

SOME COMMENTS ON THE REVENUE ACT OF 1950 *

By CHESTER C. HILINSKI †

Although House Bill 8920, the legislative beginning of the Revenue Act of 1950, was "To reduce excise taxes, and for other purposes" and was generally considered a tax relief statute, its history indicates that it was consistently thought of as a revenue raising bill rather than a relief statute.

The first official comment concerning the nature of the revenue bill to be considered in 1950 was the President's tax message to the Congress of the United States on January 23, 1950. In it he recommended to the Congress "to make a number of changes in the tax laws which will bring in some net additional revenue and at the same time improve the equity of our tax system". True, it was recommended that the oft-criticized excise tax rates be reduced, but the recommendation added that they be reduced only to the extent that the resulting loss in revenue was replaced by revenue obtained from closing loopholes and that additional revenue of one billion dollars be provided by revising the estate and gift tax and corporation tax laws. This was followed by Secretary Snyder's statement before the House Ways and Means Committee on February 3, 1950, reiterating the recommendation in the President's tax message and giving a detailed discussion of the various changes proposed which would result in a net additional one billion dollars of tax revenue.

The first official statement of a legislative body was contained in the House Ways and Means Committee Report of June 23, 1950.¹ In the general statement of the Committee, it was pointed out that the bill reported upon provided for substantial reductions in war excise taxes, but that the offsetting revenue raising provisions contained in the bill were such that in the long run there would be no net loss of revenue from the bill. As a matter of fact, it was pointed out that the additional revenue arising from the speed-up of corporate and certain other tax payments would result in a net increase of revenue during the 1951 fiscal year then soon to begin. What happened after the House Ways and Means Committee made its report is a matter of history. The outbreak of military activities in Korea and the re-

* Pub. L. No. 814, 81st Cong., 2d Sess. (Sep. 23, 1950). Hereinafter reference to the Act will be by section number only.

† LL. B., University of Pennsylvania, 1941; Member of the Philadelphia Bar.

1. H.R. REP. No. 2319, 81st Cong., 2d Sess. (1950), hereinafter referred to as "House Report."

sultant increase in military and defense expenditures made it necessary to scrap all thoughts of tax reductions and almost the entire emphasis was placed on increasing the tax revenue. On July 25, 1950, the President sent a letter to the Chairman of the Senate Finance Committee recommending the increasing of corporate and individual income tax rates and the elimination of excise tax reductions. These recommendations were followed and the bill became one "To provide revenue, and for other purposes". The bill as reported by the Senate Finance Committee,² with a few important changes,³ became law on September 23, 1950 at 3:15 P. M., Eastern Daylight Saving Time.

The most important provisions of the Act from the revenue raising standpoint are the least interesting for purposes of discussion in this Article. The expected four to five billion dollar increase in tax revenue will come mainly from increased rates of tax. In the case of the individual, the increase is accomplished in two steps.⁴ For 1950 the tentative tax is first found as in former years, but the rates of reduction are 13% instead of 17% of the first \$400 of tentative tax, 9% instead of 12% on the portion between \$400 and \$100,000, and 7.3% instead of 9.75% on the balance. In 1951 there is no reduction and the tentative tax of former years is the final tax. Special rules apply to individuals who report on a fiscal year basis.⁵ For corporations there is also a two step rate increase, coupled with tax relief for certain small corporations. The relief granted is the elimination of the disproportionately high rate of 53% formerly applicable to income between \$25,000 and \$50,000 and substituting for the previous gradations in rate a single normal tax and a single surtax rate with the allowance of a \$25,000 exemption in the computation of the surtax.⁶ For 1950, the normal tax rate is 23% and the surtax rate is 19% or a top corporate rate of 42%. For 1951, and also for all fiscal year taxpayers reporting on a taxable year ending after June 30, 1950, the normal tax rate will be 25% and the surtax rate 20% or a top corporate rate of 45%.

Closely allied to the increase in rate is the speed-up of tax payments. In the case of corporations, the payments are gradually ac-

2. SEN. REP. No. 2375, 81st Cong., 2d Sess. (1950), hereinafter referred to as "Senate Report."

3. The changes were made in Conference Committee which ordinarily is used only to iron out differences between the two Houses rather than to introduce new thoughts or major changes in the tax bill being considered. The changes are noted in the Report of the Conference Committee, H.R. REP. No. 3124, 81st Cong., 2d Sess. (1950), hereinafter referred to as "Conference Report."

4. §§ 101-104. The increased rate of tax on wages withheld at the source is applicable to wages paid after October 1, 1950. §§ 141-143.

5. § 131.

6. § 121.

celerated so that in the fifth year the tax will be paid in two installments of 50% each on the 15th day of the third month and the 15th day of the sixth month following the close of the tax year, instead of the previous permissive payment of taxes over a year period in quarterly installments.⁷

Income taxes payable by trusts also lose the quarterly installment payment privilege and are now required to pay income tax in full at the time their returns are filed.⁸ It might be mentioned here that the return date has been changed to the 15th day of the fourth month following the close of the tax year of trusts and also estates,⁹ even though the latter continue to enjoy the privilege of paying taxes in quarterly installments. Likewise, certain non-resident aliens may no longer pay taxes in installments, but must pay taxes in full at the time of the filing of their return.¹⁰ Withholding agents for non-resident aliens who previously had until June 15 in which to pay the withheld tax must now pay the tax on or before March 15, at the time the return is filed.¹¹

In dealing with a tax statute as extensive as the one we are concerned with, it will probably be easier in the long run if we merely follow the outline of the statute rather than attempt to discuss the statutory provisions in any special order of supposed importance. However, since it is always more pleasant to think of relief, all the tax relief provisions will be discussed first and the discussion will then turn to the loophole closing provisions and wind up with miscellaneous provisions not previously accounted for.

