action brought by the lessor for rent. A lessee seeking to show a breach must establish: (1) "a substantial interference with his use of the demised premises;" and (2) that the interference was caused by the lessor. 2 R. POWELL, REAL PROPERTY § 225(3), at 234 (1967).

8. N.Y. LAWS 1867, ch. 908, *cited in* 2 R. POWELL, REAL PROPERTY § 233(2)(a), at 309 (1967). The Tenement House Law of 1867 was directed at substandard conditions in tenements and lodging houses. The law established the minimum size of rooms, required transoms over doors, fire escapes, and at least one water-closet compartment or privy for every 20 occupants. Mitchell, *History of the Development of Multiple Dwelling Law*, in N.Y. MULT. DWELL. LAW XIV-XV (1946).

9. Mitchell, *History of the Development of Multiple Dwelling Law*, in N.Y. MULT. DWELL. LAW XV (1946); 2 R. POWELL, REAL PROPERTY § 233(2)(a), at 310 (1967).

10. *See* 2 R. POWELL, REAL PROPERTY § 233(2)(a), at 310 (1967).

modern housing code enforcement in America.[11] During the next several decades, both cities and states enacted housing laws,[12] but the administrative enforcement of those laws has not eliminated substandard housing.[13]

This failure has resulted in increased interest in tenant-initiated remedies.[14] Recently two states, New York[15] and Massachusetts,[16] have enacted statutory provisions aimed at allowing the tenant to rely on the legal process to initiate lawsuits against the landlords in order to compel correction of substandard conditions. The Massachusetts legislation allows any affected tenant to petition for relief from the district court for the district where the building is located.[17] If the

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11. A brief history of housing legislation will be found in Gribetz & Grad, *Housing Code Enforcement: Sanctions and Remedies*, 66 COLUM. L. REV. 1254, 1259-67 (1966).

12. Most of the early laws were based on Lawrence Veiller's Model Housing Law, published in 1914. Note, *Rent Withholding and the Improvement of Substandard Housing*, 53 CALIF. L. REV. 304, 315 (1965).

13. Figures computed from statistics obtained from 2 CENSUS OF HOUSING: 1960 pts. 2-5, revealed that in the 20 cities with the largest non-white populations, 25.6% of the total non-white rental units were deemed to be substandard. Note, *Rent Withholding and the Improvement of Substandard Housing*, 53 CALIF. L. REV. 304, 307 n.14 (1965). Reasons for the failure of adequate enforcement were: (1) "lack of adequate administrative machinery and resources;" (2) the confusion created by "overlapping jurisdiction of numerous enforcement agencies;" and (3) the minimal nature of fines which encourage the slum landlord "to absorb the slight penalty involved rather than undertake extensive repairs." *Id.* at 314-23. Another reason for lack of enforcement lies in code standards that are so exceptionally high that they cannot be enforced. Code provisions that fall into this category are modified by: (1) payments to building inspectors to forget violations; (2) the use of the code standards to threaten and intimidate landowners; or (3) the acceptance of fines by the owners. Comment, *Building Codes, Housing Codes and the Conservation of Chicago's Housing Supply*, 31 U. CHI. L. REV. 180, 186-90 (1963).

14. Some possible advantages: (1) for any resident willing to try to improve his lot, any improvement generated will, to an extent, improve the entire neighborhood; (2) a tenant who enforces the code to obtain even a "frill" will be obtaining something of primary importance to him, thus increasing the well-being and morale of tenants; (3) if tenants are given a right to enforce codes, they can learn to act more responsibly; (4) the availability of effective private rights might channel some of the tenant's resentment at his condition away from vandalism and to the more constructive paths of litigation; and, perhaps most importantly; (5) private action by the tenants could serve to supplement public enforcement and measure its effectiveness. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, DEPARTMENT OF JUSTICE & OFFICE OF ECONOMIC OPPORTUNITY, TENANT'S RIGHTS 7 (1967).

Reasons why code enforcement is insufficient and a proposed tort for slumlordism are discussed in Sax & Hiestand, *Slumlordism as a Tort*, 65 MICH. L. REV. 869, 871-75 (1967).

15. N.Y. REAL PROP. ACTIONS LAW §§ 760-82 (Supp. 1968-69). *See* Note, *Tenant Rent Strikes*, 3 COLUM. J.L. & SOC. PROB. 1 (1967); Note, *Tenant Unions: Collective Bargaining and the Low Income Tenant*, 77 YALE L.J. 1368, 1373 (1968).

16. MASS. GEN. LAWS ANN. ch. 111, §§ 127C-H (1967).

17. The petition must allege "that the premises have been inspected by the board of health or other appropriate inspection agency" and that the inspection revealed a violation of the state sanitary code; "that such condition may endanger or materially impair the health or well-being

allegations in the petition[18] are found to be true, the judge may order the affected tenants to make rental payments to the clerk of the court,[19] and may order disbursement of all or any portion of the rental payments either for repair or for the continued maintenance of the property.[20] After the substandard conditions have been corrected, the court clerk must return any excess of withheld rent above the actual expenses of removing the violation.[21] The enactment of such a law encourages the active participation and action of tenants. While the Massachusetts provisions may be carried out by one or more persons, the New York Real Property Actions and Proceedings Law, enacted in 1965, actually furthers the organization of tenant unions by providing specifically for collective action.[22] The petition filed by the

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of any tenant" in the building; and that the condition complained of "was not caused by the tenant or any other person acting under his control." MASS. GEN. LAWS ANN. ch. 111, § 127C (1967).

18. Once the petition is filed, the court issues an order of notice requiring the landlord to file an answer to the allegations, to list the names and addresses of mortgagees or lienors of record who are known to him, and to submit to a hearing on the petition. MASS. GEN. LAWS ANN. ch. 111, § 127D (1967).

19. The judge may make such an order provided the court finds "that any such violation may endanger or materially impair the health and well-being of [that] tenant, and that [his] rental payments are necessary to remedy the condition constituting the violation." The tenant must not be in arrears in his rent, and if he is, then he must pay the arrearage into the court. MASS. GEN. LAWS ANN. ch. 111, § 127F (1967). It would seem that the "affected tenant" test in the statute seriously limits the coercive and curative value of the law. If the rents of all tenants, affected or not, could be collected into the court, greater financial pressure would result on the landlord. Also, more money would be available to cure the defects as quickly as possible. Another advantage of having the rents of all tenants collected would be that landlord retaliation against complaining tenants would be seriously limited, as he could not realistically afford to evict everyone. One might also ask whether arrearage rent payment is material under the circumstances. The public interest in maintaining sanitary conditions in tenement housing should not be thwarted because of arrearage of a tenant's rent. Angevine & Taube, *Enforcement of Public Health Laws—Some New Techniques*, 52 MASS. L.Q. 205, 220 (1967).

20. MASS. GEN. LAWS. ANN. ch. 111, § 127F (1967).

21. At its discretion, the court may also render judgment for costs. MASS. GEN. LAWS. ANN. ch. 111, § 127F (1967). The clerk of the district court will remove the case to the superior court after thirty days upon the application of any party and the payment of a removal fee of five dollars. *Id.* § 127G. Several additional remedies are available in the superior court. The court may: (1) "issue appropriate restraining orders, preliminary injunctions and injunctions;" (2) "authorize any or all tenants in the respondent's building wherein the violation exists to make rental payments then due or thereafter becoming due to the clerk of the court . . . ;" (3) "order all the tenants in the respondent's building wherein the violation exists to vacate the premises, and order the board of health to close up said premises;" or (4) "appoint a receiver." *Id.* § 127H. In 1968 tenants were further protected by the enactment of section 127K, which provides that any provision of a lease or other rental agreement, the effect of which is to waive the benefits of any provision of section 127 C-I, inclusive, shall be deemed to be against public policy and void. Acts 1968, ch. 404, § 2, 4 ADV. LEG. SERV. TO ANN. LAWS OF MASS. 143 (1968).

