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Private Federal Tax Rulings Are Governed by Standard of Equality and Fairness of Internal Revenue Code, Section 7805(b)—*International Business Machines Corp. v. United States**

In a private ruling the Commissioner of Internal Revenue concluded that certain computers produced by Remington Rand, International Business Machines' sole competitor in the manufacture of that type of computer, were not subject to a previously imposed excise tax.[1] IBM immediately requested a similar ruling concerning

* 343 F.2d 914 (Ct. Cl.), *rehearing denied*, — F.2d — (Ct. Cl. 1965) [hereinafter cited as principal case].

1. INT. REV. CODE OF 1954, § 4191 (formerly Int. Rev. Code of 1939, § 3406(a)(6)).

its identical machines. After a 2½-year delay, the Commissioner ruled adversely on IBM's request and at the same time prospectively withdrew the favorable ruling from Remington.[2] IBM thereupon sued to recover the tax paid during the period Remington enjoyed the exemption.[3] The Court of Claims *held,* one judge dissenting, that when two taxpayers ask for identical private rulings, but the Commissioner rules favorably only as to one, the Commissioner abuses the discretion granted to him by section 7805(b) of the Internal Revenue Code[4] if he later reinstates the tax as to the favored taxpayer prospectively only, without refunding to the other taxpayer the taxes paid during the period of discrimination.

The Commissioner of Internal Revenue regularly issues private rulings to individual taxpayers who request an interpretation of the Internal Revenue Code as it applies to their particular fact situations.[5] These rulings do not have the status of law; rather, they are designed to enable the Commissioner to reflect his current opinion regarding the tax law.[6] A ruling embodying an incorrect interpretation of the Internal Revenue Code is considered a mere nullity. A subsequent ruling promulgating the correct interpretation retroactively supersedes its erroneous predecessor, absent some special statutory provision otherwise, for, in the absence of such a provision, the Commissioner lacks the power to deviate from the statute.[7] Because of the potential retroactive effect of a corrective ruling, it is immediately apparent that the holders of discredited private rulings who have refrained from paying taxes in reliance upon their rulings might well owe substantial sums to the government. To remedy this inequity,[8] Congress enacted section 7805(b)

2. It is not disputed that IBM's machines are properly within the scope of § 4191. Principal case at 917.

3. IBM's right to recover that portion of the excise tax passed on to its customers was conditional upon its obtaining the consent of those customers in accordance with the provisions of INT. REV. CODE OF 1954, § 6416(a)(1).

4. INT. REV. CODE OF 1954, § 7805(b) provides: "*Retroactivity of regulations or rulings.*—The Secretary or his delegate may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect."

5. Rev. Proc. 28, 1962-2 CUM. BULL. 496, 497. A "private" ruling should be distinguished from a "published" ruling, the latter being published in the *Revenue Bulletin* for the benefit and use of taxpayers at large.

6. Dixon v. United States, 381 U.S. 68 (1965); Manhattan Gen. Equip. Co. v. Commissioner, 297 U.S. 129, 135 (1936).

7. See authorities cited note 6 *supra.*

8. See H.R. REP. No. 350, 67th Cong., 1st Sess. 15-16 (1921); S. REP. No. 275, 67th Cong., 1st Sess. 32 (1921), which states that the Act of November 23, 1921, § 1314, 42 Stat. 314 (the predecessor of § 7805(b)), "authorizes the Commissioner [to issue] a regulation or Treasury decision which reverses a prior regulation or Treasury decision . . . without retroactive effect." ("Rulings" were later included within this discretionary power by the Act of May 10, 1934, § 506, 48 Stat. 757.) See H.R. REP. No. 704, 73d Cong., 2d Sess. 38 (1939); S. REP. No. 558, 73d Cong., 2d Sess. 48 (1939), explaining that the Commissioner is to use this discretion to avoid inequity where it would

of the Internal Revenue Code, which provides the Commissioner with discretionary authority to forego retroactive application of corrective interpretations. Generally, however, when the Commissioner issues rulings reversing earlier favorable private rulings, nonretroactive treatment is made available under section 7805(b) only to the holders of the favorable private rulings, and not to taxpayers relying upon private rulings issued to others.[9]