TAX RELIEF PROVISIONS

Discharge of Indebtedness.—The first relief provision is rather innocuous, extending the time to December 31, 1951 within which the corporations may exclude from income amounts attributable to the discharge of indebtedness under Sections 22(b) (9) and (10) of the Internal Revenue Code.¹² The extension provision was added to the bill by the Senate Finance Committee, undoubtedly for the same purpose for which it was added to the Tax Administration Act of 1949, namely, that the whole problem of the tax treatment of income realized from the cancellation of indebtedness should be studied in connection

7. § 205(a).

8. § 205(a).

9. § 205(b).

10. § 205(a).

11. § 219.

12. § 201.

with a general tax revenue and revision bill.¹³ The current Act, although containing a fairly large number of tax changes, cannot be considered as being other than in the nature of an interim act. This provision merely serves to postpone for the future the solution of the basic problems involved. Existing regulations¹⁴ adequately take care of the interpretation of these sections of the Code.

Exemption of Combat Pay.—The next relief provision was also added by the Senate Finance Committee.¹⁵ The relief provided¹⁶ is to exclude from taxable income compensation received by an enlisted man in our armed forces for any month during any part of which he served in a combat zone after June 24, 1950, the date of the outbreak of hostilities in Korea. The first \$200 of monthly compensation received by commissioned officers in our armed forces who serve in combat zones after June 24, 1950 is likewise excluded. The only new concept introduced into the law is the term "combat zone", which is defined to mean any area which the President of the United States by executive order so designates for the purpose of this particular provision. It would seem appropriate to have the area described geographically so as to remove any doubt as to its application to a given case. Although the provided relief was undoubtedly limited to a "combat zone" because of the somewhat localized aspect of the hostilities which led to the incorporation of the relief provision in the statute, nevertheless it would seem commendable to have combat zone in its executive determination be on a liberal basis in order to extend relief beyond only those directly in the battle area. As far as determination of enlisted or commissioned status is concerned, the present regulations¹⁷ dealing with compensation received by members of the armed forces prior to January 1, 1949 should remove any doubt as to status even before any regulations to cover this relief provision are promulgated. Complementing the exemption is the provision which removes from the definition of wages for income tax withholding purposes all compensation for active service in a month during any part of which service was performed in a combat zone.¹⁸

Circulation Expenditures.—In 1944, the Commissioner of Internal Revenue issued a statement¹⁹ in response to numerous inquiries

13. SEN. REP. No. 831, 81st Cong., 1st Sess. (1949), accompanying H.R. 5286 and the Statement of the Treasury Staff and the Staff of the Joint Committee on Internal Revenue Taxation on H.R. 4965 whose provisions were incorporated in H.R. 5286.

14. U.S. Treas. Reg. 111, §§ 29.22(b) (9)-1, 2 and 29.22(b) (10)-1 (1943).

15. Understandably so since the bill had already been reported out by the House Ways and Means Committee by the time of the Korean outbreak.

16. § 202(a).

17. U.S. Treas. Reg. 111, § 29.22(b) (13)-1 (1943).

18. § 202(b).

19. P.S. 42-42, June 23, 1944, 443 CCH para. 6407.

regarding the policy of the Bureau with respect to the classification of circulation promotion expenses. The policy statement was to the effect that current operating expenses embrace whatever is spent to maintain circulation and capital expenditures embrace whatever is spent to expand circulation.²⁰ The application of this policy to a given set of facts where there were fluctuations in circulation was difficult to say the least.²¹ To remove the uncertainty involved,²² the Senate Finance Committee added Section 23(bb) to the Code to permit expenditures for the maintenance, establishment or increase of circulation to be taken as deductions.²³ Publishers are given an election to capitalize the portion of such expenditures which is deemed chargeable to capital account under regulations to be prescribed. Such an election, if made, must be for the entire amount of that portion of the expenditures chargeable to capital account under the regulations and is binding for all subsequent taxable years unless, upon application by the taxpayer, he is permitted to revoke. Revocation may be subject to such conditions as are deemed necessary to protect the revenue. This is a desirable amendment inasmuch as it removes a totally unnecessary and unreasonable risk from those faced by businessmen in the publishing field and should bring an end to litigation as well as to uncertainty with respect to this particular point. It is hoped that the regulations will permit capitalization where desired on a basis reduced to practically mathematical certainty. The amendments made by Section 204 are applicable with respect to taxable years beginning after December 31, 1945 and therefore attention should be paid to the possibility of refund claims for those years which are still open for tax purposes.

Liquidation Under 112(b)(7).—The provisions of Section 112(b)(7) of the Code are restored for 1951 by Section 206 of the Act. Section 112(b)(7) of the Code was originally added by the Revenue Act of 1943 and permitted considerable tax savings in the liquidation of domestic corporations provided certain requirements were met. As extended by the present Act, the conditions are that liquidation must be effected pursuant to a plan of liquidation adopted after December 31, 1950 and accomplished during a single calendar

20. In support of the application of the same distinction maintained with respect to repairs being deductible expenses and expansion costs or remodeling costs being capital in nature to maintenance or expansion of circulation on the part of publishing concerns, the Commissioner cited the Eighth Circuit Court decisions of *Public Opinion Publishing Co. v. Jensen*, 76 F.2d 494 (8th Cir. 1935); *Meredith Publishing Co. v. Commissioner*, 64 F.2d 890 (8th Cir. 1933); and *Perkins Bros. v. Commissioner*, 78 F.2d 152 (8th Cir. 1935).