22. One-third or more of the tenants occupying a multiple dwelling located in the city of

tenants must specify the nature of the defects,[23] the number of tenants making the petition,[24] the nature of the work required to remedy the defect, cost of the repair,[25] and the amount of rent due from each petitioner monthly.[26] If the owner cannot affirmatively establish any of the statutory defenses[27] and the tenants obtain a judgment, the owner will be given the opportunity to perform the repair himself.[28] In the event that the landlord should fail to make the necessary repairs, all of the tenants in the building are ordered to pay into court any rents due, and any future rents as they accrue.[29] Both statutes, New York and Massachusetts, encourage tenant action, and the tenant union is a normal outgrowth of these provisions. The tenant union gives the individual tenant greater bargaining strength by providing an organization, not only receptive to his complaints, but capable of achieving greater success because of outside help that is knowledgeable of the procedures that need to be followed.[30] Even though the codes may allow organized tenant groups to pursue the landlord until, all avenues of escape blocked, he finally makes the repairs complained of, code enforcement through the courts has lacked the two things tenement dwellers need most: (1) the continued

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New York may maintain the proceedings in the civil courts of the city for the purpose of remedying conditions dangerous to life, health or safety. N.Y. REAL PROP. ACTIONS LAW §§ 769-70 (Supp. 1968-69).

23. *Id.* § 772(1).

24. *Id.* § 772(2).

25. *Id.* § 772(3).

26. *Id.* § 772(4). There must also be a statement of the relief sought. *Id.* § 772(5).

27. Three defenses may be asserted to any tenant action: (1) that the condition never existed or has been repaired; (2) that the condition was caused by the petitioners; or (3) that the tenant has refused entry to the owner so as to make correction of the condition impossible. *Id.*, § 775.

28. The landlord must (1) demonstrate his ability to undertake the work required promptly and (2) post security for the performance of the work. *Id.* § 777.

29. The New York law, by allowing the collection of rent payments from all tenants, avoids at least one problem evident in the Massachusetts law. *See* note 19 *supra*. After the landlord's failure to perform, the court is empowered to appoint a person other than the owner to administer the rent moneys or the security, *supra* note 28, deposited with the clerk. The administrator is then authorized to remove or remedy the conditions specified in the judgment. N.Y. REAL PROP ACTIONS LAW § 778 (Supp. 1968-69). It is interesting to note that the typical owner will not make the repairs himself. Only one out of every ten owners assumes the obligation. Note, *Tenant Rent Strikes*, 3 COLUM. J.L. & SOC. PROB. 1, 12 n.91 (1967).

30. Tenants alone, without outside help, are not only unaware of their legal rights, but generally have little concept of the means for implementing those rights. Interviews showed that some tenants, even after signing the petition, were unaware of the nature of the proceedings in which they were involved. Note, *Tenant Rent Strikes*, 3 COLUM. J.L. & SOC. PROB. 1, 7 n.61 (1967).

arbitration of complaints; and (2) protection from retaliation by the landlord. Because of this need, the South End Tenants Council approached the Rabbinical Court of Massachusetts, a body well suited to their needs. The Beth Din, or "court of justice," has survived history and finds its primary role today as that of a court of arbitration, wherever large numbers of Jews are to be found in a community.[31] Being a court of arbitration, the Beth Din is obligated to bring about a compromise, in which the parties will abandon part of their claims,[32] and make concessions to the party of opposing interest. The success of the parties in reaching a compromise and the desire of the court to utilize every possible avenue in order to facilitate a mutual agreement, are illustrated by the instant case.

The history-making agreement[33] signed by the South End Tenants Council and the Mindick family was the result of three months of arbitrated negotiation.[34] The final agreement reflected the thinking of

31. 2 UNIVERSAL JEWISH ENCYCLOPEDIA 250 (1940).

32. Jewish legalists are of the opinion that even a correct court decision can leave parties embittered and unable to leave the court as anything other than enemies. A compromise results in justice and moderation. 8 UNIVERSAL JEWISH ENCYCLOPEDIA 649 (1940); G. HOROWITZ, THE SPIRIT OF JEWISH LAW 651-52 (1953).

33. "It was the first time in U.S. history that a Rabbinical Court, normally concerned with interpretation of Jewish law, divorce cases, disputes between synagogues, religious functionaries, family counseling, has undertaken to deal with such a profound social issue." The Jewish Advocate, August 8, 1968 (reprint), on file with the VANDERBILT LAW REVIEW.

34. An earlier agreement had been signed on Wednesday, June 26, 1968. That tentative agreement was to have been finalized on or before fourteen days from June 26. In that agreement the landlord agreed to continue removing any hazardous conditions present on the properties concerned. It was further agreed that a Board of Review would be appointed by the Rabbinical Court to consider all grievances of the signing parties. The decree of the Rabbinical Court, rendered in conjunction with the agreement, continued the Board of Arbitration and asked for a final report not later than July 10, 1968. No agreement was reached in the fourteen day period, and the Rabbinical Court extended the time during which the interim deeree would remain in force. The decree of July 10, 1968, among other things, provided for the following: (1) the Board of Arbitration was continued with its powers to render judgment, invoke rules, regulations, provisions and ordinances and to impose sanctions in order to insure compliance, also to call on all governmental agencies necessary to effectuate its regulations and to explore any resources, either private or governmental, that might be of assistance to landlord and tenants alike; (2) the date for final agreement was to be on or before August 1, 1968; (3) the owners were to recognize only the Tenants Council as agents of the tenants; (4) the owners were enjoined from harassing any tenant because of involvement with the Tenants Council; (5) the Tenants Council was enjoined from using any means of undue pressure to force the individual tenants to join the Council; (6) a complaint or grievance against the landlord would not serve as a legitimate excuse for a tenant not to pay his rent; (7) delay in the payment of rent should not serve as an excuse for the landlord to delay the removal of unsanitary or hazardous conditions; (8) the landlord had a right to evict a tenant if, in the opinion of the Board of Arbitration, such tenant constituted a public nuisance, carried on illegal activities, or was a menace to other tenants; (9) the landlord had a right to evict a tenant for nonpayment of rent, but a tenant

the Rabbinical Court expressed in the interim decrees that were handed down in an effort to effectuate a settlement as soon as possible by establishing certain basic elements.[35] In addition to many of the elements included in the interim decrees, the final agreement contained thirteen articles covering the complete spectrum of the owner-tenant relationship.[36] The Rabbinical Court noted that the

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should have a reasonable period of time to make payment without being subjected to untenable or uninhabitable conditions; and (10) the tenant must abstain from contributing to unsanitary or hazardous conditions. The Rabbinical Court then reminded the parties that it would not allow itself to be used as an instrumentality for deviationary tactics by either of the parties. "Our aim is clear, it is—justice for all concerned." The final agreement was signed August 5, 1968.

35. Note particularly the July 10, 1968 decree, note 34 *supra*.

36. Article III provides for "Building Conditions and Repairs." Section 2 lists 7 specific undertakings that the landlord is committed to in addition to repair, rehabilitation, maintenance, painting and the like. The landlord will undertake to: (1) "[i]nstitute and maintain daily supervisory, janitorial or caretaker services for the building;" (2) maintain adequate garbage storage and removal; (3) "cooperate in community efforts regarding police protection;" (4) "install and maintain locks on all doors leading from entranceways to hallways and in all unit entrances" and to provide a key system for tenants; (5) provide snow removal service and adequate lights in all common grounds and areas; (6) install window shades and adequate screens; and (7) maintain all apartments, stairways, hallways and common appurtenances in keeping with governmental requirements. Section 3 requires the landlord to furnish hot and cold water and a minimum temperature of 68 degrees between 7 A.M. and 11 P.M. Section 4 provides the machinery for complaints to be made and a time limit for the landlord's compliance. The Tenants Council may have emergency work done by workmen chosen from a list provided by the landlord.

Article IV sets out rules on "Rent and Eviction" and contains comprehensive sections covering: (1) tenants who are in arrears in their rent payments, providing for a payment schedule; (2) a roomer of less than three months who is already in arrears in his rent; (3) notice to be given a tenant at will before eviction proceedings are started; and (4) eviction proceedings for other than non-payment of rent, notice given to the Tenants Council of the action, and the tenants' right to challenge before the Board of Arbitration.

Article V outlines the "Tenant Responsibilities." The tenant recognized his obligation to comply with the following: "(a) to maintain that portion of the premises under his control in a clean condition; (b) to refrain from destruction of the landlord's properties; (c) to make every reasonable effort to prevent his guests and members of his family from damaging the landlord's property; (d) to cooperate with all reasonable efforts made by the landlord to comply with the spirit and intent of this agreement."

Article VI outlines the "Tenants Council Responsibilities." The Tenants Council agreed to assist the landlord in securing the cooperation of tenants and to advise the tenants of rules and proper procedures to be followed. The Council also agreed to "[s]ponsor meetings and programs to encourage tenants' feelings of pride in, and responsibility toward their apartment building as a place to live."