In the principal case the Court of Claims, unable to find more appropriate statutory language to support its result, resorted to a rather imaginative application of section 7805(b).[10] Although IBM had never held a favorable private ruling on this matter, the court nevertheless allowed recovery, reasoning that IBM, having taken the trouble to apply promptly for its own ruling, was entitled to the same treatment that its competitor, Remington, had received.[11] How-

otherwise occur if a new interpretation were applied "to past transactions which have been closed by taxpayers upon existing practice."

At present, the general policy of the Internal Revenue Service is not to revoke a private ruling retroactively except in certain rare circumstances. Rev. Proc. 28, 1962-2 CUM. BULL. 496, 505; Rev. Rul. 164, 1954-1 CUM. BULL. 88, 91. The courts have enforced this policy, holding that the Commissioner may be found to have abused the discretion vested in him by § 7805(b) when he retroactively revokes a favorable private ruling upon which the holder has relied. See, *e.g.*, Lesavoy Foundation v. Commissioner, 238 F.2d 589 (3d Cir. 1956). See also Automobile Club of Michigan v. Commissioner, 353 U.S. 180, 183-84 (1957), which held that the Commissioner cannot be equitably estopped to apply retroactively a revocation of a ruling when the original ruling embodied a mistake of law, but that the Commissioner's action may be disturbed if he abuses the discretion vested in him by § 3791(b) (the predecessor of § 7805(b)). See generally Lynn & Gerson, *Quasi-Estoppel and Abuse of Discretion as Applied Against the United States in Federal Tax Controversies*, 19 TAX L. REV. 487 (1964).

9. Hanover Bank v. Commissioner, 369 U.S. 672, 686 (1962); Bornstein v. United States, 345 F.2d 558 (Ct. Cl. 1965); Minchin v. Commissioner, 335 F.2d 30, 32-33 (2d Cir. 1964); Weller v. Commissioner, 270 F.2d 294 (3d Cir. 1959); Goodstein v. Commissioner, 267 F.2d 127 (1st Cir. 1959); Gerstell v. Commissioner, P-H Tax Ct. Mem. ¶ 62181 (1962), *aff'd*, 319 F.2d 131 (3d Cir. 1963); Arnold A. Schwartz, 40 T.C. 191 (1963); Bennet v. Commissioner, P-H Tax Ct. Mem. ¶ 60253 (1960). Where taxpayers without private rulings have alleged discrimination because they were not given the same favorable treatment accorded similarly situated taxpayers with private rulings, the courts have denied relief, holding that the fact a taxpayer secured a ruling is, in itself, a sufficient basis for allowing preferential treatment. Weller v. Commissioner, *supra*; Arnold A. Schwartz, *supra* (by implication).

10. The court apparently felt it necessary to base recovery on statutory grounds in order to alleviate IBM's burden of showing damages, a burden which the court implied would have to be imposed if it were to resort to "principles of estoppel evolved judicially as part of a limited 'common law' effort to further fairness." Principal case at 925.

11. Principal case at 924. In Bornstein v. United States, 345 F.2d 558 (Ct. Cl. 1965), handed down by the Court of Claims one month after the principal case, the plaintiff neglected to request a private ruling and therefore lost the case: "In [International Business Machines Corp. v. United States] . . . the court applied Section 7805(b) . . . in behalf of a taxpayer who had made prompt application to obtain a private ruling to the same effect as a ruling issued to another taxpayer, which manufactured and sold business machines that were similar in all material respects to the machines manufactured by plaintiff. In [Bornstein v. United States] . . . , none of the taxpayers . . . asked for rulings." *Id.* at 564 n.2.