21. For example, see *Journal of Living Publishing Corp. v. Commissioner*, P-H 1944 TC MEM. DEC. ¶ 44,224 (1944).

22. Senate Report at 63.

23. § 204.

month in 1951. The plan of liquidation must be adopted after December 31, 1950 regardless of whether the taxable year of the corporation began on, before or after January 1, 1951. Section 112(b)(7) was extended because it was felt by the Senate Finance Committee that certain types of corporations, namely, domestic personal holding companies, are undesirable and their liquidation should be facilitated.²⁴ In order to avoid conversion of assets of the corporation to be liquidated into securities which could be distributed tax free in anticipation of this legislative action, the section provides that stock or securities acquired after August 15, 1950, the date when the Senate Finance Committee approved the extension of 112(b)(7), is to be treated as a capital gain. Inasmuch as the present regulations²⁵ are adequate to cover this section with slight changes of dates, it is to be hoped that the Commissioner will soon advise taxpayers that they can act upon existing regulations. In acting, taxpayers should be extremely careful in their analysis of the consequences of liquidation²⁶ as well as to conform with care to the statutory requirements.

Transportation Cost as Part of Gross Income for Percentage Depletion Purposes.—Another special relief provision inserted at the Senate Finance Committee level of legislative action is that amending Section 114(b)(4)(B) of the Code.²⁷ The special relief permits the inclusion of the value added in the form of transportation costs of minerals within the concept of gross income from mining property for determining percentage depletion. This permits a seller who has to transport the mined product from the point of extraction to a place where ordinary treatment processes are applied the right to include the value of that transportation as well as the value of ordinary treatment in computing gross income from mining property if the transportation covers 50 miles or less. If the distance involved is greater than 50 miles such treatment is permitted only if the Secretary finds that the physical and other requirements are such that the mineral must be transported a greater distance to a plant for its ordinary treatment processes. Such a plant may not be further removed from the

24. Senate Report at 63. Liquidation is facilitated in a case of a non-corporate shareholder by treating his gain (1) as a dividend to the extent of his pro rata share of earnings and profits accumulated after February 28, 1913, (2) as a capital gain to the extent that cash and the value of securities acquired by the corporation after August 15, 1950 received by him exceed his pro rata share of such earnings and profits, and (3) the balance is not recognized until disposition by the shareholder of the remaining assets distributed to him. In the case of corporate shareholders who qualify, gain is treated as capital gain to the extent of (1) pro rata share of earnings and profits accumulated after February 28, 1913 or (2) cash and the value of securities acquired after August 15, 1950, whichever is greater, with the balance of gain postponed as in the case of the individual.

25. U.S. Treas. Reg. 111, § 29.112(b)(7)-1 *et seq.* (1943).

26. *Cf.* Sam Goldman v. Commissioner, 9 CCH TC MEM. DEC. 936 (1950).

27. § 207.

mine than where such plants would be normally located. The Senate Finance Committee points out that the section of the Code being amended was added by the Revenue Act of 1943 with the intent that it would have the same application as that of the Revenue Act of 1932 and the regulations interpreting the 1932 Act. Those regulations specified that gross income for purposes of depletion was to be "before transportation from the place where the last of the (ordinary treatment) processes listed below was applied."²⁸ The absolute right to include such transportation costs in gross income where the transportation covers a distance of 50 miles or less resolves that problem in its entirety and, since the taxpayer is dependent on a finding by the Secretary where the distance involved is greater than 50 miles, the possibilities of litigation would seem remote. In the House version of the bills the provision was to the effect that the term gross income "shall in no case include transportation beyond the property" in order "to restrict depletion to the actual product of mineral extraction."²⁹ In receding, the House introduced the 50 mile limitation and made relief for transportation costs for greater distances dependent upon a finding of the Secretary.³⁰ This amendment is applicable to taxable years beginning after December 31, 1949.

Redemption of Stock to Pay Death Taxes.—Although this amendment deals with the income tax aspects of stock redemptions its prime use for the tax practitioner will be in connection with estate planning. Added to the Act by the House this provision³¹ is designed to remove redemptions by issuing corporations of stock of such corporations held by a decedent's estate from the category of taxable dividends under certain restricted circumstances. Section 115(g) of the Code, to which this amendment is added as subsection (3), treats a redemption of stock as a taxable dividend where the redemption is essentially equivalent to a dividend. The problem of financing the payment of death taxes in cases of estates made up of holdings in family or closely held corporations was made particularly difficult by the possible application of 115(g) to stock redemptions by estates. Aside from possible sales which were difficult of accomplishment because of the limited market for such securities there was little practical relief available in this sort of situation.³² The net result in many cases was, as pointed

28. U.S. Treas. Reg. 77, art. 221(g) (1933).

29. House Report at 65.

30. Amendment No. 65 of the Conference Report.

31. § 208.

32. In the House Report at 63 it is pointed out that § 822(a) of the Code gave the Commissioner the right to extend the time for payment of the federal estate tax in cases of undue hardship for a period not in excess of ten years provided that interest at the rate of 4% was paid. As pointed out in the Report, the margin of return after paying a 4% interest rate ordinarily was not sufficiently large to solve

out by the House Report, "to accentuate the degrees of concentration of industry in this country" by the absorption of family businesses by larger corporations or competitors. In order to prevent the enforced sale of interests in such businesses³³ Section 115(g) has been amended to provide that the redemption of any part of stock which is included in the gross estate of a decedent is not to be considered a taxable dividend under 115(g) provided three conditions are met.