Article VII of the agreement sets up a Board of Arbitration to deal with disputes between the landlord and the tenants or the Tenants Council. The Board consists of five members, two selected by the landlord, two selected by the Tenants Council, and one member to act as chairman appointed by the Rabbinical Court. The Board is given the power to effect any neeessary decisions or orders and to authorize the escrow of rent, the ordering of repairs, and the method of financing those repairs. Any party that feels aggrieved by any decision or order of the Board can request a hearing before the Board of Review. The Board of Review, also

agreement proceeds from the belief that both landlords and tenants have obligations with respect to each other and that new arrangements are necessary if these obligations are to be met, if "decent" shelter is to be provided and reasonable care exercised in its use.[37] The court believed that these standards can only be met by continuing negotiations. The court noted that tenants in difficult neighborhoods may have special needs which their landlords must accept if they are to do business there.[38] The imbalance of resources, the availability of expert counsel and the intimate knowledge of legal and governmental subtleties by the landlord, as compared to the lack of such knowledge by the tenant, must be kept in mind when dealing with these problems. To the court, this imbalance points in two directions. First, the efforts to organize tenants into coherent groups should be supported by the landlord, since he stands to benefit from tenants who have pride in their homes and a sense of responsibility; but because of the conflicts that may arise between landlord and tenant this obligation must be fixed contractually. Second, the landlord cannot expect that all tenants will suddenly become responsible renters; but irresponsible tenants should be a shared concern of the landlord and his fellow tenants. The judgments on each issue confronting landlords and tenants alike, the court said, are based essentially on the question of responsibility as determined by what the reasonable man would define as the burden of the landlord engaged in rentals in a low-income, high-transient area. However, when the issue of profit for the landlord is considered, the court believed that two issues were involved, the one relatively simple, the other far more complex. The simple issue is that a landlord must accept a price for carrying on his business,[39] determined by fixed basic standards for issues arising from disputes over rising standards of living or marginal improvements properly the subject of negotiation. The more complex issue, the court believed, derives from the problem of providing reasonably attractive housing

provided for in Article VII, consists of three members, all of whom are appointed by the Rabbinical Court. The Board of Review has "the power to alter, modify, abrogate or confirm, in part or in full, any and all decisions or decrees of the Board of Arbitration . . . ."

Article XII of the agreement provides for the extension of the agreement beyond August 5, 1969, if the parties should so desire.

37. The statement of the court, issued after the agreement was signed, is reported in OEO, 3 *Law in Action* 2-4 (August, 1968).

38. "We believe that a landlord who would do business in a low income area must accept the special hazards of such areas, at least insofar as his properties are concerned."

39. For example, the court said that if the landlord's resources will not permit him to maintain non-hazardous dwellings, then he has no right to be a landlord.

facilities. Here the issue of profit is directly confronted, for the landlord is a private businessman and he cannot be expected to undertake vast rehabilitation projects at his own expense. The court believed that the issue of investments beyond the basic minimum would be best handled by establishing a fixed formula for annual investments, perhaps based on the current fair market value of the property.[40] Furthermore, the money made available through such a formula should be allocated according to the wishes of the tenants, as expressed through the tenants' organization, since the tenants can be presumed to be the most expert judges of their own needs.

The instant case reflects the gap that exists between the law as it is enforced by common law courts and Jewish law which is bound to advert to the ethical imperative, or higher law.[41] While the common law emphasizes the persuasive powers of the advocate, the Jewish law concerns itself with relative justice for the parties involved. The scope of Jewish law is therefore not limited to what the courts will or will not enforce, but instead to what is intrinsically right or wrong.[42] The duty of the landlord to his tenant in such a case becomes more than a simple adherence to minimal standards provided for in housing codes. In the instant case the Rabbinical Court believed that the landlord's obligation should reflect the standards of the community. Failure to give expression to such standards weakens the authority of the law and the faith or trust that the citizen can place in it. A problem arises, however, when one tries to ascertain what standards will be applied in any given situation. The Rabbinical Court believed that the reasonable man would supply the answer.[43] It is unlikely, however, that many tenant unions will find the favorable arbitration atmosphere that existed for the South End Tenants Council.[44] The

40. The court believed that given the rising market for real estate in general, and for property in the South End of Boston in particular, a formula tapping a portion of the annual increase in value would be the simplest and fairest to administer.

41. The Rabbinical Court cited an article entitled *Moral Rights and Duties in the Jewish Law*, by Dr. Issac Herzog. 1 I. HERZOG, THE MAIN INSTITUTIONS OF JEWISH LAW 381 app. (2d ed. 1965).

42. *Id.*

43. *See* text accompanying notes 38-39 *supra.*

44. A study of tenement ownership in Newark, New Jersey, indicates that the professional slumlord with large holdings is typically the white middle-aged businessman, substantially of Jewish or Italian origin. The major proportion of these people are professionals in real estate. G. STERNLIEB, THE TENEMENT LANDLORD 137 (1966). It is possible that tenants in the future may look to the Catholic Church for similar aid in influencing Italian slumlords to rehabilitate slums, as the solution in the instant case, other than the ready availability of the Rabbinical Court system, is hardly unique to the Jewish faith. One can hope that the Catholic Church is able to meet this social challange.

exceedingly reasonable man is usually absent from bargaining tables. A tenant union is likely to find a landlord who lacks involvement with his property. Because of the probable tendency of the large-scale owner of slum housing to treat the property involved as only an impersonal facet of his business affairs[45]—accentuated by the fact that he may seldom see the property or the people that live in it[46]—the tenant union will have to make its presence felt in order to draw the landlord to the negotiating table, or else the landlord may simply ignore the buildings where the pressure originated. With the large-scale owner, adequate pressure will mean organizing tenants in as many of the landlord's buildings as possible; rent withholding is likely to be the most potent weapon available to the typical tenant union, since the owner probably needs a steady flow of rent money to meet mortgage payments.[47] Even if the tenant union manages to get the landlord to the arbitration table, many possible factors would influence the landlord's willingness to sign an agreement. Because of the high level of risk involved in tenement ownership,[48] the landlord demands a high return on his investment and is unlikely to negotiate and agree to repair, or provide for the needs of the tenants, without some promise that the tenants will alleviate some of his basic problems. The tenant union can do a great deal to lessen this risk by advising the tenants of rules and regulations and by encouraging pride in and responsibility toward their apartment building, so as to decrease vandalism or unsanitary conditions. The mutual promises of the landlord and the tenant union make the agreement a viable contract. A contract without means of enforcement, however, would do the tenants little good, as they would then have to go to court to enforce it when and if the landlord backed down. In the instant case a mechanism has been provided that will allow the tenant union to guarantee continuity to the operation of the agreement. The Board of Arbitration and its power to place rent money in escrow gives this guarantee, since a breach of the agreement would cost the landlord his rental money.[49] If the promises of both sides are faithfully adhered to

45. G. STERNLIEB, *supra* note 44, at 139.

46. *Id.* at 140.

47. Note, *Tenant Unions: Collective Bargaining and the Low Income Tenant*, 77 YALE L.J. 1368, 1385 (1968).

48. G. STERNLIEB, *supra* note 44, at 95-96.

49. If either of the parties should choose to ignore the agreement, the Board of Arbitration is empowered to take any steps necessary to insure the faithful performance of the obligations under the agreement.

and the agreement of August 5, 1968 is renewed in 1969, the South End Tenants Council and the Mindick family will have contributed significantly to private action in the rehabilitation of the nation's tenement slums by providing an entirely new approach to the problems of tenement housing which others may be able to utilize.[50]

Taxation—Federal Estate Taxation—Under Treasury Regulation Section 20.2031-8(b), Value of Shares in Mutual Funds Is Public Offering Price on Date of Death Rather Than Redemption Price

The estate of decedent Wells contained shares in three open-end investment companies (mutual funds). On decedent's estate tax return the executor valued the shares at the redemption ("bid") price. The Commissioner assessed a deficiency, valuing the mutual fund shares at the public offering ("asked") price in accordance with the federal estate tax regulations.[1] On petition to the Tax Court of the United States, *held*, for the Commissioner. Shares in open-end investment companies are properly valued for estate tax purposes at the public offering price on the date of death in accordance with Treasury Regulation section 20.2031-8(b). *Estate of Wells*, ¶ 50.88 P-H TAX CT. REP. & MEM. DEC. 603 (Sept. 16, 1968).

