1982

Recommended tax law changes

American Institute of Certified Public Accountants. Federal Taxation Division

AICPA American Institute of Certified Public Accountants

RECOMMENDED TAX LAW CHANGES

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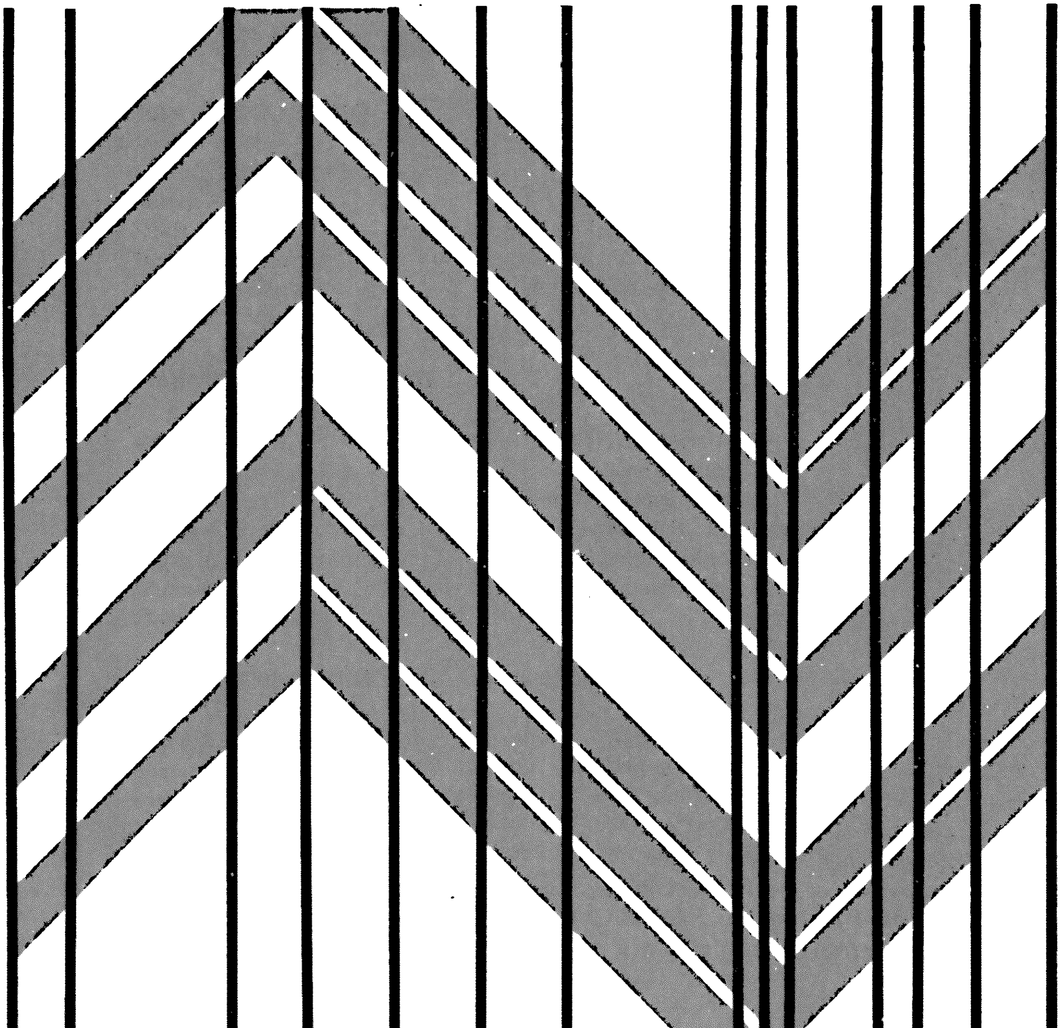

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FOREWORD

Recent years have seen the passage of considerable legislation affecting our tax system, indicating the interest that Congress and the Administration have had in making that system simpler and more equitable.

The AICPA Federal Taxation Division supports and encourages the continuing review and evaluation of tax legislation. As part of that effort, the division offers for consideration these legislative recommendations, arranged in Internal Revenue Code section order. These recommendations are in addition to those contained in other publications of the AICPA Federal Tax Division, which are provided to you as they are published.

Included in this booklet are some recommendations that would simplify both the understanding and the implementation of the tax laws and reduce inequities in the tax system. These provisions relate to areas where an intended tax benefit or alternative is made available to taxpayers, but where there are onerous penalties for inadvertent noncompliance with unnecessarily complicated technical requirements. This creates a dramatic inequity between the taxpayer who has sophisticated counsel and one who does not. In some cases, the tax system favors the taxpayer who is merely lucky enough not to have fallen into a trap.