First, the redemption must take place within the period of the statute of limitations for the assessment of the estate tax or within 90 days after the expiration of such period. This means that in addition to the 15-month period after date of death available for the filing of a return, the decedent's estate has an additional three years and 90 days after the filing of the return within which the redemption may be accomplished without being considered a taxable dividend. Thus, if full advantage is taken of the 15-month period for the filing of a return and the three years and 90 days after filing within which redemption may take place, one has a period of $4\frac{1}{2}$ years after the date of death within which to operate under this amendment. As a matter of fact, the Senate version proposed that the period within which distributions might be made tax free should include the period of any suspension under Section 875 of the Internal Revenue Code. The Senate provision was not adopted by the Conference Committee but that Committee did extend by 90 days the period provided for under the House provision which had limited it to the period of limitations provided in Section 874(a).

Second, the exemption applies only to that dollar amount redeemed which is not in excess of the total of the estate, inheritance, legacy, or succession taxes imposed because of the decedent's death. The determination of what taxes have been imposed by virtue of the decedent's death should not raise any real problem. It should be noted there is no requirement in the amendment that the redemption be for the purpose of paying death taxes even though the amount that may

the problem of financing death taxes. The other possible existing remedy mentioned in the House Report was that, under U.S. Treas. Reg. 111, §29.111-9 (1943), "a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation does not effect a distribution of a taxable dividend." It was recognized that the minimum requirement under this regulation was for the estate to dispose of its entire holdings and, even so, there would be no guarantee that a taxable dividend had not occurred. Cf. *Estate of Ira F. Searle v. Commissioner*, 9 CCH TC MEM. DEC. 957 (1950).

33. One of several recent cases which have been brought to the public's attention is that of Booth & Flinn Co., a construction firm of national reputation idolized by the chant of Pittsburgh school children—"Who made the world? God made the world. Who filled it in? Booth and Flinn."—which had to be sold in order to pay the estate taxes after Mr. Flinn's death. *Wall Street Journal*, Aug. 17, 1950, p. 1, col. 4.

be withdrawn tax-free is measured by the amount of death taxes imposed. Although the House Reports points out that this provision was designed to provide an effective method of financing the payment of death taxes when the estate consists primarily of stock in a closely held business and that the relief is restricted "to situations in which true hardships exist", it is doubted that any attempt will be made to read into the statute a requirement that moneys realized through redemption must be used in the payment of death taxes. Thus, this amendment should permit the withdrawal of funds tax-free from a corporation even though other liquid funds are available and are or have been used for the payment of the death taxes. Any increase in value over the values of the stock for estate tax purposes will have to be returned and paid for either at ordinary or capital gains rates depending on the length of holding period of the stock redeemed, but otherwise the redemption is tax-free.

Third, the value of the stock of the corporation involved in the redemption must be more than 50% of the value of the decedent's net estate.³⁴ The question of value should not, in most cases, cause any concern since that will be determined by the audit of the estate tax return. In those cases where the valuation has not been finally determined and the redemption period is nearing an end conservatism would seem to be dictated by the practicalities of the situation. This may result in "true hardship" in given cases since one may not only be unable to determine with assurance the amount to be redeemed, but also be in a quandary as to whether to redeem any amount. This would be particularly true where the government is contending that lifetime transfers are subject to estate tax since one can easily be caught in this box—that if they were, the 50% test is not met, but if they were not, it is met. It will even be worthwhile to contend in some cases that the value of a stock is higher for estate tax purposes than the value contended for by the Commissioner. Because of the added uncertainties that may thus arise in the settlement of decedent's estates, the Senate-proposed period of redemption was much more preferable.

Although this is an extremely helpful relief provision, the wisdom of the 50% restriction is also questionable. If a decedent's entire estate consists of stock of three corporations of approximately equal value, it may be impossible to take advantage of this redemption provision.

34. As introduced in the House, the limitation was that the value of the stock must be more than 70% of the decedent's net estate. The Senate eliminated this provision entirely believing the 70% limitation unduly restrictive. On conference, Amendment No. 75 effected a compromise at 50% pointing out the percentage relationship was to be "computed by taking, as the numerator, the value of the stock included in determining the value of the decedent's gross estate, and by taking, as the denominator, the value of the decedent's net estate."

Likewise, if lifetime transfers enter into the makeup of the estate for tax purposes, it may well be that more than 50% of the net estate may not be in the form of stock in a given company although the stock of that company comprises practically the total of available assets for the payment of the death taxes. On the other hand, there is no requirement that the stock be owned by the decedent at his death or by the estate at the time of redemption. This would permit beneficiaries of the estate or donees of the decedent to take advantage of the redemption provision. If there are several beneficiaries who are in a position to take advantage of the redemption provision, conservatism would dictate that the total redemption by all beneficiaries not exceed the total of the death taxes imposed on the decedent's estate. There is no provision in the statute which would indicate the extent of the tax-free distribution for a given beneficiary, although equitably each beneficiary should be entitled to a pro rata interest in the tax-free redemption concept of the security received by him. This is one point upon which a clear position should be taken by the Commissioner in order to avoid any possible future litigation as between beneficiaries although, in the final analysis, this undoubtedly is a question that will have to be determined by local decisions.

This amendment provides tax practitioners and estate planners with an extremely useful tool in the form of an added source of liquidity for estates as well as providing a means for obtaining corporate funds tax-free. It is an extremely necessary and worthwhile provision, for it brings relief to the family business group which too often in the past was required to sell its business in order to pay the estate tax resulting from the death of one of its owners. It is applicable with respect to taxable years ending on or after September 23, 1950, and applies only to amounts distributed by way of redemption on or after that date.