The typical mutual fund—technically referred to as an open-end diversified management investment company[2]—is a corporation which sells shares in itself and invests the proceeds in securities of other companies.[3] The price at which mutual funds offer a share to the

50. The South End Tenants Council has already approached two other Boston landlords. One of these, a Jewish landlord, has signed a similar agreement. Wall Street Journal, Sept. 9, 1968, at 8, col. 2.

1. Treas. Reg. § 20.2031-1(b) (1965) provides in part: "The value of every item of property includible in a decedent's gross estate . . . is its fair market value at the time of the decedent's death . . . ."

Treas. Reg. § 20.2031-8(b) (1963) provides in part: "The fair market value of a share in . . . a . . . 'mutual fund' is the public offering price of a share . . . ."

2. This is the terminology of the Investment Company Act, 15 U.S.C. §§ 80a-5(a)(1), 80a-5(b)(1), 80a-4(3) (1940).

3. The mutual fund is unrestricted in issuing new shares, its asset value growing with each new share sold and declining with each share redeemed. The fund's investments are not concentrated in the stock of any particular issuer, but rather are alterable by the fund management in pursuit of the fund's investment policy. The mutual fund sells its shares to the

public (the "asked" price) is the net asset value per share,[4] plus the underwriter's sales charge ("sales load").[5] At the time the investor buys, the fund agrees to redeem his shares at anytime for the net asset value (the "bid" price).[6] Section 2033 of the Internal Revenue Code of 1954 includes in the gross estate "the value of all property . . . to the extent of the interest therein of the decedent at the time of his death." The Internal Revenue Service has interpreted "value" to mean "fair market value."[7] Generally, where there is an existing market, market price is determinative of "value."[8] For this reason market price is used to ascertain the value of ordinary (closed-end) securities.[9] However, in the absence of an existing market, replacement cost is used, as in the case of such things as life insurance policies and jewelry.[10] As promulgated, Treasury Regulation section 20.2031-8(b), regarding valuation of mutual funds, was included in the

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public through an underwriter acting as an agent for the fund. The fund's principal underwriter bears the entire cost of literature, statistical presentations, and other sales aids and is usually the fund's investment adviser as well. As investment adviser, its primary duties are to make investment decisions relating to the day-to-day purchases and sales of securities of the fund. WHARTON SCHOOL OF FINANCE AND COMMERCE, A STUDY OF MUTUAL FUNDS: PREPARED FOR THE SECURITIES AND EXCHANGE COMMISSION 49, 449, 469, 471 (1962).

4. Net asset value per share (the price at which an investor redeems his shares with the fund) is determined by adding together the current market values of the fund's investments, deducting the liabilities, and dividing by the number of shares outstanding. Lobell, *The Mutual Fund: A Structural Analysis*, 47 VA. L. REV. 181, 183 n.6 (1961).

5. Sales charges vary from about 0.5% to 9%, with charges of 8% to 8 1/2% being common. This "load" varies with dollar amounts of shares purchased, reduced charges applying to larger single purchases. *Id.* at 182 n.5; ARTHUR WIESENBERGER & CO., MUTUAL FUNDS PANORAMA (1962).

6. In disposing of mutual fund shares, nearly all investors redeem with the fund itself, rather than selling to an independent investor. ¶ 50.88 P-H TAX CT. REP. & MEM. DEC. at 604; Lobell, *Rights and Responsibilities in the Mutual Fund*, 70 YALE L.J. 1258, 1262 n.19 (1961). Some funds charge a redemption fee which is generally from 0.5% to about 1%. *Id.* However, the majority of the funds which charge a sales fee do not charge a redemption fee. ARTHUR WIESENBERGER & CO., *supra* note 5.

7. Treas. Reg. § 20.2031-1(b) (1965).

8. Market price is the price at which a sale takes place between a willing seller and a willing buyer, neither being under a compulsion to sell or buy. Newberry v. Commissioner, 39 B.T.A. 1123 (1939).

9. Treas. Reg. §§ 20.2031-2(a) & (b) (1965). For convenience, market price for stocks and bonds is set at the average selling price for the day in question. Ordinary securities include stocks and bonds for which there is a market on a stock exchange, over-the-counter market, or otherwise. These securities are to be distinguished from mutual fund shares in that the former represent ownership in a "closed-end" investment company, which is limited in the number of shares which it may issue. The price of its shares, therefore, is determined by the natural market operations of supply and demand.

10. *See, e.g.*, Guggenheim v. Rasquin, 312 U.S. 254 (1941); Estate of Gould, 14 T.C. 414 (1950).

section valuing "certain life insurance and annuity contracts" and utilized the replacement cost valuation.[11] Several cases have upheld the replacement cost as the value for estate tax purposes of a life insurance policy on the life of a person other than the decedent, on the grounds that the owner of the policy has more than the right to redeem it; he has the right to retain it for its investment benefits, which will exceed the redemption value upon the insured's death.[12] No previous cases have determined the validity of Treasury Regulation section 20.2031-8(b).

In the instant case the Tax Court found that mutual fund shares were a "different breed of cats" from ordinary stocks and bonds[13] and, in valuing mutual fund shares, a criterion more like that applied in the case of life insurance policies should be used.[14] The court stated that the transactions in which the public buys from the fund more clearly represent the fair market value, for only in these situations are there both willing sellers and willing buyers. On the other hand, the court noted that redemption of fund shares lacks a "willing" buyer, because the fund is obligated to repurchase the shares. By implication the majority thus adopted the price which a willing buyer would pay to a willing seller as its definition of "value." Further, the court found that life insurance contracts and mutual fund shares were similar.[15] In both instances all the economic benefits of ownership must be considered in determining value. The owner of a life insurance policy has, in addition to the mere right to surrender the policy, the right to retain it for its investment value.[16] Likewise, the estate may continue to own the mutual fund shares and enjoy all the benefits of ownership, including the right to retain the shares and receive dividends. The court concluded that despite the possibility of other reasonable methods of valuation, the replacement cost method

11. Treas. Reg. § 20.2031-8(b), *supra* note 1. The replacement cost is the "public offering price" ("asked" price), *i.e.*, what it would cost an investor to purchase the mutual fund shares held by the deceased on the date of the latter's death.

12. Guggenheim v. Rasquin, 312 U.S. 254, 257 (1941) (value of a life insurance policy for gift tax purposes is what it would cost to purchase it). The Regulations offer no distinction between valuation for gift tax purposes and valuation for estate tax purposes. Treas. Reg. §§ 20.2031-8(a) & 25.2512-6(a) (1963).

13. See note 9 *supra*.

14. See note 10 *supra* and accompanying text.

15. The court based its reasoning on gift tax valuation cases, declaring that the test for valuing a gift is applicable to an estate, since the latter involves testamentary gifts. ¶ 50.88 P-H TAX CT. REP. & MEM. DEC. at 606.

16. See text accompanying note 12 *supra*.

was reasonable and should be upheld.[17] In a dissenting opinion, Judge Tannenwald declared that the fact that mutual fund shares were different from ordinary stocks and bonds did not place them in the same class with life insurance contracts. The dissent stated that fair market value is the price which a willing seller could reasonably be expected to obtain from a disposition of his property. Therefore, the redemption value ("bid" price) of mutual fund shares should be the ceiling for determining fair market value, because it is the maximum amount obtainable from a sale of the shares by the estate. The dissent stated also that the elements of insurability and risk separate securities from life insurance contracts. Further, the dissent pointed out that although the estate may continue to own the mutual fund shares and enjoy added benefits therefrom, this possibility exists with all securities; despite this analogy, not all securities are valued at replacement cost for estate tax purposes. The dissent concluded that Treasury Regulation section 20.2031-8(b) was "unrealistic" and should not be given effect.

Because Treasury Regulations are to be sustained unless they are found to be unreasonable, the question is whether the method of valuation adopted by the Treasury, and upheld by the majority in the instant case, is in fact unreasonable. The Regulations define the "value" of property includable in an estate as its "fair market value,"[18] which, for tax assessment purposes, has traditionally been the price which a purchaser, willing but not obligated to buy, would pay an owner, willing but not obligated to sell.[19] Therefore, both willingness and lack of obligation are necessary to obtain the "fair market value" of an asset. When the fund offers to sell its shares to the public at the "asked" price, both the fund and the purchaser are willing and under no obligation to sell or buy. However, when a mutual fund redeems a share, it is not, in fact, a "willing" buyer, because it is obligated to buy its investor's shares at the "bid" price. Consequently, it is at the "asked" price that the trading of a mutual fund share more closely establishes "fair market value." However, it is puzzling that the majority couched its decision in terms of "fair market value." Even when the shares are traded at the "asked" price, there is no "market" in the truest sense of the term. Since "fair

17. *See, e.g.*, Commissioner v. South Texas Lumber Co., 333 U.S. 496 (1948).