The recommendations presented in this booklet would have significant effect, direct or indirect, on taxpayers. We urge their adoption and are prepared to respond to requests for assistance in formulating sound tax policy.

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Determination of Tax Liability

SECTION 47

Disposition of Section 38 Property — Additional Exceptions

Section 47(b) should be amended to provide an additional exception to the definition of "early dispositions" where the sale or exchange of qualifying section 38 property by one member of a "controlled group" (as defined in section 1563) is to another member of such group and the transferee agrees to be liable for the recapture of the investment credit upon a subsequent disposition of such qualifying property.

Section 47(b) presently recognizes that an "early disposition" does not occur by reason of a mere change in the form of doing business. However, several requirements are necessary for a transaction to be excepted, including (1) the retention by the taxpayer of a substantial interest in the trade or business and (2) a carryover basis to the transferee.

In the situation covered, the property has been sold or exchanged to a different corporation, but the controlled group of corporations has remained intact.

Regulations section 1.47-4(b) provides for an agreement similar to that contemplated above in order to avoid recapture of investment credit where a corporation makes an election under section 1372 to be an electing small business corporation.

Computation of Taxable Income

SECTION 61

Compensation for Services

Such items as commissions earned by an insurance agent on policies on his own life, real estate commissions received by a salesman on purchases of real estate for his own account, and commissions on sales of securities made by a broker for himself represent reductions in cost and should not be treated as compensation for services rendered [section 61(a)(1)].

In *Sol Minzer* v. *Commissioner,* 279 F.2d 338 (5th Cir. 1960), it was held that an agent's commission on policies on his own life was income to him. In *Kenneth W. Daehler* v. *Commissioner,* 281 F.2d 823 (5th Cir. 1960), the commissions received by a salesman on real estate purchased for his own account were considered to be compensation for services. In *Leonard J. Kobernat,* T.C. Memo 1972-132, commissions on purchases and sales of securities for the joint and separate personal accounts of a stockbroker and his wife were ruled to be includible in their taxable income.

No real economic income appears to be derived from the services rendered in such instances, and, therefore, no taxable income should arise from such transactions.

SECTION 162

Application of "Overnight Rule" for Business Expenses

A deduction should be allowed for meal expenses on business trips whether or not the taxpayer is away from home overnight [section 162(a)(2)].

Section 162 permits a deduction for business expenses incurred while away from home on business trips. The IRS has consistently disallowed such expenses unless the taxpayer is away from home overnight, except where business needs require that rest be obtained during released time.

Until 1967, the courts did not support the IRS, stating, in effect, that the word "overnight" does not appear in the Internal Revenue Code and, therefore, has no application. However, in 1967, the Supreme Court (*United States* v. *Correll* et ux. 389 U.S. 299 (1967)) held that daily trips not requiring rest or sleep are not "away from home." Business expenses incurred during such trips are not deductible. Thus, the traveling salesman away from home for over eighteen hours in a day and the businessman flying in one day from New York to Dallas and back to New York cannot deduct the cost of meals unless they rest sometime during the day.

Legislation should be enacted so that the taxpayer is required neither to be away from home overnight nor to rest or sleep to claim the deduction.

SECTION 167

Amortization of Intangible Assets

The cost of purchased goodwill, trademarks, trade names, secret processes, formulas, licenses, and other similar intangible assets should be amortizable over a stated period fixed by statute to the extent (that such items are not otherwise deductible under other sections) of the code [sections 167, 177, 248].

The code permits a deduction for *development* of certain intangible assets (research and experimental expenses under section 174 and trademark or trade name expenses under section 177).

It is inequitable to treat the costs of intangible assets *purchased* by a taxpayer differently from those incurred in the development of intangible assets. A taxpayer who purchases certain intangible assets can amortize their costs if a definitely determinable life can be established for them or, failing that, upon proof of abandonment of the asset.

While it may be difficult or impossible to demonstrate with reasonable certainty either a definitely determinable life or abandonment, the value of any intangible ultimately disappears. The recorded cost of such assets should be amortized over some period—if not the useful life, then an arbitrary time period.

A statutory provision for the amortization of the cost of intangibles would recognize the resolution of the accounting problems presented by such assets. The earlier accounting treatment of intangibles without a limited life was to defer their write-off until it became reasonably evident they were worthless.

AICPA Accounting Principles Board Opinion 17 (August 1970) states that the cost of an intangible asset should be written off over its estimated life and that such life should be determined by analysis of appropriate factors, but the period of amortization should not be in excess of forty years.