Loss Carryovers and Carrybacks.—The amendment to Section 122(b) of the Code reducing the period of loss carryback to one year and increasing the loss carryover to five years³⁵ is a relief provision that should meet with general approval and raise no new administrative problems. Although the reduction of the carryback of losses from two years to one year may be harmful to isolated corporations or individuals, nevertheless, the overall result is one to be commended. The extension of the carry-forward of losses to cover a five-year period should prove especially attractive to new businesses and businesses with fluctuating incomes. The emphasis on the loss carry-forward also gives a greater incentive to management to attain efficient and profitable

35. § 215.

operations than does the carryback provision allowing current operational losses to be financed by tax refunds from the past. In addition, the carry-forward provision would seem to be easier of administration than a carryback of equal length. Since the amendment extends the average period from five years to seven years, it qualifies for that reason also as a relief provision. The amendment applies only with respect to losses incurred in taxable years beginning after December 31, 1949; any losses incurred in taxable years beginning before January 1, 1950 will continue to be governed by the two-year carry-back and two-year carry-forward provision of Section 122(b) prior to its amendment by the Revenue Act of 1950.

Amortization of Emergency Facilities.—The provision restoring the privilege of amortizing emergency facilities is more than a relief provision; strictly speaking, it is emergency relief.³⁶ Added by the Senate Finance Committee because of the emergency brought on by the Korean situation, it is patterned quite closely after the amortization deduction permitted during World War II by Section 124 of the Code and has the same purpose of encouraging private expansion of industry to help meet national defense needs. Like its older brother, it permits taxpayers, individuals as well as corporations, at their option to write off the cost of emergency facilities over an accelerated period of five years instead of the longer period of normal depreciation ordinarily allowed. In order to do so, however, the facility must be certified as necessary for national defense during the emergency period by a certifying authority to be designated by the President. Moving with commendable promptness, the President designated the Chairman of the National Security Resources Board as the certifying authority.³⁷ Moving equally promptly, the certifying authority issued regulations dealing with the certification of facilities as emergency³⁸ and announced that application forms and procedures for certification of emergency facilities were available. Although the income tax regulations have not yet been amended, there should not be any great difficulty in that sector since the statutory provisions are complete and clear and there is available the knowledge and background of the World War II amortization deduction regulations.

As stated, the 1950 provisions parallel in many respects the provisions dealing with amortization during World War II. However, there are some important differences. An emergency facility is defined as being any facility the construction, reconstruction, erection, installa-

36. § 216.

37. Exec. Order No. 10172, 15 FED. REG. 6929 (1950).

38. Issuance of Necessary Certificates under § 124A of the Int. Rev. Code, NSRB Regulation, 15 FED. REG. 7265 (1950).

tion, or acquisition of which was completed after December 31, 1949, and which is certified as necessary for the national defense during the emergency period beginning on January 1, 1950 and ending with a termination date to be designated by the President. Part of a facility as well as the entire facility may be certified for this purpose.³⁹ The certification in either case must be applied for within six months from the time it is acquired, or its construction begins, or by March 23, 1951, whichever is later. In addition, in order to qualify for amortization for any taxable year, the certificate must be issued before the return for that year is filed except in the case of a facility acquired between January 1, 1950 and the date of the passage of the Act in which latter case amortization will be allowed if the certificate is issued by September 23, 1951. One very important difference which must be kept in mind is that if a taxpayer sells or exchanges an emergency facility at a profit, the gain to the extent that the amortization deductions exceed the amount of depreciation otherwise allowable is taxable as ordinary income.⁴⁰ In the case of disposition of land, which may qualify but is non-depreciable, it would seem that profit will be taxed as ordinary income to the extent of the amortization deductions.

In addition to having a permissive right to elect amortization, a taxpayer has the right to terminate the amortization election as of the beginning of any month specified by the taxpayer in a written notice filed with the Secretary before the beginning of such month. After such termination he is entitled only to ordinary depreciation on the balance of the cost of the facility and has no right to reelect amortization for that facility. In the event of Presidential termination of the emergency period there is no provision similar to that of World War II days permitting increased amortization on the basis of the shortened period; instead, the write-off will continue over the length of the five-year period. However, if the government reimburses a taxpayer for all or part of the unamortized cost of an emergency facility and the payment is includible in income, the amortization deduction for the month of payment is to equal the amount of the payment.

The amortization amendments are applicable with respect to taxable years ending after December 31, 1949. The concept of amortization of emergency facilities should prove extremely useful to the business world. It remains to be seen how broad the administrative concept will be although clearly a broad interpretation of "emergency

39. In the Senate Report at 59, it was pointed out, however, that toward the end of World War II certificates limiting amortization to a percentage of the total cost of a facility were issued.

40. This treatment is accomplished by § 216(c), which adds par. (3) to § 117(g) of the Code.

facility" will be most beneficial to the national defense effort. As in the past, related fields such as renegotiation should complement the program by recognizing the certification of facilities as emergency and permitting their amortization for renegotiation as well as tax purposes.⁴¹

Employee Stock Options.—A salutary attempt to clear the air in a sector of income taxation vexatious to both the taxpayer and the government is the amendment adding Section 130A to the Internal Revenue Code.⁴² The previous history of the government's position with respect to the taxation of stock options granted employees shows a lack of certainty of purpose as well as a lack of uniformity.⁴³ The last change in government position was occasioned by the decision in *Commissioner v. Smith*⁴⁴ which, on a finding below that the option involved was given as compensation for services rendered, affirmed a holding that the difference between option price and fair market value upon exercise of the option was the intended compensation. In making its last change in position the government, although relying on *Commissioner v. Smith*, went beyond the scope of that decision and took the position that regardless of the intent with which the option was granted, if there was a difference between option price and fair market value at the time of exercise, that difference represented compensation.⁴⁵

As so often happens when the pendulum swings too far in one direction, relief was soon forthcoming. After an abortive attempt to provide relief in the Revenue Revision Bill of 1948⁴⁶ relief began to emerge at the Senate Finance Committee level of the current Act. In discussing its proposed amendment the Senate Finance Committee pointed out that the Regulations went beyond the decision in *Commissioner v. Smith*, indicating quite clearly that the Regulations are not to be considered as having been ratified by Congress through the passage of this or any preceding revenue legislation. In addition to that important comment, the Committee's Report stresses the purpose of such options as incentive devices to attract or retain management and

41. Renegotiation regulations 383.2.

42. § 218.