18. Treas. Reg. § 20.2031-1(b) (1965).

19. *Id.*; *e.g.*, State *ex rel.* Evansville Mercantile Ass'n v. Evansville, 1 Wis. 2d 40, 82 N.W.2d 899 (1957).

market value" is an economic concept depending upon the natural market operations of supply and demand, it becomes impossible to find a "fair market value" in the case of mutual funds. Mutual fund shares represent ownership in an "open-end" company, unrestricted in issuing new shares. The value of a share in a mutual fund does not depend upon supply and demand, but upon the fund's success in its investments in other companies. Thus, neither the "asked" nor the "bid" price truly represents "fair market value." The better approach would have been to have looked at the shares' "worth". rather than their "fair market value." The question then is whether to examine replacement cost or "worth" to the executor. It seems fairer to look at the shares' "worth" from the executor's point of view. The instant decision imposed a hardship upon the executor by taxing him on a dollar amount he could not realize, for in selling the mutual fund shares, the most he can obtain is their net asset value (the "bid" price times the number of shares sold). However, to look at replacement cost to value mutual fund shares is consistent with prior authority which indicates that where value is difficult to determine, replacement cost is proper as the best evidence of value.[20] While not properly articulated, the instant court's determination of reasonableness will probably not be overturned. However, in view of the unique nature of the mutual fund, it would seem proper to determine the "value" of mutual fund shares for estate tax purposes by examining the "worth" of the shares in the hands of the executor. It is urged that the Internal Revenue Service re-examine its mutual fund valuation regulation with a view toward either re-evaluation in terms of "worth," or creation of an exception to the "fair market value" test as here applied, since it is obvious that slavish adherence to the definition of a shorthand phrase can, as here, produce wholly unrealistic results.

Taxation—Income—Multiple Trusts Created Solely for Tax Avoidance Accorded Separate Tax Treatment Where Identity of Each Trust Maintained

The Commissioner of Internal Revenue assessed a deficiency in the income tax returns of certain irrevocable inter vivos trusts after

20. *See* Duke v. Commissioner, 200 F.2d 82 (2d Cir. 1952), *cert. denied*, 345 U.S. 906 (1953); Publicker v. Commissioner, 206 F.2d 250 (3d Cir.), *cert. denied*, 346 U.S. 924 (1953); Guggenheim v. Rasquin, 312 U.S. 254 (1941).

determining that there were two trusts, rather than twenty trusts as claimed by petitioner, the trustee. The substantially identical trusts were created on the same day by the execution of ten separate declarations of trust. Each declaration purported to create two identical trusts, one for each of the two primary beneficiaries.[1] Each trust kept separate books of accounts and records, maintained separate bank accounts, and filed separate income tax returns. At all times the trusts were treated as separate entities by the grantor and trustees. Petitioner contended that each of the ten declarations of trust created two trusts[2] and that under section 641(b) of the Internal Revenue Code[3] each trust was to be accorded separate tax treatment. Respondent asserted that the trusts were created solely for reasons of tax avoidance and should be consolidated as one trust for each beneficiary for the purposes of taxation. On determination by the Tax Court, *held*, for petitioner. Where separate trusts are created by a grantor and are meticulously treated as such by the parties, then each trust is to be accorded individual income tax treatment under section 641(b) despite the fact that tax avoidance was the sole purpose for their creation. *Estelle Morris Trusts*, ¶ 51.4 P-H TAX CT. REP. & MEM. DEC. 13 (Oct. 18, 1968).

A grantor may, by one instrument, create in an undivided corpus two or more trusts for different beneficiaries.[4] The validity of multiple trusts for tax purposes depends upon the intent of the grantor[5] and the

1. Each trust instrument directed the trustee to accumulate the trust income for the life of the primary beneficiaries, after which the principal and income were to be distributed to their surviving issue. The only differences among the declarations of trust were the prescribed periods of income accumulation and distribution and the termination dates. The instruments provided for distribution of corpus or income upon a showing by the beneficiary that a distribution was essential to maintain his present standard of living or to meet emergencies.

2. Each declaration of trust read: "The Trustee shall apportion the Trust Estate into two (2) equal shares, each of which shall be a separate Trust."

3. "The taxable income of an estate or trust shall be computed in the same manner as in the case of an individual . . . and shall be paid by the fiduciary." INT. REV. CODE of 1954, § 641(b).

4. United States Trust Co. v. Commissioner, 296 U.S. 481 (1936). Whether this purpose has been accomplished is a question of fact which must be determined by an examination of the words used and the means employed by the grantor to create the trusts. *Id.* at 486-88. In Kohtz Family Trust, 5 T.C. 554 (1945), the Tax Court relied on *United States Trust Co.* to reach the conclusion that where a grantor expressly provides in the same instrument that separate trusts be created out of a common corpus, multiple trusts may exist even if the trustee does not subsequently divide the corpus in order to facilitate administration of the estate.

5. The Commissioner puts much reliance on whether the trusts created are referred to by the grantor as being singular or plural. Such phrases as "the trust fund" and "the body of said trust estate" have been regarded as determinative of a singular trust. State Sav. & Trust Co. v.

subsequent behavior of the trustee;[6] consequently, where the words used are sufficient to create multiple trusts, but the actions of the parties have obscured their individual identity, the tax benefit will be denied and consolidation into a single trust required for tax purposes. In *Boyce v. United States*,[7] the grantor's primary reason for creating 90 trusts was tax avoidance. While the language employed in the trust instruments was sufficient to support a claim that multiple trusts had been created, subsequent inconsistent behavior by the parties led the court to find a single trust.[8] The court stated that such trusts "[flout] the statutory purpose of our laws . . . [and] ought to be struck down forthwith."[9] A similar result was reached in *Sence v. United States*,[10] where the Commissioner contended that since the "principal purpose" for creating the 19 trusts was tax avoidance, they should be taxed as a single trust. The court consolidated the trusts,[11] but intimated that if a taxpayer with tax avoidance motivation affirmatively showed that he created and maintained truly separate trusts, the court would accord them separate tax treatment.[12] Thus, no court had expressly ruled on the question whether multiple trusts created solely for tax avoidance purposes, but carefully maintained as separate entities, were entitled to individual treatment under section 641(b) of the Internal Revenue Code.

Commissioner, 63 F.2d 482, 484 (7th Cir. 1933). *See also* MacManus v. Commissioner, 131 F.2d 670 (6th Cir. 1942); Lincoln Elec. Co. Employees' Profit-Sharing Trust, 14 T.C. 598 (1950), *rev'd on other grounds*, 190 F.2d 326 (6th Cir. 1951); Tom R. Booth Trust, 22 CCH TAX CT. REP. 1337 (1963).

6. This is the so-called "close scrutiny" test. Childs, *Multiple Trusts: A Word of Warning*, 107 TRUSTS & ESTATES 183, 184 (1968). In essence, the determination of whether there are in fact multiple trusts is based on the reality of the transaction. Not only must the proper words be present, but the taxpayer's treatment of the transaction must be consonant with the grantor's expressed intent. *See, e.g.*, Boyce v. United States, 190 F. Supp. 950 (W.D. La.), *aff'd per curiam*, 296 F.2d 731 (5th Cir. 1961); Sence v. United States, 394 F.2d 842 (Ct. Cl. 1968).

7. 190 F. Supp. 950 (W.D. La.), *aff'd per curiam*, 296 F.2d 731 (5th Cir. 1961).

8. While there was a manifest intent to create multiple trusts, the funds were all deposited in one bank account and checks drawn for the beneficiary were credited to the account as a whole rather than to the individual trusts. *Id.* at 957-58.

9. *Id.* at 957. No statutory or case authority was cited by the court for this proposition.

10. 394 F.2d 842 (Ct. Cl. 1968).

11. Petitioner, as trustee, had not maintained the identity of the trusts; he failed to keep his own assets separate from those of the purported trusts. Petitioner also treated the property as his own by failing to endorse checks as trustee and by making payments to parties other than the named beneficiary. *Id.* at 850-51.

