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SOME PRACTICAL COMMENTS ON THE TAX PRACTICE

HOWE P. COCHRAN*

ABOUT twenty years ago I talked to the deans of several eastern universities suggesting that federal tax law was growing up very much like the law merchant had done in the distant past, and that it would be wise to anticipate that fact and put in courses dealing with tax practice as distinct from substantive tax law. Then, as now, I found almost all the colleges hostile to the idea.

Tax practice, nevertheless, has finally taken shape, and like the law merchant, it is indeed different from ordinary practice. Considering that to be a fact, it is astonishing how little has been written on the subject.

Both the student and the old time practitioner must make up their minds that federal tax practice is different from other law practice. This is not as hard a problem for the student as for the old timer. I have seen old timers die very hard on the subject; and almost always their clients "die" with them. The subject would fill a book as thick and as cumber-

some as a textbook on bills and notes. So you see all I can do here is to outline some of the peculiarities of tax practice.

I.

For clarity I have divided the subject into various classifications, which naturally overlap. Federal tax law, as it has finally grown up, differs from other law in three great particulars. The first is that the doctrine of estoppel applies with tremendous force against the taxpayer and does not apply at all in his favor. The second is that legal trans-

actions legally planned and legally carried out may be treated as a nullity in order to sustain a tax liability and yet be fully effective for other purposes. The third is that legal transactions, legally conceived and legally carried out and proper in every respect, may be treated as a nullity so far as taxes are concerned unless you can show a good, sound motive grounded in business expediency.

I shall discuss these three problems *seriatim*, and you will note that there is no support either in the body of the general law or in the tax law for the strange way tax practice has developed. These rules have developed over the last thirty years, and they have become a special body of law for tax procedure, superior to the written law.

1. The first item was the problem of estoppel. While enunciating the doctrine of estoppel, which is the same as it has always been, roughly,

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that there must be a wilful misleading representation relied on by the adverse party to his hurt, the courts have deemed that everything a taxpayer does is a wilful misleading representation, and that the Commissioner of Internal Revenue always relied on it to his hurt. They have strained the rule of estoppel and bent it around so that now, in self-defense, every time a taxpayer or his counsel does anything they must qualify it by some sort of notice or disclaimer.

To show how far this doctrine has gone, it is only necessary to call attention to the Mahoning Investment Company case\(^1\) in which it was held that an equivocal letter sent to the collector of internal revenue in Buffalo, New York, and which he put in his files without communicating its contents to anyone, misled and deceived a different collector, who was located in New York City, and misled and deceived the Commissioner of Internal Revenue, who was located in Washington, so that acts done by them out of time became timely; and the taxpayer was estopped to plead the Statute of Limitations.

Because of this situation, cautious tax counsel have adopted a definite plan of procedure which I shall explain to you. If you observe what I am about to tell you, you will be forever in my debt; if you do not observe it, the day will come when you will tell yourself you wish you had.

When a well-advised taxpayer files a tax return, he writes and sends with it a letter explaining that he has made the return to the best of his ability, but that no doubt he has made numerous mistakes; that he does not wish to be bound by those mistakes, and reserves the right to correct them. He states that if he has inadvertently made any election he does not wish to be bound by the election but reserves the right to change it; that if he has made any errors he has done it unintentionally and is willing to correct them. Then he says that while his affairs are not extensive, they are, like all business affairs, more or less complicated; and that, while no doubt there are many transactions which the government might wish to look into, he recalls certain ones which he wishes to bring to the government's attention, and that perhaps there are others which he has overlooked. He then explains in detail those transactions which need explaining, along with those transactions in which he feels that the decision he has reached might be controversial. He closes the letter with an invitation to the government to send its agent at the earliest possible moment to check over his affairs, adding that he wishes to get his tax matters behind him, and that he will cooperate with the government's agent to the fullest

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\(^1\) Mahoning Investment Co. v. United States, 78 Ct. Cl. 231, 3 F. Supp. 622 (1933).
extent. It takes time, patience and skill to draw such a letter; and time is valuable and patience is scarce at the time when returns are due. Nevertheless this job must be done.

In addition to this letter, it is best to file all returns in person whenever possible, and to obtain a receipt bearing the government's official stamp. If you do not think this last is important, I invite your attention to the Perkins case\(^2\) where such a receipt was instrumental in saving the taxpayer something over five hundred thousand dollars.

From the time of filing the return until the end of the tax case, it is the custom to qualify all statements, including those by counsel. It is the custom to say in every letter to the government that it is written in connection with a controversy and looking towards a settlement thereof, that the letter contains no admissions and no representations, and that the government is respectfully requested to look into all the facts through its own investigating department. These qualifying statements and these disclaimers appear even in affidavits. Of course, there are obviously some affidavits which are positive representations; in such a case the best thing to do is omit the disclaimer about representations but to include the suggestion that the government not rely on what the taxpayer says and that it look into the facts through its own investigating agencies. Old time general practitioners call this procedure stupid, and I note with some regret that some professors who teach tax law claim that it is over-technical, but it is not stupid and it is not over-technical, as any man experienced in tax practice can tell you. I suggest to you that a different and less technical form of procedure would have lost the Perkins case. The man who was so careful was neither stupid nor over-technical.