43. In U. S. Treas. Reg. 94, Art. 22(a)-1 (1936) 211, the difference between the option price and the fair market value of the stock subject to the option at the time of exercise of the option was considered additional compensation and the Regulations were so applied in I. T. 3204, 1938-2 CUM. BULL. 126. In U.S. Treas. Reg. 103, § 19.22(a)-1 (1940), the position was taken that the employee was to include in gross income the difference between the option price and the fair market value to the extent that such difference was "in the nature of compensation for services rendered or to be rendered." This position was continued in U.S. Treas. Reg. 111, § 29.22(a)-1 (1943).

44. 324 U.S. 177 (1945).

45. T.D. 5507, 1946-1 CUM. BULL. 18.

46. H.R. 6712, 80th Cong., 2d Sess. § 137 (1948)

give employees generally a more direct interest in the success of the particular business involved. The actual hardship to be relieved, as pointed out by the Committee, is the imposition of a tax on a supposed amount of compensation not realized in cash at the time of the exercise of an option, with the result that it was often necessary to sell some of the stock acquired under the option in order to finance the payment of the tax.

The relief given is to defer taxation until sale or disposition of the stock acquired under an employee stock option and also, in its most favorable aspect, to accord gains on sales of the stock the benefit of the capital gains provisions. In order to qualify for such treatment, the option granted must be a restricted stock option and the employer must give up any deduction for the option or the shares under it. The restrictions are numerous and indicate the Congressional feeling that the stock option incentive device requires a certain amount of safeguarding. Unfortunately, a number of problems are raised by Section 218 of the Act, some of which it is hoped will be solved by administrative interpretation of the statutory provisions.

The amendment applies only to shares of stock acquired on the exercise after 1949 of a restricted stock option. The preferential treatment applies only if the shares so acquired are not disposed of within two years from the date the option is granted nor within six months after the transfer of stock to the employee. These requirements may be satisfied conjunctively; if the acquisition occurs within one year after the granting of the option, then both holding tests will be satisfied if the disposition is not made until two years and one day after the date of the granting of the option. It might also be noted that if an employee disposes of part of the stock within the barred period so as to lose the benefit of the preferential tax treatment for those shares of stock, the remainder of stock acquired or still under option could nevertheless qualify if all of the other requirements were also met.

The employee at the time he exercises the option must be an employee of the "corporation"⁴⁷ granting the option or he must have been an employee within three months previous to the exercise of the option. The option must be one granted after February 26, 1945⁴⁸ for reasons connected with the employee's employment. At the time the option is granted, the option price must be at least 85% of the

47. Throughout the stock option section it is permitted to have the option granted by a parent or subsidiary corporation (both terms being defined) as well as the employing corporation. Therefore "corporation" will be used for the purpose of this discussion as embracing the parent and subsidiary corporations as well as the employing corporation.

48. The date of the decision in *Commissioner v. Smith*, *supra*.

fair market value of the stock. Unfortunately, Conference Committee consideration of the price restriction resulted in the creation of two classes of restricted stock options. The first class is where the option price is 95% or more of the fair market value at the time the option is granted. The 95% class enjoys the preferential tax treatment in full; no income is realized until the stock is sold and any profit realized is taxed as capital gain. The second class comprises all other restricted stock options, namely, those where the option price is 85% or more but less than 95% of fair market value at the time the option is granted. In the 85% to 95% class, the difference between option price and fair market value (1) at the time the option was granted or (2) at the time of disposition or employee's death, whichever is the lesser, is taxed as ordinary income. In the event of disposition, the basis for the stock is increased by the amount taxed as ordinary income. If the disposition is by way of sale, the balance of gain is taxed as capital gain. In the event of death, the basis becomes fair market value at date of death or at the optional valuation date under Section 113(a)(5) of the Code and therefore there is no specific treatment in the stock option provisions as to basis in the event of death. Disposition by definition includes a sale, exchange, gift, or any transfer of legal title, but does not include a transfer from a decedent to his estate or a transfer by bequest or inheritance, a tax-free exchange falling within Section 112(b)(2) or (3) of the Code, or a pledge.

The provisions discussed thus far raise several interesting problems. It might be well to discuss them briefly before covering the remaining restrictive conditions. The familiar problem of value of unlisted securities is present, even though some effort to lessen the drastic effects of differences of opinion as to value is made by permitting qualification on the basis of an option price which is 85% of the fair market value at the time the option is granted. The 85% rule was put in for that very purpose by the Senate Finance Committee, which in its version of this relief provision had only one class of restricted stock option, according deferment of income and the benefit of capital gains taxation to any stock in the 85% or higher range. The concept of taxing the 85% to 95% class to some extent at ordinary rates was introduced in Conference by the House members. The wisdom of providing ordinary income treatment for the spread in value is certainly doubtful. It will add very little to the revenue; it will pose many administrative problems; and it will leave taxpayers unnecessarily in doubt as to the proper reporting of gains on the sale or disposition of stock acquired under stock options. Although there is an overall cushion of 15% on the question of value, there is only

a 5% cushion for the full tax benefit type of option. Anyone who has experienced valuation problems in the past will undoubtedly feel that practically the only result of having the two classes will be to encourage litigation and make the full tax benefits available only to employees of corporations whose stock is listed or extensively traded. The anomaly of this is that the incentive device of stock option is most useful in the hands of smaller business for the purpose of attracting able management to the business.