12. "If it is permissible to create separate trusts solely for tax avoidance reasons . . . then it is appropriate to require a taxpayer to turn square corners—to dot his i's and cross his t's—in order to take advantage of the rule." *Id.* at 851-52. *See also* Morsman v. Commissioner, 90 F.2d 18, 22 (8th Cir. 1937).

After determining that the sole purpose of the grantor was the avoidance of taxation,[13] the instant court held that where multiple trusts are created and maintained separately, the tax avoidance motives of the grantor should not dictate tax liability under the Code.[14] The only issue to be considered is whether in form and in substance multiple trusts exist. Recognizing that the abuses of multiple accumulation trusts have been a subject of congressional concern since at least 1937,[15] the court concluded that Congress' failure to take substantial remedial measures was significant.[16] The court found that the legislative history of the Code did not limit the plain meaning of section 641(b) and therefore upheld "[t]he validity of the long-established policy [of] deferring . . . to congressional procedures in the tax field."[17] Furthermore, the court argued that when a law is so fraught with policy considerations that it continually confounds Congress, a court, with its limited facilities, should be slow to create laws to fit its concepts of justice.[18] In view of the inconclusive legislative background of section 641(b), the court was

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13. ¶ 51.4 P-H TAX CT. REP. & MEM. DEC. at 25.

14. *Id.* at 30.

15. *Id.* at 27. In 1937 President Roosevelt requested Congress to examine the problem of tax avoidance through the use of multiple trusts. Message of the President of the United States, H.R. Doc. No. 260, 75th Cong., 1st Sess. 4 (1937).

16. Despite testimony concerning the gross abuse of multiple trusts before the Joint Committee on Tax Evasion and Avoidance, held pursuant to President Roosevelt's request, the only action taken by Congress was a reduction of trust exemptions from $1000 to $100. Revenue Act of 1937, ch. 815, § 401 50 Stat. 813, 829, eliminated the exemption for accumulation trusts which did not distribute an amount equal to their net income; Revenue Act of 1938, ch. 289, § 163 (a) 52 Stat. 447, 518, deleted prior provisions for an exemption of $1000 for trusts and, on grounds of administrative expedience, allowed a "credit" of $100 against net income. No other congressional action was taken until 1954 when the five year throwback rule was added to subchapter J, for the purpose of lessening the tax advantages of accumulation trusts, but no specific provision was made for regulating multiple trusts. *See* INT. REV. CODE of 1954, §§ 665-69.

In 1956, the House Subcommittee on Internal Revenue Taxation of the Ways and Means Committee prepared a report calling attention to the problems of multiple accumulation trusts, and the report was referred to an advisory group studying subchapter J. In this report a new Code section was recommended which would have required the consolidation of multiple trusts where the primary beneficiaries were "substantially the same." HOUSE COMM. ON WAYS AND MEANS, STAFF COMMITTEE ON INTERNAL REVENUE TAXATION ON SUBSCHAPLR J, 85TH CONG. 2D SESS. FINAL REPORT ON ESTATES, TRUSTS, BENEFICIARIES AND DECEDENTS 1 (Comm. Print 1958). Hearings have been held on subsequent proposed amendments based on this report, but none have been enacted into law.

17. ¶ 51.4 P-H Tax Ct. Rep. & Mem. Dec. at 29. *citing* American Auto. Ass'n v. United States, 367 U.S. 687, 697 (1961). *See also* Commissioner v. Brown, 380 U.S. 563, 578-80 (1965).

18. ¶ 51.4 P-H TAX CT. REP. & MEM. DEC. at 29, *citing*, American Auto. Ass'n v. United States, 367 U.S. 687, 697 (1961).

also wary of the broad-scale application of the doctrines of "tax avoidance,"[19] "business purpose,"[20] or "sham" in the area of multiple accumulation trusts, especially since those concepts are not statutorily applied to trusts.[21] Because the court found that in form as well as substance the instant multiple trusts were created and maintained separately, the close scrutiny test applied in *Sence*[22] and *Boyce*[23] was held inapplicable.[24]

While the instant case dealt with irrevocable inter vivos trusts, there seem to be no policy reasons forbidding application of this case to short-term trusts.[25] Thus the whole range of tax-saving methods made possible by multiple trusts would seem open to general use.[26] Where a declaration of trust is carefully drawn and the multiple trusts are carefully managed as separate entities, the Commissioner now

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19. Not all transactions are upset merely because tax avoidance is a motive of the parties. Evidence of tax avoidance does not invalidate family partnerships. Commissioner v. Culbertson, 337 U.S. 733, 744 n.13 (1949). Corporations are not invalidated if the creator's aim is tax reduction, but are recognized for tax purposes if they engage in some business activity. *E.g.*, Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943); Jackson v. Commissioner, 233 F.2d 289, 290 (2d Cir. 1956), *aff'g* 24 T.C. 1 (1955).

20. The government raised the question of "business purpose," relying on Knetsch v. United States, 364 U.S. 361 (1960), and Gregory v. Helvering, 293 U.S. 465 (1935), for the proposition that where no business purpose is to be served except that of tax avoidance, the tax benefit sought will be denied. The instant court rejected the "business purpose" test on the ground that it is inapplicable to the donative dispositions of family trusts. The same is true of charitable trusts. *See* Childs, *supra* note 6, at 184-85.

21. The instant court noted that certain provisions of the Code specifically require the Commissioner to disregard transactions in which tax avoidance was the motivation: section 269 (disallowing tax benefits otherwise available in the corporate area as a result of certain acquisitions); section 306(b)(4) (allowing capital gain treatment of certain dispositions of § 306 stock); section 482 (permitting the reallocation of income among certain related entities in order to prevent tax evasion); section 532 (conditioning the applicability of the accumulated earnings tax); section 1551 (disallowing the corporate surtax exemption or the accumulated earnings credit, available as a result of a transfer of assets). It was noted by the court that while terms such as "tax avoidance," "business purpose," and "sham" were applicable to corporations because of the provisions of the Code, there were no similar statutory restrictions on multiple trusts.

22. Sence v. United States, 394 F.2d 842 (Ct. Cl. 1968).

23. Boyce v. United States, 190 F. Supp. 950 (W.D. La.), *aff'd per curiam*, 296 F.2d 731 (5th Cir. 1961).

24. ¶ 51.4 P-H TAX CT. REP. & MEM. DEC. at 30-31.

25. *See* INT. REV. CODE of 1954, §§ 671-78. Apparently Congress saw this possibility and in one proposed addition to the Code included a ten year throwback provision. H.R. 9662, 86th Cong., 2d Sess. § 113 (1960); *See* H.R. REP. NO. 1231, 86th Cong., 2d Sess. 15, 64-69 (1960).

26. Friedman & Wheeler, *Effective Use of Multiple Trusts*, N.Y.U. 16TH INST. ON FED. TAX. 967 (1958). These possibilities include accumulation trusts, trusts to receive capital gains, and trusts to disburse income in respect of decedents. *See also* Childs, *supra* note 6.

appears to be without an argument for consolidation.[27] It now appears that any action taken must be initiated by Congress. Proposed amendments have been aimed at multiple trusts in general, but the import of these proposals has been to require the Commissioner to consolidate all multiple trusts created by a common grantor for substantially identical beneficiaries.[28] Although the proposals did contain certain exceptions,[29] many multiple trusts created for purposes other than tax avoidance could have been subjected to consolidation. The proposed statutory remedies would seem to violate the principle that legislation should be no broader than the problem which it seeks to remedy.[30] Thus the problem that faces Congress is to devise legislation broad enough to defeat tax avoidance schemes, yet narrow enough to permit bona fide use of multiple trusts. Since the validity of multiple trusts for tax purposes should be determined by reference to the purposes of the grantor, or perhaps to the independent significance of each of the trusts created,[31] no rigid test would seem feasible. However, a congressional enactment of the principal purpose test, advocated by the Commissioner in *Sence* v. *United States*,[32] would allow sufficient flexibility to permit a reasonable determination of the tax status of a multiple trust under any given set of facts. Thus, where the Commissioner found that the principal purpose of the trusts was the avoidance of taxation, he would be required to disregard the

27. Where the declaration is carefully drawn, the Commissioner may be precluded from finding that the grantor did not intend to create multiple trusts. If the estates are managed in such a manner as to maintain separate identities, the close scrutiny test is thwarted; as stated in the instant case, the "business purpose" test is inapposite to donative transfers.