ever, because IBM's request for a private ruling holding its computers nontaxable was never granted, there was never a threat to IBM that a subsequent ruling would retroactively impose a tax not previously levied. IBM paid the tax throughout the period in question, and the Commissioner's later ruling merely articulated the assumption upon which both IBM and the Service had been acting —that IBM's computers were taxable. The court seems to have arbitrarily assumed, however, that the ruling rejecting IBM's application for an exemption was somehow "retroactive."[12] The court then proceeded to find that the Commissioner had abused his discretion under section 7805(b) because he did not make this ruling nonretroactive like the ruling reinstating the tax upon Remington.[13] Although the court devised what it felt to be an adequate basis for the application of section 7805(b), the statute is simply not constructed to provide a general means of recovery where the Commissioner's refusal to grant a favorable private ruling results in discrimination.[14] As previously indicated, application of section 7805(b) is wholly dependent upon an eventual adverse private ruling which may be construed to have retroactive effect; there is no necessary correlation, however, between retroactive effect and arbitrary discrimination.[15] If, for example, the Commissioner, instead

12. Principal case at 921. The court's conclusion seems to be that all adverse rulings, regardless of whether they reflect a change in the Commissioner's interpretation of the tax laws, are "retroactive" unless the Commissioner makes them "nonretroactive" by refunding taxes paid prior to the issuance of the ruling.

13. The Commissioner was forced to make the ruling as to Remington Rand nonretroactive, because the Revenue Act of 1926, § 1108(b), 44 Stat. 9, 114, forbids the levying of a tax on any article sold if at the time of sale there was a ruling holding the sale nontaxable.

14. Two cases were cited by the court for the proposition that recovery of back taxes is allowed if the Commissioner makes a ruling retroactive as to the plaintiff-taxpayer, but nonretroactive as to others without a rational basis for the distinction. Exchange Parts Co. v. United States, 279 F.2d 251 (Ct. Cl. 1960); Connecticut Ry. & Lighting Co. v. United States, 142 F. Supp. 907 (Ct. Cl. 1956). However, both are distinguishable from the principal case because each involved a reversal by the Commissioner of a tax exemption policy applicable to the public at large, rather than a refusal to grant a private ruling. Unlike the plaintiffs in both of the cited cases, IBM never fell within the reach of any expression by the Service holding its products nontaxable.

15. The principal case leaves unanswered the further question whether, in the absence of a reply by the Commissioner, IBM might have brought an action for mandamus or mandatory injunction in a federal district court to compel the Commissioner to issue a ruling. The only possible limitation upon the Commissioner's discretionary right to refuse to issue a ruling seems to lie within the language of § 7805(a) of the Int. Rev. Code of 1954, which authorizes the Commissioner to issue "needful" rules and regulations. Note, 113 U. PA. L. REV. 81, 109 (1964). Nevertheless, since the language is that of authorization and not of requirement, it is doubtful that a court would hold that it embodies any limitation upon the Commissioner's discretion to refuse to rule. *Ibid.* Furthermore, at least one court has held that a refusal to issue a declaratory order is not a final order susceptible to review. United Pipe Line v. FPC, 203 F.2d 78 (5th Cir. 1953). Finally, courts have historically been reluctant to issue writs of mandamus in discretionary areas. See generally Davis, *Mandatory Relief From Administrative Action in the Federal Courts*, 22 U. CHI. L. REV. 585 (1955). The author of the Note, 113 U. PA. L. REV., *supra*, suggests that as an alternative a taxpayer could go before

of waiting 2½ years, had promptly rejected IBM's request for a private ruling but continued to offer Remington favorable treatment, or if the Commissioner had simply refused to rule, there would appear to be no basis upon which to argue that IBM had been subjected to the retroactive effects of a ruling, yet IBM would have been subjected to discriminatory taxation.