Let me tell you that there are hundreds of cases where a careful line of conduct such as I am here advocating has saved the day for the taxpayer. A very interesting case along that line is the Scott case,\(^3\) which succeeded solely because this procedure was followed. In substance, the court in that case said "the department must follow the rules of law. The department ran the wrong way with the ball, and it cannot complain because the rules require that a score be imposed against it rather than in its favor. The corporation was not off-side (there was no misrepresentation of fact)\(^4\) so the score must stand."

2. It is well settled tax law now that legal transactions which are binding under state law are not good enough to support the taxpayer in

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COMMENTS ON TAX PRACTICE

a tax case unless he can show a superlative degree of good faith in planning and carrying out his plans. This is a wide departure from the law of the land which generally holds that, if you did what you had a right to do, you cannot be blamed. The tax rule is that if you did what you had a right to do, and it has the effect of reducing the tax bill, then you are bound by your conduct on the one hand but you owe the full tax on the other, unless the court decides that you acted in the greatest degree of good faith.

Very recently the Supreme Court of the United States has again enunciated this rule. In each of two similar cases, which it decided, it seemed that husbands had gone into partnerships with their wives. They had given their wives property, had paid the gift tax on the property, and the government had accepted the gift tax. Then the wives had put the property into a partnership with their husbands. The partnerships were binding on the wives and their estates, too, subjected their estates to the federal estate tax, and rendered them accountable to creditors; yet their shares of the income of the partnerships were held to be taxable to their husbands. Thus, under the income tax law, they are not partners. The reason for this conclusion seems to have been that the court did not think that the tax saving motive, and the way they carried it out, should relieve the husbands of the tax bill.

Under ordinary law we will all agree that the wives were partners for all purposes or for none. But that is not the rule in tax law. In tax law the wives are partners for all purposes except for taxes, but because it brings more money into the treasury when the tax on the whole income is levied against the husbands, and because deep underneath the Court thought the deal lacked substance, the wives are not partners when the tax bill comes in. Do not misunderstand me: I am not complaining about these cases, I am merely pointing out to you this feature of tax practice which you must keep before you at all times.

3. A somewhat kindred subject is the question of business purpose, which probably applies principally to corporations. It is the tax law now, although it is not written into the Code, that in every controversy concerning taxes where the conduct of a corporation is involved it is necessary to show that the transactions were carried out in pursuance of a business purpose. You must show this in addition to showing that the transactions were legal in every respect. Unless you prove the business purpose, I am afraid that you will usually find that any tax advantage from the transaction will disappear.

I think it is fair to sum up these three propositions by saying that, in addition to the law of the land, you must consider in every tax transaction:

First. Whether by the widest stretch of the imagination, on any theory, however absurd, it can be suggested to the court that your client failed to come way out into the open in all its dealings with the government.

Second. Whether or not you can say to the court that, aside from the conduct of your clients as viewed by the law, their conduct was always governed by sound and proper motives and characterized by meticulous performance both in theory and in substance.

Third. Whether you can say and prove, in corporation tax cases, that the conduct out of which the tax dispute arises was based, not only upon legal rights, but upon proper business purposes.

TAX PLANNING

I do not mean to suggest that there is not a big field for tax planning, that is to say, rearranging people's affairs in such a way as to reduce their taxes; but such arrangements must fit into the rules which I have set out above or they will fail.

Since I have mentioned tax planning, I think I should add a few notes from experience.

1. Almost all tax saving schemes end in disaster.

2. It is a mistake to change the way of life of one or more persons in the hope of saving a few dollars tax money, unless the new way of life is better than the old, and it rarely is.

3. It is a mistake to rearrange a man's affairs so that he is handicapped or inconvenienced either in his business or his personal life. If you make your donor dependent upon his donees for his annual trip to Florida, you may be sure he will stay home from now on.

I always tell people who are going into estate planning to sit down and read Shakespeare's "King Lear" and then to ask their client to read it before any plans are made.

II.

We now come to three new propositions which appear in tax practice.

The first proposition is that tax law is so controversial that, in the great majority of cases, the court can decide the matter either way, and no matter which way it decides it, there is very little chance for reversal.

The second is that, no matter what the facts are, a great number of tax cases turn on the papers and not on the facts.
The third proposition is that, no matter what caused the original controversy, many tax cases are decided on some new proposition of fact or law that was not in the case when it started.

From the above it follows that it is necessary to win in the trial court, for the probability is that the appellate court will not reverse the court below.

1. Suppose the question involved is the deductibility or the reasonableness of officers' salaries, or that it is a question of loss of useful value or obsolescence, or suppose it is a question of whether a given depreciation rate shall be four percent or six percent. It is true that there have been a few cases among the many thousands that have been tried where the decision of the lower court was reversed, but you can count them on your fingers. The great probability is that the decision below will never be disturbed. The lesson to be gained from this situation is that the best prepared side, that is to say the side that offers the best prepared case to trial court, will usually win in the end. I realize that the idea that it is well to be prepared is not a new idea, just discovered through the development of tax practice; but it does have added force in tax practice.