A similar rule should be established for tax purposes. In addition, there should be provision for recapture of claimed amortization in the event of a sale or other disposition of the intangible asset.

SECTION 177

Trademarks and Trade Name Expenditures

Trademarks and trade name expenditures should be amortizable unless the taxpayer elects not to amortize.

Section 177 provides that trademark and trade name expenditures may, at the election of the taxpayer, be amortized over a period of not less than sixty months. It further provides that the manner for making the election shall be prescribed by regulations. Under present regulations, it is necessary to identify the character and amount of each expenditure to which the election applies.

This situation creates an undue hardship for a taxpayer who, in good faith, unintentionally omits an item from the statement of election. The consequence is a permanent loss of the right to amortize the expenditure.

The rule should be that trademark and trade name expenditures are amortizable unless an election is made not to amortize. The potential for abuse should be dealt with administratively. The proposed election would be no different from that of a current deduction rather than capitalization of an expenditure for any fixed asset.

SECTION 195

Start-Up Expenditures

Start-up expenditures should be amortizable unless the taxpayer elects not to amortize.

Section 195 provides that start-up expenditures may, at the election of the taxpayer, be amortized over a period of not less than sixty months. It further provides that the manner for making the election shall be prescribed by regulations. The committee report on Pub. L. 96-605 anticipates that the election will be made in a manner similar to that for section 248 of the Internal Revenue Code. Thus, it may be necessary to identify the character and amount for each expenditure to which the election applies.

This situation creates an undue hardship for a taxpayer who, in good faith, unintentionally omits an item from the statement of election. The consequence is a permanent loss of the right to amortize the expenditure.

The rule should be that start-up expenditures are amortizable unless an election is made not to amortize. The potential for abuse should be dealt with administratively. The proposed election would be no different from that of a current deduction rather than capitalization of an expenditure for any fixed asset.

SECTION 212

Deduction for Preliminary Investigation of Business or Investment Opportunities

Expenses paid or incurred by an individual during a taxable year with respect to a search for a prospective business or investment should be deductible regardless of whether the proposed transaction was consummated.

Prior to 1957 the IRS followed I.T. 1505 (I-2 C.B. 112) in permitting a deduction for expenses incurred in determining whether or not an investment should be made. The ruling held that such an investigation constitutes a transaction entered into for profit and that, upon abandonment of the enterprise, the expenses incurred become a loss that is deductible in the year of abandonment.

The IRS revoked I.T. 1505 after reviewing the history of the rule's application and issued Revenue Ruling 57-418 (1957-2 C.B. 143), which established that "a loss sustained during a taxable year with respect to expenditures incurred in search of a prospective business or investment is deductible only where the transaction has actually been entered into and the taxpayer abandons the project."

Revenue Ruling 77-254 (I.R.B. 1977-30) amplified Revenue Ruling 57-418 by providing that a taxpayer will be considered to have entered a transaction for profit if the taxpayer has gone beyond a general investigation of a new business or investment and focused on the acquisition of a specific business or investment. Revenue Ruling 77-254 fails to solve the problem because it makes an inappropriate distinction between the tax treatment of audit expenses incurred with regard to the acquisition of a new business and the treatment of legal fees relating to the same transaction.

Code section 195, added in 1980, provides a procedure for deducting the start-up expenses of an actual new business over a sixty-month period. While certainly an improvement with regard to start-up expenditures of new businesses that are actually entered into, this section does nothing to alleviate the problem with regard to a preliminary investigation of business or investment opportunities that are not entered into.

Expenditures made in connection with a preliminary investigation of business or investment opportunities should be deductible even if a taxpayer abandons the prospective project before entering into a material amount of activity in connection with it. Such preliminary expenditures should be equivalent to those that are admittedly deductible by taxpayers who have engaged in material activity. See *Charles T. Parker*, 1 T.C. 709 (1943), distinguished by the IRS in Revenue Ruling 57-418.

There is no equitable justification for limiting the deduction of investigatory expenses to situations in which the prospective business or investment was actually entered into and subsequently abandoned. If a taxpayer makes a good-faith investigation of a business prospect entered into for a profit that is clearly identifiable and incurs reasonable and necessary expenditures, he should be permitted a deduction for those expenses.

Taxpayers already engaged in a particular business are permitted to deduct expenses of investigating the expansion of their business into new areas. Thus, by not being allowed to deduct the expenses of investigating the establishment of a new business, a newcomer to a particular type of business is placed at a competitive disadvantage not only with those already in that business but also with existing businesses seeking to establish new branches.

The deduction should be permitted under either section 165(c)(2), for expenses relating to business prospects, or section 212, for investment-connected expenses.