28. *See* 1 W. BOWE, ESTATE PLANNING AND TAXATION § 4.18 (1957). The American Bar Association would have authorized consolidation of multiple trusts only where the "principle purpose" of the trusts was "to reduce or eliminate the tax liability of such trusts." *Hearings Before the House Comm. on Ways and Means*, 86th Cong., 1st Sess., Advisory Group Recommendations on Subchapters C, J, and K, of the Internal Revenue Code 265 (1959) [hereinafter cited as Advisory Group Recommendations].

29. Advisory Group Recommendations at 247, 249, 263-71. The proposed section, 641(c), would have been inapplicable to: (1) multiple trusts with income of less than $2000 per year; (2) inter vivos trusts not in excess of three in number and created at intervals of five years or more; and (3) cases where the combined tax produced by consolidation would be less than the total of the separate taxes otherwise payable by the separate trusts. Soter, *Federal Taxation Aspects of Multiple-Accumulation Trusts*, 31 U. CIN. L. REV. 351, 399 (1962).

30. Sugarman, *Estates and Trusts*, in 3 HOUSE COMM. ON WAYS AND MEANS, COMPENDIUM OF PAPERS ON BROADENING THE TAX BASE, 86TH CONG., 1ST SESS. 1749, 1755 (Comm. Print 1959).

31. It has been suggested that the test should be based on the effect of the grantor's action, rather than on his intent or purpose. The question to be answered is: "Are the consequences of the trustor's actions of such differing significance that the trust created thereby should be accorded the dignity of a separate taxpaying entity." Childs, *supra* note 6, at 188.

32. 394 F.2d 842 (Ct. Cl. 1968).

arrangement for tax purposes. The application of the principal purpose test to consolidate multiple trusts would preserve present congressional policy considerations by permitting bona fide multiple trusts to be accorded separate tax treatment. The question is so fraught with policy considerations that Congress, not the courts, should act on it.[33]

Taxation—Mineral Rights—Carried Interest Loses Dednction for Depletion, Depreciation, and Intangihle Drilling Costs Dnring Recoupment

Taxpayers, owners of various mineral interests, contracted with Humble Oil and Refining Company for the exploitation of their property.[1] Humble, the carrying party, agreed to advance, in the form of a loan, all money necessary for the drilling operations and to recoup the sums it had advanced to cover the taxpayers' (the carried parties') proportionate share of the development expenses only from a percentage of the carried parties' share of production.[2] Thus, the carried parties assumed no personal liability for production costs, but agreed only to subordinate a portion of its production interest for the repayment of the carrying party's outlays. Arguing that they owned 25 per cent of the oil produced, the taxpayers reported as income the

33. One author felt that because of the conflicting policy interests, not even Congress should attempt an attack on multiple trusts without first fully reconsidering the whole area of family taxation. Sugarman, *supra* note 30, at 1754-56.

1. Taxpayers (all members of a family), one Goodrich, and Humble Oil owned working interests in mineral leases in St. Martin Parish, Louisiana. For developing the property, the parties entered into a joint operating agreement which gave Humble control of the exploration and production of the oil. Humble was given a 50% interest in production, while Goodrich and the taxpayers each had a 25% interest.

2. Humble could use only one-half of these parties' shares for repayment of the loaned money advances. A seeond agreement, relating to other properties, had similar terms. In any carried interest transaction, such as this, one of the owners, the producer, agrees to advance all funds necessary for the exploration and exploitation of the minerals. Because he depends solely on the other owner's share of production for repayment of the money advanced, this owner, the carrying party, risks his entire investment against the possibility that there will not be enough production to reimburse him for his costs. The other owner, the carried party, invests nothing in the production and assumes no personal liability for the costs. The carried party waits until the carrying party has recouped his development expenses before he takes his full share of the production. Such transactions, varying vastly in provisions, are common in the field of oil and gas. *See generally* Caplan, *Taxation of Carried Interests: A Study in Gossamer Distinctions*, 7 S. TEX. L.J. 239 (1964).

sums Humble took out of their share of production to pay the share of the drilling costs that they had agreed to bear and deducted an amount proportionate to their production interest for depletion,[3] intangible drilling costs,[4] and depreciation.[5] The Commissioner disallowed those items attributable to the sums used by Humble for recoupment of its expenses on the ground that Humble had earned that income.[6] The district court ruled for the taxpayer.[7] On appeal to the United States Court of Appeals for the Fifth Circuit, *held*, reversed. A taxpayer who takes no actual financial risk in oil and gas exploration does not have a sufficient economic interest in the oil used to pay his share of the development expenses to realize gross income from that oil or to take the accompanying deductions. *United States v. Cocke*, 399 F.2d 433 (5th Cir. 1968).

Solely as a matter of grace,[8] Congress allows a deduction from gross income for depletion of mineral deposits.[9] For oil and gas wells, the taxpayer may deduct 27½ per cent of the gross income from the property after excluding payments made for rent and royalties.[10] To claim this deduction, the taxpayer need not have legal ownership of the oil,[11] but must show an "economic interest" in it.[12] This requires that the taxpayer acquire, by investment, an interest in the oil in place and look only to the extraction of oil and gas for a return on his capital.[13] In carried interests transactions,[14] the carried party has no economic interest in the oil used to pay his share of the production costs when he assigns his interest to the carrying party subject to the right of reversion if the well proves profitable.[15] Likewise, he receives

3. INT. REV. CODE of 1954, §§ 611, 613.

4. *Id.* § 263. By the terms of the contract, the taxpayers gained title to a part of the drilling equipment.

5. *Id.* § 167.

6. Of course, the taxpayer could claim gross income and the depletion allowance for the oil from such of their interests which Humble could not use to recoup their expenses.

7. Cocke v. United States, 263 F. Supp. 762 (S.D. Tex. 1966).

8. There is no constitutional requirement for any allowance of the exhaustion of mineral deposits resulting from mining operations. Stanton v. Baltic Mining Co., 240 U.S. 103 (1916). Nevertheless, Congress, since 1913, has allowed the taxpayer to deduct for depletion in computing taxable income.

9. INT. REV. CODE of 1954, § 611.

10. *Id.* § 613.

11. Lynch v. Alworth-Stephens Co., 267 U.S. 364 (1925).

12. Palmer v. Bender, 287 U.S. 551, 557 (1933).

13. Commissioner v. Southwest Exploration Co., 350 U.S. 308 (1956); Treas. Reg. § 1.611-1 (1965).

14. *See* note 1 *supra*.

15. *E.g.*, Manahan Oil Co., 8 T.C. 1159 (1947).

no deduction if he assigns his interest in the oil produced to the carrying party during the period of recoupment.[16] On the other hand, the Sixth, Ninth, and Tenth Circuits have ruled that the carried party does realize gross income (with accompanying deductions) on the oil used to pay his share of the drilling expenses if the carrying party advanced as a loan the funds used to pay his share of these costs.[17] In such a case, the carried party assumes no personal liability, but simply agrees to secure the loan with his future profits, if any. The Fifth Circuit, however, adopted the contrary view on the ground that the carried party did not have in fact a capital investment in the oil.[18] Then, in the 1947 case of *Commissioner v. J. S. Abercrombie Co.*, the carrying party agreed to lend the carried party's share of the drilling expenses and to look only to "net profits" for repayment.[19] The carried party retained legal title to his interest. Arguing that income is taxable to the owner of the producing property, the Fifth Circuit implied that the carried party was entitled to the deductions by holding that the carrying party did not realize gross income on the proceeds used to pay the carried party's share of the expenses.[20] A dual argument later developed to support this decision.[21] First, it was contended that the transaction was a loan of the funds necessary to exploit the minerals. The carried party's production was simply used to repay the loan. Therefore, the production is gross income to the carried party on the theory that payment of a debt by another is income to the debtor.[22] Secondly, it was argued that the carried party retained title to his share of the oil. He surrendered nothing except a right to recoup costs from the production payment. Commentators have severely criticized these arguments,[23] and the Internal Revenue Service has construed the *Abercrombie* decision with remarkable

16. *E.g.*, Herndon Drilling Co., 6 T.C. 628 (1946).

17. J. K. Harris Co. v. Commissioner, 112 F.2d 76 (6th Cir. 1940); Helvering v. Armstrong, 69 F.2d 370 (9th Cir. 1934), *overruled*, United States v. Thomas, 329 F.2d 119 (9th Cir. 1964); Reynolds v. McMurray, 60 F.2d 843 (10th Cir.), *cert. denied*, 287 U.S. 664 (1932).