2. I have just told you that the side that is best prepared on the facts wins, and now I will tell you that most cases turn on the papers and not on the facts. In tax cases the papers often become the facts. The Perkins case did not turn upon the merits of the case at all. It turned upon the papers. The papers became the ruling facts. The Scott case did not turn upon the merits of the controversy, and it would almost seem that the rights were with the government. It turned on the papers, which again constituted the ruling facts. I feel that if you would list ten thousand decided tax cases, and should check those that turned on the merits against those that turned on the manner in which the papers were prepared, you would find, to your amazement, that well nigh half of them turned on the papers. The lesson to be gained from this situation is that, since we draw the papers, we ought to win half our cases regardless of their merits, for we know now that we must prepare our papers correctly.

3. The most interesting of these propositions is that many cases turn upon new matter injected by the attorneys after the controversy started. This is so different from the rule in general practice that I think I should explain it more fully. In general practice the little girl ran off the sidewalk chasing her tennis ball and the truck hit her and broke her leg. One lawyer represents the truck owner and one lawyer represents the little girl. We have a clear-cut issue. What the little girl did last week, and what the truck hauled three months ago have nothing to do with the case. But that is not the way it is with tax matters. An income tax case,
no matter what item is questioned, covers all of the transactions which occurred in the taxable period under review, whether they are in controversy or not. An estate tax case involves the value of everything the decedent died possessed of, whether the value has been questioned or not. A gift tax case covers everything the donor gave away between June, 1932, and the end of the year in which he made the gift that is under review. As a result of these circumstances any tax controversy whether it concerns income, gift, or estate taxes, throws open a wide field for investigation, and the determination in litigation of one little item in that wide terrain precludes consideration of all the other transactions in the whole area.

For example, if a dispute arises over one little item on an income tax return, and the case goes to court and is decided, all the items on the whole return, whether right or wrong, become finally fixed. When a question arises over the value of a single share of stock in an estate and it goes to court and is decided, the entire value of the estate is thereby fixed. If a question arises over one item of gift and it goes to court and is settled, the value of all the gifts made during the year is thereby determined. It follows from this that the raising of a controversy over one single item of income requires the cautious attorney to investigate in full detail all of the transactions of the entire taxable period involved. If a question arises about a single item given away, it becomes the duty of the attorney to investigate the value of all the gifts made from June, 1932, to the end of the year in question.

Results have shown that investigation of these matters invariably uncovers new items. Sometimes the new items increase the tax, sometimes they decrease it. If they tend to increase the tax you may be sure that, sooner or later and before the controversy is over, the government will dig them up. If they tend to decrease the tax, it is your duty to find out all about them and to obtain the decrease. Since that situation is as it is, you would find, if you should look over the great tax cases that, in an incredible number of them, astute tax lawyers have brought out new matter on which the final outcome of the litigation really turned.

I will summarize the above three points by saying that the best prepared man wins and that you ought to be the best prepared man; that many cases turn on the papers, and since you prepare the papers you should win those cases; and that thousands of cases turn on new matter dug up by the persons employed to handle the case, and that if you are employed to handle a case you should dig up the winning new matter. Whenever you have a tax case you should investigate the matter in all its angles, particularly those not in controversy.
From twenty-five years of tax practice, partly as an accountant and partly as a lawyer, I have worked out certain rules of conduct which I shall set out below. These are the same rules of conduct I set out in a pamphlet that I wrote for the Practising Law Institute of the American Bar Association.

1. Never underestimate the government tax official.
3. If any government official should suggest anything improper, do not understand him.
4. Keep your client away from government conferences.
5. Make full disclosure of all the facts that the government ought to know, and do so at the first opportunity.
6. Write a covering letter whenever you file a paper with any of the tax authorities.
7. Take a receipt. A registered letter receipt is not good enough.
8. Abandon now the hope that the awkward items in any given tax account will escape detection.
9. At all costs, so conduct yourself as to prevent the arising of any grounds, however flimsy, for a claim of estoppel.
10. Never waive a right, at least not unless it appears after the fullest consideration that new rights or advantages more than commensurate will be gained.
11. Never sign any paper without making certain that it says what you mean, and only that.
12. Consider straddling all questions.
13. Know all the facts of your case—those in dispute and those not in dispute.
14. Know all the law of your case. I do not think that there is as yet any index to any tax service that will give you much comfort here.

These have been discussed by me at some length elsewhere and I believe every lawyer looking forward to much practice in tax matters might well read those discussions.⁶

The more I read and study tax cases, the more I become aware of the pitfalls that my neighbors have fallen into, the more I struggle to extricate myself from the pitfalls that I myself have fallen into, and the more I come to foresee, ever so dimly, those pitfalls that are ahead of me, I conclude that the question of tax practice and the lessons learned from should not be condensed into a few pages of a law journal, but

should be the subject of a full year’s study, preferably in law school. A knowledge of the pitfalls, and of the means of avoiding them, is worth a great deal to any lawyer, and worth a fortune to his clients.