SECTION 212

Deductibility of Expenses of Estate Planning

It should be made clear that a deduction is allowable for the ordinary and necessary expenses paid or incurred in connection with estate planning.

The economic complexities of life today are immeasurably increased upon death unless there has been proper planning for this event. For this reason, many individual taxpayers seek advice in the planning of their estates. Some of the benefits from such advice are assurance of the proper transfer of assets, the preservation and conservation of these assets until beneficiaries are mature enough to own and manage them outright, saving of income and estate taxes, and obtaining increased liquidity for the estate.

In many instances, it is possible to demonstrate that the expense incurred for such advice is deductible because it was incurred for the management, conservation, or maintenance of property held for the production of income. Thus in *Bagley*, 8 T.C. 131 (1947), acq. 1947-1 C.B. 1, the court allowed a deduction for fees paid for advice and planning with respect to rearrangement and reinvestment of a taxpayer's estate.

A major part of most estate planning advice is the possibility of tax savings. Although the advice given is for future use as opposed to advice in connection with an immediate tax liability, the expense incurred to obtain such advice still should be deductible. Expenses incurred for tax advice should be allowed regardless of whether the advice is for present or future tax liability. Tax planning is accepted as a necessary defense, and the cost of obtaining advice to minimize or defer future tax liabilities should be as deductible as similar costs paid for present taxes.

No estate plan is complete without the drafting of necessary legal instruments such as wills or trusts. Since such costs are related to the other estate planning activities (that is, preservation of property, obtaining of tax advice, and so forth), the ordinary and necessary expenses for such advice also should be deductible.

This area is charged with uncertainty today, and it would be preferable to have a clear statutory statement that the ordinary and necessary expenses of obtaining estate planning advice are deductible.

SECTION 212

Deductibility of Expenses of Tax Planning

It should be made clear that a deduction is allowable for the ordinary and necessary expenses paid or incurred in connection with tax planning or determining the tax effects of a given transaction or investment.

Many prospective financial transactions require thorough study and analysis of their tax aspects. Costs incurred to obtain such a study and analysis should be deductible regardless of whether the tax services provided by the advisor relate to general tax planning, evaluation of potential investments, or the acquisition or disposition of an investment. Since such tax planning is an essential part of these transactions, the cost of obtaining this advice should be deductible currently.

There should be a clear statutory statement that the ordinary and necessary expenses of obtaining tax planning advice are deductible. An amendment to section 212(3) to include the term "interpretation" would accomplish this result.

SECTION 245

Certain Dividends Received From Wholly Owned Foreign Subsidiaries

The 100 percent dividends-received deduction should be liberalized by reducing the required percentage of ownership by the domestic corporation from 100 percent to 80 percent and permitting this deduction to U.S. corporations whose foreign subsidiaries have less than all of their gross income effectively connected with a U.S. trade or business [section 245(b)].

Section 245(a) provides that, if a foreign corporation is engaged in trade or business in the United States for a thirty-six-month period, and if 50 percent or more of its gross income for such period is effectively connected with the U.S. trade or business, a corporate recipient of dividends paid by the foreign corporation is entitled to the 85 percent dividends-received deduction to the extent the dividend is paid out of earnings and profits attributable to gross income effectively connected with the foreign corporation's U.S. business.

Section 245(b) provides that, in lieu of the 85 percent deduction of section 245(a), a 100 percent deduction will be allowed if (1) the foreign corporation is a 100 percent-owned subsidiary and (2) *all* of its gross income for the year creating the earnings and profits from which the dividend is paid was effectively connected with a U.S. trade or business. The 100 percent deduction is only available if a section 1562 election for the parent was not effective either in the year the earnings arose or in the year the dividend is received.

Section 245(b) is generally comparable to section 243(b), which allows a 100 percent dividends-received deduction for certain domestic intercorporate dividends. However, section 243(b) requires only the 80 percent ownership needed for affiliated group status to qualify the dividend for the special deduction, rather than the 100 percent required in section 245(b).

Further, the requirement that *all* gross income of the foreign corporation be effectively connected with a U.S. business seems extremely harsh. The benefits of the 100 percent dividends-received deduction could be lost entirely in situations where as little as $1 of the gross income of the foreign corporation is not effectively connected with a U.S. business.

It does not appear that there is any logical reason for the rules of section 245(b) to be more restrictive than those of section 245(a) as long as conditions comparable to those of section 243(b) are met. Accordingly, section 245(b) should be amended to permit a 100 percent deduction in an appropriate case as long as there is 80 percent ownership by the domestic corporation and at least 50 percent of the gross income of the foreign corporation for a thirty-six-month period is effectively connected with a U.S. trade or business. The amount of this deduction would be computed on the same basis as is now provided for the deduction under section 245(a).