18. Commissioner v. Caldwell Oil Corp., 141 F.2d 559 (5th Cir. 1944).

19. 162 F.2d 338 (5th Cir. 1947).

20. The court subsequently held that a carried party realized gross income. Prater v. Commissioner, 273 F.2d 124 (5th Cir. 1959).

21. *See, e.g.*, Sowell v. Commissioner, 302 F.2d 177 (5th Cir. 1962).

22. INT. REV. CODE of 1954, § 61(a).

23. *E.g.*, Bredding, *The Trend in Carried Interest Cases*, 17 Sw. L.J. 242 (1963); Hambrick, *Another Look at Some Old Problems — Percentage Depletion and the ABC Transaction*, 34 GEO. WASH. L. REV. 1 (1965); Ryan, *The Carried Interest in the Fifth Circuit, or, Is Abercrombie Dead?*, 4 HOUSTON L. REV. 477 (1966).

ambivalence.[24] The Fifth Circuit did, however, in *Weinert's Estate v. Commissioner* narrowly limit the doctrine of *Abercrombie,* warning that the use of common law definitions of title have no place in the taxation of oil and gas.[25] Finally, the Ninth Circuit, which had formerly followed the rule of *Abercrombie,* rejected its rationale.[26] Noting that the property relationships of the parties do not control a determination of economic interest, that circuit held that the carried party had title to the oil in form only; in substance, he had assigned his interest.

The Fifth Circuit, sitting en banc, in an opinion by Circuit Judge Goldberg, found the instant case factually indistinguishable from *Abercrombie.* In deciding to overrule that case, the court claimed to look to the substance of the transaction, not its form. Although admitting that the taxpayers had title under state law, the court dismissed the notion that the location of title should control federal tax consequences. Since title is a legal conclusion which may vary from state to state, its relevance for tax purposes is limited to the benefits and burdens that may accompany it. Here, the court decided, the significant issue was whether the carried party had an economic interest in the oil in question. In resolving this issue, the court found the loan to be a fiction only; in reality, it was a sharing arrangement. The taxpayers risked nothing, for they were not liable for repayment

24. *See, e.g.,* Commissioner v. Abercrombie, 162 F.2d 338 (5th Cir. 1947), *aff'g* 7 T.C. 120 (1946), *non-acquiescing in* 1946-2 CUM. BULL. 6, *acquiescing in* 1949-1 CUM. BULL. 1, *non-acquiescing in* 1963-1 CUM. BULL. 5. *Compare* 25 Fed. Reg. 3761 (1960) (abrogation of *Abercrombie* rule), *with* 1965-2 CUM. BULL. 182 (objections to *Abercrombie* eliminated). The tax court has proved just as inconsistent as the Internal Revenue Service. *See, e.g.,* Dave Rubin, ¶ 59,223 P-H TAX CT. REP. & MEM. DEC. and cases discussed therein.

25. 294 F.2d 750 (5th Cir. 1961). In that case, taxpayer assigned one-half his interest in oil and gas properties and a production payment of $50,000, payable out of his retained half-interest, to the carrying party in consideration for $100,000 cash and an agreement to advance up to $150,000 of the taxpayer's share of the development costs. The taxpayer had no personal liability to the carrying party, although he remained liable to third parties. Taxpayer then assigned his interest to a trustee instructed to pay over the net profits to the carrying party until he had recouped his advances and the $50,000 obligation. During the years in dispute, net profits were used only to repay the loan. The court held that the taxpayer realized no income. While distinguishing this case from *Abercrombie* on the technical ground that the taxpayer here did not hold title, the court made short order of the loan argument. The transaction did not constitute a loan, because the parties did not consider it a loan and because its nature only vaguely resembled the traditional loan. During the period of recoupment, the carrying party received full economic value of the oil; moreover, he furnished all the risk capital. *See also* Wood v. Commissioner, 274 F.2d 268 (5th Cir. 1960).

26. United States v. Thomas, 329 F.2d 119 (9th Cir. 1964). This case, though factually similar, may be distinguished from *Abercrombie* on the ground that the taxpayer never gained title to the drilling equipment.

if the well proved dry. They had no right to receive their full share of minerals until Humble had recouped costs. Oil in the ground, not the taxpayers' credit, secured Humble's advances. In holding that the taxpayers had no economic interest, the court found that the carrying party alone bore the risk and burden of the development expenses, looking solely to production for recoupment. Gross income was attributable to Humble not only because it had the economic interest in the oil but also because under the terms of the contract it had a right actually to receive the funds. Such a result, the court argued, would fulfill the policy of rewarding risk-taking in the exploitation of hidden resources. To the court, the more adventurous party deserves the deductions accompanying gross income.[27] While recognizing the Internal Revenue Service's inconsistency in handling the *Abercrombie* doctrine and the taxpayers' possible reliance on the Commissioner's pronouncements, the court refused to make the decision purely prospective, on the ground that prospectivity "must be a matter of judicial grace sparingly invoked."[28] Circuit Judge Clayton, specially concurring, noted that the decision limits the power of the parties to fix by contract the tax consequences of what they do. Since depletion is a matter of congressional grace, he felt such action may more properly be legislative than judicial. Four judges, in an opinion written by Circuit Judge Ainsworth, would have given the decision only prospective effect to prevent hardship and manifest injustice to those taxpayers acting in reliance on *Abercrombie*.

This decision gives a measure of consistency to an overly confusing area of tax law.[29] By seeing through such sham transactions as the fictional loans, the instant court places the taxation of carried interests on a more rational basis: the one who receives the income pays the tax; the one who incurs the expenses receives the deduction. Yet, by overturning a principle of twenty years standing, the court radically changes the value of the contract rights to the prospective

27. Although the court concluded that the deductions for depreciation and intangible drilling costs go to the party entitled to the depletion allowance, alternate grounds for denying the deductions exist: since the taxpayer did not spend any of his funds for equipment, he has no investment or basis from which to depreciate; likewise, he did not "pay" or "incur" any expense for intangible drilling costs and may not, therefore, deduct the money paid by another. *See* Helvering v. Price, 309 U.S. 409 (1940).

28. 399 F.2d at 452.

29. In describing the nice subtleties of oil and gas taxation, Justice Frankfurter once noted: "To draw such distinctions, which hardly can be held in the mind longer than it takes to state them, does not achieve the attainable certainty that is such a desideratum in tax matters, nor does it make generally for the respect of law." Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25, 38 (1946) (dissenting opinion).

parties. The taxpayers, relying on that doctrine, might well have bargained for provisions creating an *Abercrombie* interest with its tax advantages in lieu of other valuable consideration.[30] Furthermore, the court emphasizes that such a decision rewards and encourages risk-taking, since the party that risks its capital on the success of the venture receives the benefit of the deductions. In many cases, this is undoubtedly true, especially when the carried party, as owner of the land before exploitation, invests no cash;[31] however, the court appears to overlook the fact that the carried party may well have purchased interests at speculative values on the possibility that they may prove productive.[32] Since these speculative values will vanish if the drilling is unsuccessful, the carried party may incur substantial risk. Likewise, the shifting of tax advantages, particularly those which are promptly realizable, to the more established and financially capable party may tend to inhibit new entrants into a field that is already heavy with initial costs.[33] For these reasons it is submitted that the courts should have left so major a change to Congress, which has more appropriate facilities for examining the consequences of such a decision.

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30. In an action by the taxpayers against Humble, a court could conceivably find it inequitable to allow Humble to profit from this change in tax law if the court also finds that the parties relied on the former law when drawing up the contract. Of course, careful drafting with provisions for change in tax policy would eliminate this problem.

31. He would, however, risk losing the speculative value in his land. Realizing this, courts have awarded substantial damages for unauthorized geological study. *See, e.g.*, Phillips Petroleum Co. v. Cowden, 241 F.2d 586 (5th Cir. 1957), *on second appeal*, 256 F.2d 408 (5th Cir. 1958); Shell Petroleum Corp. v. Scully, 71 F.2d 772 (5th Cir. 1934).

32. Or, after his private exploration, he may have purchased the interests without revealing his investigations. Is it as socially desirable to encourage risk-taking for land speculators as for explorers or producers?

33. *See* Galvin, *The "Ought" and "Is" of Oil-and-Gas Taxation*, 73 HARV. L. REV. 1441, 1479 (1960). Such tax changes do not necessarily benefit the carrying parties, because in bargaining for an interest they may well be obligated to offer additional consideration more valuable to them than a tax advantage, *i.e.*, the carried party may be in a higher tax bracket.