It has always been the hope of all tax practitioners that the question of value could be solved at least partially by means of a mathematical formula that the government would consider as binding upon it. This is even more important in situations, such as stock options, involving the fourth dimensional problem of time. Unless solved by administrative rules, conservatism may in some cases require an employee to attempt to test the question of value by sale of a part of his stock and litigation to determine value before selling a large block of stock, a time wasting procedure. It is hoped that in order to avoid the many assorted value problems that might and will arise under the stock option provisions, the Commissioner will be willing to undertake the determination of the question of value at the outset and be willing to issue rulings or enter into closing agreements on the question of value for the purpose of this section at the time or shortly after an option is granted. One other value problem that may be involved in some options is where the option covers a period of years with rights to pick up shares accruing at annual or other intervals during the term of the option and with the price to be determined by reference to book value at such times. This problem could and should be resolved by the Commissioner's ruling that price as determined at any time by book value should relate back in time to the date of the granting of the option and be considered the option price as of that time. In the absence of such a ruling or interpretation, however, the wisdom of using book value as a price determinant, extensive though that practice has been in the business world in selling stock of unlisted securities, would seem very questionable.

Of more than passing academic importance is the indication of a possible trend in governmental tax thinking in the taxing as ordinary income of a portion of the spread in value of an 85%-95% type option in the event of gift of the stock or death of the option holder. There have been in the past numerous proposals to tax the difference between cost basis and value at date of death for income tax purposes. In some quarters it might be thought that this presents the opening wedge. However, to consider this provision in its clear retrospect it must be

remembered that the difference to be taxed as ordinary income was considered in the Conference Committee to be in the nature of added compensation which easily leads to the view that in any event it was susceptible to tax under Section 126 of the Code.⁴⁹ The one important difference is that in the stock option field the tax is on the decedent employee and there is also a complementary tax in the event of a gift.

Another interesting point is that nowhere do the stock option amendments speak of capital gains treatment other than in the negative. However, they do provide that income shall not result at the time of the exercise of the option and, since the government has never taken the position that an employee recognizes income upon receipt of an option, it would tend to follow that stock acquired under the option is a capital asset to be accorded capital gains treatment unless the law provides otherwise. Of course, the various restrictions incorporated in the statute must be met before one is entitled to capital gains treatment. If they are not met then, as pointed out by the Senate Finance Committee, one "will continue to be taxed as under existing law", a state of confusion that only time will unravel. There should not be any great difficulty in interpreting the provisions to mean that taxpayers are entitled to capital gains treatment even though such treatment is not specifically set forth in the statutory language. Both the Senate Finance and Conference Committee Reports make this clear. The Senate Report states that "the gain realized by the sale of stock acquired through the exercise of the option will be taxed as long-term capital gain" and the Conference Report gives several examples of the tax consequences of restricted stock options which show that capital gains treatment was intended.

The other restrictions may be touched upon briefly. The option must be non-transferable except by will or intestacy and be exercisable, during lifetime, only by the employee. The employee at the time the option is granted may not own more than 10% of the total combined voting power of all classes of stock of the corporation. For this purpose an individual is considered as owning stock owned directly or indirectly by or for persons bearing a certain relation to him and stock owned directly or indirectly by or for a corporation, partnership, estate, or trust is to be considered as being owned proportionately by or for its shareholders, partners or beneficiaries.⁵⁰ Since the 10% test is restricted to the time the option is granted, the number of shares

49. Interestingly enough the Revenue Revision Bill of 1948 considered this problem as a Section 126 amendment.

50. The constructive ownership provisions are similar to those appearing in Section 503 of the Code, which covers stock ownership for the purpose of the Personal Holding Company Surtax.

included in the option should not be considered either as outstanding or owned by the employee in determining whether the 10% stock ownership restriction is satisfied.

For the purposes of subsection (d), which defines "restricted stock option", "parent corporation", "subsidiary corporation", and "disposition", it is provided that if the terms of any option are modified, extended, or renewed, then such modification, extension, or renewal is to be considered as the granting of a new option in which case the fair market value at the time of the granting of the option is to be considered as the fair market value (1) on the date of original option, (2) on the date of the modification, or (3) on the date of any intervening modification, whichever is the highest. The restrictions to be concerned with if an amendment is being considered would seem to be the price and stock ownership restrictions. Since the stock option provisions are designed to make the stock option a useful device and since they apply to any options granted after February 26, 1945, the date of the decision in *Commissioner v. Smith*, it would seem desirable to give taxpayers the privilege of modifying options received prior to September 23, 1950 in unimportant respects in order to permit those options to qualify as restricted stock options without requiring present fair market values to be considered. Unimportant considerations might mean all those other than price, number of shares, and length of time the option is to be in existence. The privilege should be extended for only a very limited period of time. However, in view of the statutory language and the background of litigation in the stock option field, it is doubtful whether any such privilege will be given.

Undoubtedly, many problems will arise in the administration of the restricted stock option provisions. On the whole, however, they are provisions to be welcomed since they give the benefit of governmental sanction to the use of the stock option device. The success of this relief provision for employees of companies whose stock is not actively traded will depend on the administrative treatment of the problems involved.