The result of these changes would be that, if the domestic parent could have made a section 243(b) election with respect to a foreign corporation's dividends if the foreign corporation had been a domestic corporation, it would be permitted the same tax treatment as if such an election had been made, but only to the extent that the dividends are paid out of earnings and profits already subjected to full U.S. tax. In cases where a section 243(b) election would not be permissible if the subsidiary were domestic, either because of less-than-80-percent ownership or the existence of a section 1562 election, the 85 percent deduction would continue to apply.

SECTION 246

Limitations on Deductions for Dividends Received

The dividends-received deduction should be determined without regard to taxable income [section 246(b)].

Section 243(a)(1) allows a deduction to a corporation of an amount equal to 85 percent of the dividends that it receives from domestic corporations, but section 246(b)(1) limits the 85 percent deduction to 85 percent of taxable income. Section 246(b)(2) provides that the limitation in section 246(b)(1) does not apply for any taxable year for which there is a net operating loss. The limitations imposed on the dividends-received deduction by sections 246(b)(1) and (2) cause needless complexity and sometimes provide an illogical result when the existence of an insignificant amount of net operating income causes a substantial curtailment in the dividends-received deduction which would not have occurred if a net operating loss (no matter how small) had existed.

SECTION 248

Organizational Expenditures

Organizational expenditures should be amortizable unless the taxpayer elects not to amortize.

Section 248 provides that organizational expenditures may, at the election of the taxpayer, be amortized over a period of not less than sixty months. It further provides that the manner for making the election shall be prescribed by regulations. Under present regulations, it is necessary to identify the character and amount of each expenditure to which the election applies.

This situation creates an undue hardship for a taxpayer who, in good faith, unintentionally omits an item from the statement of election. The consequence is a permanent loss of the right to amortize the expenditure.

The rule should be that organizational expenditures are amortizable unless an election is made not to amortize. The potential for abuse should be dealt with administratively. The proposed election would be no different from that of a current deduction rather than capitalization of an expenditure for any fixed asset.

SECTION 265

Dealers in Tax-Exempt Securities

Dealers in tax-exempt securities should be allowed a deduction for interest expense attributable to securities carried in inventory to the extent such interest exceeds the exempt interest earned on such securities [section 265(2)].

A dealer in tax-exempt securities may incur debt in order to carry such securities as part of his inventory. In such case, the interest expense is an ordinary and necessary business expense, and its deductibility should not be limited by rules more appropriate to investment activity. The guidelines issued in Revenue Procedure 72-18 (1972-1 C.B. 740) and the court decisions cited therein make it clear that legislation is needed to permit the dealer a deduction for his interest expense. Such deduction should be reduced by the interest income earned on the exempt securities held in inventory. This rule would result in a clearer reflection of income in the business of dealing in exempt securities.

SECTION 267

Transactions Between Related Taxpayers

A taxpayer on the accrual basis should be permitted a deduction for unpaid expenses and interest of a taxable year if such amount is paid to a related person on the cash basis within the time prescribed for filing the return for the taxable year, including extensions. A taxpayer who failed to meet the above requirement should be allowed a deduction on the cash basis, in the year paid, of the subject expenses [section 267(a)(2)].

Under present law, a taxpayer is denied a deduction if payment of certain expenses is not made, actually or constructively, to a related person within two-and-one-half months after the close of the taxable year. This is true although the payment will be taxable to the recipient at the time it is received. The rule has been especially harsh because of the stringent two-and-one-half-month time limit for the payment.

The principal purpose of the existing law is to prevent related taxpayers from taking advantage of different methods of accounting in order to obtain a deduction without the reporting of income. The purpose of the law would be equally served if the payment date were extended to the due date of the accrual basis taxpayer's return, including extensions, and if the deduction were permitted in a subsequent year for a taxpayer who paid after that date.

If the taxpayer has incurred an expense, then a deduction should be allowed at some point in time. This treatment would coincide with the purpose of section 267(a)(2), as set forth in the 1937 committee reports (U.S., Congress, Senate and House Ways and Means Committee, 75th Cong., 1st sess., 1937, S. Rep. 1242 and H. Rep. 1546, p. 29; see 1937-2 C.B. 630), and yet remedy the harsh tax treatment incurred by taxpayers who fail to meet the technical requirements of section 267(a)(2). Further, this proposal would be a move toward both simplification and equity.

SECTION 269

Acquisitions to Evade or Avoid Federal Income Tax

It should be made clear that section 269(a)(1) does not apply in the case of an acquisition of control of one corporation by another corporation where both corporations were controlled by the same stockholders immediately before the acquisition.