By allowing IBM to recover because Remington had received a favorable private ruling, the Court of Claims has established an exception to the general concept that a private ruling affects only the taxpayer to whom it is issued.[16] Consequently, the Commissioner may find that by issuing a private ruling to a single individual, he will become bound to numerous other taxpayers requesting similar treatment. Such a result may be equitably sound, but before it is too vigorously applauded courts should carefully consider its probable adverse effect on the pre-transactional guidance role of private rulings.[17] Because of high tax rates and the complexity of tax statutes, taxpayers frequently hesitate to consummate important business transactions without official assurance of the tax consequences.[18] Therefore, a great number of requests for private rulings are received by the Internal Revenue Service,[19] and the necessity for a prompt reply limits the scope of review allotted to each ruling, thereby increasing the chance that an interpretation will be erroneous.[20] If the effect of such errors is no longer to be limited solely to the recipients of the erroneous rulings, the Service may not be as willing to rule, particularly in the more difficult cases, where rulings generally are of the greatest value.

To avoid posing this obstacle to the issuance of private rulings, courts should require that the taxpayer alleging discrimination prove more than that the Commissioner has not ruled favorably as to him but has ruled favorably as to other taxpayers similarly situated. The complaining taxpayer should further be required to show that the

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the Tax Court and ask for a declaratory order under § 5(d) of the Administrative Procedure Act, 60 Stat. 240 (1946), 5 U.S.C. § 1004(d) (1964). The effect of this approach would not be to compel the Commissioner to rule, but for the Tax Court itself to rule upon the issue and thereby "remove uncertainty" created by the Commissioner's refusal to rule.

16. See cases cited note 9 *supra*.

17. Goodstein v. Commissioner, 267 F.2d 127, 132 (1st Cir. 1959); Caplin, *Taxpayer Rulings Policy of the Internal Revenue Service: A Statement of Principles*, N.Y.U. 20TH INST. ON FED. TAX. 1, 26-29 (1962); Note, 113 U. PA. L. REV. 81, 108 (1964); *cf.* Wolinsky v. United States, 271 F.2d 865, 868 (2d Cir. 1959); Arnold A. Schwartz, 40 T.C. 191, 194 (1963).

18. Rev. Proc. 30, 1964-2 CUM. BULL. 944; Caplin, *supra* note 17; Note, 113 U. PA. L. REV. 81, 84 (1964).

19. The Service receives about 30,000 to 40,000 requests annually. Caplin, *supra* note 17, at 9.

20. Caplin, *supra* note 17; see Int. Rev. Service News Rel., May 21, 1964, 7 STAND. FED. TAX REP. CCH ¶ 6610.

Commissioner's handling of his request was so careless or blatantly arbitrary that equitable considerations clearly outweigh the need for limiting application of the favorable rulings to their recipients. However, since section 7805(b) is not designed to remedy discrimination, it offers no guarantee that the courts will impose the suggested stringent burden. Thus, the responsibility for policing discriminatory rulings must be assumed by the Commissioner. It is to be hoped that the Commissioner will take necessary precautions to avoid discrimination caused by wholly unjustifiable delays in issuance of rulings like the 2½-year delay to which IBM was subjected[21]—especially in cases where there is the possibility of a substantial excise tax discrepancy.[22] If administrative control does not prove effective, section 7805 should be legislatively expanded to provide the judiciary with appropriate guidelines for remedying discriminatory dispensation of rulings. The expanded statute should allow recovery where the taxpayer has, as in the principal case, requested a ruling, and where the Commissioner's failure to issue a favorable ruling results in discrimination which is both "intentional and arbitrary."[23]

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21. For example, the Commissioner might establish a policy that all delays of one year will be ended by a favorable ruling.

22. The framers of the revised excise tax enacted as a part of the Revenue Act of 1932 adverted to the problem of competitive misalignment that could result from uneven administration of the tax. The House Ways and Means Committee noted that "it is of utmost importance that the tax be imposed and administered uniformly and without discrimination." H.R. REP. No. 708, 72d Cong., 1st Sess. 31, 32 (1932).

23. The Supreme Court requires that alleged instances of discriminatory state taxation be intentional and arbitrary before the Court will find a violation of the equal protection clause of the fourteenth amendment. Sioux City Bridge v. Dakota County, 260 U.S. 441, 447 (1923). See also Township of Hillsborough v. Cromwell, 326 U.S. 620, 623 (1946).