Regulated Investment Companies.—This is a worthwhile relief amendment which should be received favorably by administrators and taxpayers alike.⁵¹ It adds paragraph 8 to Section 362(b) of the Code and gives a regulated investment company the election to treat a dividend paid by it, including a capital gain dividend, as having been paid during the taxable year if declared after the close of the taxable year and before the due date, as extended, of the company's return for that

51. § 222.

year, provided the dividend is distributed in the twelve month period after the close of the year and not later than the first regular dividend payment date following declaration. Added by the Senate Finance Committee to avoid the difficulties involved in effecting a distribution of 90% of income where such companies are in receipt of substantial year-end dividends or gains, the amendment applies to taxable years ending after September 23, 1950. The amendment has no effect as to treatment of the dividend by the stockholders; they still report the dividend as income in the year it is received.

Personal Holding Company Income.—This relief provision is entirely retroactive in operation. It provides that rents from a 25% stockholder are not to be considered personal holding company income if (1) received during taxable years ending after December 31, 1945, and before January 1, 1950, and (2) the stockholder paid the rents for the use of property in the operation of a bona fide commercial, industrial, or mining enterprise.⁵² It should be noted that this relief provision applies only to Section 502(f) of the Code. Thus, rents other than those covered under Section 502(f) will continue to constitute personal holding company income under Section 502(g) if they constitute less than 50% of gross income. Since 502(g) excludes only those rents which are personal holding company income under 502(f), the effect of this amendment is to throw 502(f) rents into 502(g) and make the status of all rents dependent on whether the 50% rule was met.

This provision was added by the Senate Finance Committee to aid closely held corporations who have unwittingly become personal holding companies through renting operating assets to stockholders. It is pointed out that this relief is solely for the current and past years and that arrangements of such type, which can result in tax avoidance, will not be permitted this relief in future years. Since the amendment is retroactive in application, refund possibilities for open years during the period for which relief is given should be investigated.

Transfers in Contemplation of Death.—The last two relief provisions of the 1950 Act concern themselves with the estate tax. The first of these⁵³ is the frequently mentioned and long awaited amendment to Section 811 of the Code providing that no transfers made more than three years prior to the date of death can be considered to have been made in contemplation of death, but that transfers made within three years of date of death will be presumed to have been made

52. § 223.

53. § 501.

in contemplation of death. The reasons for these changes are well known to all tax practitioners. While the concept of including transfers in contemplation of death in a decedent's gross estate is undoubtedly necessary to prevent avoidance of estate tax, it is a very difficult concept to administer fairly since it deals with a decedent's intent at the time the transfers were made. The greater the time lag between the transfer and date of death, the more difficult it is to administer the concept fairly. This, to some extent, undoubtedly resulted in the tendency on the part of the government to assert that almost all lifetime gifts were made in contemplation of death. The amendment provides a cut-off date which precludes the raising of the question as to transfers made prior thereto. This permits more certain estate planning and makes even more desirable the making of life-time gifts. The fact that the period within which a transfer is presumed to have been made in contemplation of death is increased from two to three years is little enough for taxpayers to offer in trade for the benefits to be derived from the cut-off feature of the amendment.⁵⁴ As before, the taxpayer still has the right to rebut the presumption and show that the transfer was not made in contemplation of death. Whether the courts and administrators will tend to treat gifts within the three year period more harshly than before remains to be seen, although there would seem to be no sound basis for any departure from past decisions. The amendment is effective only with respect to the estates of decedents dying after September 23, 1950.

Reversionary Interests—Life Insurance.—The second estate tax relief provision⁵⁵ is designed to extend the relief accorded reversionary interests by the Technical Changes Act of 1949 to a narrow segment of estate taxation of life insurance proceeds. Under the Technical Changes Act of 1949 lifetime transfers are not includible in the gross estate merely because of a retained reversionary interest if the value of such interest immediately before death was not more than 5% of the value of the property, or if the property would revert only by operation of law. The insurance relief given is to amend Section 404(c) of the Revenue Act of 1942 so that a decedent shall not be considered to have retained an "incident of ownership" for purposes of the premium payment test merely because of the retention of a reversionary interest if the value of such interest between January 10, 1941, and the date of his death was not more than 5% of the value of the policy, or if such

54. The House Ways and Means Committee, in which this provision was introduced, estimates that the overall effect will be to reduce revenue by about four million dollars a year when both provisions are in full operation.

55. § 503, added by the Senate Finance Committee.

reversionary interest arose solely by operation of law. This amendment brings this very narrow part of estate taxation in line with the treatment accorded possibilities of reverter generally under the estate tax law and will undoubtedly be interpreted to accord with the interpretation given its model.⁵⁶ It applies only for the purpose of determining whether the estate tax applies to insurance proceeds represented by premiums paid by the insured on or before January 10, 1941. Since the question of value is determinable with exactness through the use of mortality tables and actuarial principles, there would seem little likelihood of the amendment generating new problems. The amendment applies to the estates of all decedents dying after October 21, 1942, the date of enactment of the Revenue Act of 1942, and provides that no interest is to be allowed on refunds with respect to overpayments made prior to September 23, 1950.*

56. Unfortunately, the proposed regulations on the possibility of reverter provisions of the Technical Changes Act of 1949 are somewhat strained providing as they do that "A reversionary interest will be considered to arise by the express terms of the instrument of transfer if the instrument contains an express disposition which affirmatively creates a reversionary interest, *even though the terms of the disposition do not refer to the decedent or his estate, as such.* For example, where a disposition which, in terms, is to the next of kin of the decedent constitutes, under the applicable local law, a reversionary interest in the decedent's estate, such reserved reversionary interest will be considered to arise by the express terms of the instrument and not by operation of law." (Italics supplied.) Proposed §81.17(c) of U.S. Treas. Reg. 105, 15 FED. REG. 7882 (1950). It is to be hoped that in their final form the regulations will prove to be a more realistic appraisal of both Congressional intent and statutory language.

* In a subsequent article Mr. Hilinski will deal with the loophole closing and other miscellaneous provisions of the Act.