Section 269 provides for the disallowance of deductions, credits, or other allowances in the case of certain acquisitions where the principal purpose of the acquisition is the evasion or avoidance of federal income tax. The section covers two types of acquisitions: (1) acquisition of control of a corporation and (2) acquisition of property of another corporation, the basis of which is determined by reference to the basis of such property in the hands of the transferor corporation.

In the case of the acquisition of property (number 2 above), there is an exception where the transferor corporation and transferee corporation were controlled by the same shareholders immediately before the acquisition. The exception insures that deductions, credits, or allowances will not be denied due to transfers within a single economic group.

As presently constituted, subsection 269(a)(1) can operate to deny losses or other deductions sustained within a single economic group. The congressional committee reports under section 129, Internal Revenue Code of 1939 (predecessor of section 269), do not indicate that this was intended. To the contrary, the reports cite the abuses of purchasing corporations with current, past, or prospective losses for the purpose of reducing income taxes. In the case of *The Zanesville Investment Co.*, 355 F.2d 507 (6th Cir. 1964), the IRS even challenged the deductibility of losses sustained after affiliation of two corporations that were owned by one individual prior to affiliation.

Rulings published by the IRS have permitted the utilization of tax benefits through statutory mergers (or equivalent thereof) of controlled corporations, since the mergers constituted acquisitions of assets rather than acquisition of control of corporations. See Revenue Ruling 66-214 (1966-2 C.B. 98), Revenue Ruling 67-202 (1967-1 C.B. 73), and Revenue Ruling 70-638 (1970-2 C.B. 71). There is no reason for a distinction.

Accordingly, it is recommended that subsection 269(a)(1) be amended to make clear that it does not apply where a corporation acquires control of another corporation, both of which were controlled by the same stockholders before the acquisition.

Corporate Distributions and Adjustments

SECTION 302

Lost Basis When Redemption or Sale of Stock Is Taxed as Dividend

A redeeming or selling shareholder should realize a loss to the extent of the basis of the stock redeemed or sold in the event such redemption or sale is taxed as a dividend and such shareholder has no other shares to which such basis can be allocated.

Under section 302, a distribution in redemption of stock that does not qualify as a payment in exchange for such stock will be treated as a dividend under section 301. Similarly, under section 304, the sale of the stock of one corporation to another corporation will be treated as a redemption if the selling shareholder is in control of both corporations; and thus, if it does not qualify under section 302 as a payment in exchange for such stock, it will be treated as a dividend under section 301.

The regulations under section 1.302-2(c) provide for allocation of the basis of the stock redeemed, where the redemption is treated as a dividend, to other shares of stock held by the redeeming shareholder or his spouse. Similar provisions under regulations section 1.304-2(a) require allocation to shares held in the controlling acquiring corporation or the issuing corporation. However, no provision is made under these sections for allocations where the redeeming (or controlling) shareholder actually holds no stock to which such basis can be allocated.

Unless statutory provision is made to preserve the basis of stock redeemed or sold where such redemption or sale is treated as a dividend, it would appear that the basis in such stock "disappears" in many situations. See, for example, Revenue Ruling 70-296 (1970-2 C.B. 75), where under section 304 the controlling shareholder did not own stock in either the acquiring corporation or the issuing corporation after the sale. The IRS rules that the basis of the stock surrendered by the shareholder "disappears." This result is obviously inequitable.

If a sale or redemption of stock has been taxed as a dividend on account of attribution (through family, partnership, estate, corporation, or trust), the basis of that stock could be allocated to the stock that was attributed. However, such a mandatory allocation could be inequitable in those cases where the person to whom such allocation was made does not have an actual identity of interest with the person whose shares are redeemed. Accordingly, it would seem appropriate to allow the redeeming or selling shareholder to realize a loss on the sale or exchange of such shares. The loss, generally a capital loss, would be allowable to the extent of the basis in such shares.

Accordingly, it is recommended that if a redemption or sale of stock is taxed as a dividend under section 301 pursuant to section 302 or section 304, and the shareholder is unable to allocate the basis of such stock since no stock is owned in the redeeming corporation after the redemption or in the issuing or acquiring corporation after the sale, such shareholder will realize a loss on the sale or exchange of such shares to the extent of basis in the stock redeemed or sold.

SECTION 302

Constructive Ownership of Stock

The exception to the family attribution rule in determining a complete termination of interest should be clearly expanded to avoid attribution when the family rule would apply to any point in the chain of ownership [section 302(c)(2)].

Section 302(c) permits a distribution in termination of a shareholder's interest as described in section 302(b)(3) to be treated as a distribution in full payment in exchange for stock, even though the family attribution rule described in section 318(a)(1) might otherwise prevent complete termination.

The IRS position is that the exception to the family rule avoids attribution between the redeeming shareholder and the next link but not between other links in the chain of ownership. In effect, the terminating shareholder must be an individual. See Revenue Ruling 59-233 (1959-2 C.B. 106), Revenue Ruling 68-388 (1968-2 C.B. 122), and Revenue Ruling 72-472 (1972-2 C.B. 202).

Where stock in a corporation is owned by a son and by his father's estate, of which his mother is the sole beneficiary, a complete redemption of the son's stock will terminate his interest. The stock of the estate may be attributed to the wife as beneficiary, but under the family exception, the interest of the wife would not be reattributed to her son.

According to the IRS position, however, redemption of the stock of the estate will not result in complete termination of interest. The IRS considers that the stock of the son may be attributed to his mother for the sole purpose of reattributing the ownership to the estate. This is contrary to the result in a situation in which the mother owned the shares personally and the estate did not. Then, either the son or his mother could qualify for a complete termination of interest under section 302(c)(2).

The courts have recently taken a view in opposition to the IRS in holding that redemption of the stock of an estate or a trust can result in a complete termination of interest. See *Lillian M. Crawford*, 59 T.C. 830 (1973), nonacq. 1974-2 C.B. 5, and *Johnson Trust*, 71 T.C. 84 (1979).

It is recommended that the exception to the family attribution rule described in section 302(c) be applied to any point in the chain of ownership. The exception will then operate in a more logical and consistent manner.

SECTION 303

Distributions in Redemption of Stock to Pay Death Taxes

The present provisions of section 303(b)(2)(B), permitting the benefits of section 303(a) in situations where the decedent's estate includes stock holdings of two or more corporations, seem unduly restrictive. The percentage of ownership of the stock of each corporation required in order for the 35 percent test to apply should be calculated using constructive ownership rules.

This section of the IRC provides for aggregating the values of stock in two or more corporations if the estate owns more than 20 percent in value of the outstanding stock of each of such corporations. In *Estate of Otis E. Byrd*, 388 F.2d 223 (5th Cir. 1968), it was held that this test applies only to directly owned stock. Thus it is possible for an estate to own beneficially most of the stock of several corporations and yet not qualify for aggregation of the values, simply because some of the stock might be held by other corporations in the same group. It seems equitable that the constructive ownership rules of section 318 be applied for determining qualification under section 303(b)(2)(B). These rules apply to redemptions under section 302, and in the interest of consistency the constructive ownership rules of section 302(c) should be extended to section 303 redemptions.

SECTION 304

Acquisitions by Related Corporation Other Than Subsidiary

The present statute seems unclear and possibly conflicting in its wording. It is recommended that in a brother-sister acquisition, even though the constructive ownership rules of section 318 might indirectly create a parent-subsidiary relationship, the transaction should be governed clearly by section 304(a)(1) rather than section 304(a)(2).

Section 304(a)(1) presently sets out rules for acquisitions of stock by related corporations other than subsidiaries. Section 304(a)(2) provides rules for acquisitions by subsidiaries. Under the constructive ownership rules of section 318, stock of a sister corporation can be attributed indirectly to the brother corporation, or vice versa, thereby creating indirectly a parent-subsidiary relationship. A literal interpretation might then require that this type of acquisition (brother-sister) be construed under the provisions of section 304(a)(2) rather than 304(a)(1). Since there is some difference in treatment under the sections, the statute should be amended to state clearly that an acquisition in a brother-sister situation be governed solely by section 304(a)(1), and that only a direct parent-subsidiary relationship be governed by section 304(a)(2).

Although not conclusive, Revenue Rulings 70-111 (1970-1 C.B. 185) and 71-527 (1971-2 C.B. 174) tend to clarify the area and appear to support the explication sought.

SECTION 316

Liquidating Dividends for Personal Holding Companies

Section 316(b)(2)(B) should be amended to allow a personal holding company that has made liquidating distributions to noncorporate shareholders to treat subsequent increases in undistributed personal holding company income as dividends paid to such shareholders for purposes of the dividends-paid deduction.

Section 562(b)(2) presently provides that a personal holding company may treat liquidating distributions to its corporate shareholders as dividends to the extent of their share of undistributed personal holding company income (as ultimately determined) for purposes of the dividends-paid deduction. Under section 316(b)(2)(B), however, distributions to noncorporate shareholders in liquidation may only be treated as dividends and deducted if they are so designated in the Form 1120 PH.

A problem arises when a personal holding company has its undistributed personal holding company income increased after it has been liquidated and its assets distributed to noncorporate shareholders. Such increased amounts of undistributed personal holding company income would not be deductible as a "deficiency dividend" under section 547, since there must be an actual distribution of the dividend to the shareholders in order to qualify as a deficiency dividend. Similarly, such distributions would not qualify as "liquidating dividends" under section 316(b)(2)(B), since no designation will have been made in the Form 1120 PH for the additional undistributed personal holding company income.

This problem was considered in the case of *Michael C. Callan,* 54 T.C. 1514, aff'd 476 F.2d 509 (9th Cir. 1973). The corporation had already been liquidated, and the shareholders contributed cash to that corporation and then immediately thereafter had the corporation pay a dividend of such cash. The Tax Court held that the corporation was liable for the personal holding company tax and refused to treat the transaction as a genuine distribution pursuant to the deficiency dividend procedures or pursuant to the liquidating distribution procedure. See also *L.C. Bohart Plumbing and Heating Co.,* 64 T.C. 602 (1975).

Therefore, section 316(b)(2)(B) should be amended to allow liquidating distributions paid to noncorporate shareholders to be treated as dividends to the extent of undistributed personal holding company income, as ultimately determined, for purposes of computing the dividends-paid deduction. In order to protect against the possibility that the statute of limitations for the noncorporate shareholders will have run, thereby allowing them to avoid treating the increase as a dividend, provision should be made to hold the statute of limitations open solely for the purpose of taxing such additional dividends.

SECTION 333

Determination of Gain Upon Section 333 Liquidation

Realized gain to be recognized by a shareholder in a section 333 liquidation should be computed with reference to stock or securities acquired by the distributing corporation after a date five years prior to the date on which the corporation adopts a plan of liquidation. Such holding period should

include the transferor's holding period where the stock or securities were acquired by the liquidating corporation in a section 351 transfer.

For purposes of determining the amount of gain realized by a qualifying shareholder in a section 333 liquidation, section 333(e) provides that gain is realized by the shareholder to the extent that the shareholder receives a distribution consisting of money or of stock or securities acquired by the distributing corporation after December 31, 1953. The purpose for the December 31, 1953, date was to deter corporations from investing cash in stock or securities in anticipation of a liquidation under section 333. The December 31, 1953, date has lost its significance and should be changed to allow for a cutoff date five years prior to the date on which the corporation adopts a plan of liquidation.

The acquisition date of stocks or securities acquired by the corporation in a section 351 transaction should include the holding period of the transferor. Section 917 of the Tax Reform Act of 1969 provides that, for 1970 liquidations only, the corporate acquisition date of stock or securities includes the transferor's pre-1954 holding period if the property was received in a section 351 transfer. Based upon the aims and purposes of section 333, there are no policy reasons to restrict the carryover of the transferor's holding period in a section 351 transaction to 1970 liquidations only.

SECTION 334

Basis of Property Received in a Liquidation to Which Section 334(b)(2) Applies

Where a section 334(b)(2) liquidation occurs within six months after the "80 percent control test" is met, at the election of the acquiring corporation, the liquidation would be deemed to have been accomplished on the date the control test was met.

At the election of the acquiring corporation, the basis of assets received in a liquidation to which section 334(b)(2) applies should be determined, when the liquidation occurs within six months after the date the "80 percent control test" is met, by allocating the basis of the subsidiary's stock at the date the control test is met in proportion to the assets' fair market values on that date. For all purposes of the Internal Revenue Code, the liquidation would be deemed to have been accomplished on that date.

Under regulations section 1.334-1(c)(4), the basis of the stock must be allocated to the assets on the basis of their fair market values on the date the assets are received upon liquidation. Enactment of this recommendation would eliminate this burden. Also, its enactment would eliminate complex basis calculations where disposition is made of the assets in the period between the purchase and liquidation dates, where new assets are acquired in that period, and where there are interim adjustments for liabilities and earnings and profits.

If the election is made, the subsidiary's transactions, gains, and losses for the interim period from the date the "80 percent control test" is met until liquidation within the following six months would be reflected in the parent's return as though the subsidiary were a branch, and the subsidiary would not reflect such transactions in its return. If the date on which the "80 percent control test" is met were a date other than the last day of the subsidiary's taxable year, the subsidiary's final return would include only the period ending on such date. In determining gains or losses, depreciation, and other tax effects after the deemed liquidation, with respect to the subsidiary's assets in the parent's return during the short period, the basis of the subsidiary's stock in the hands of the parent would be allocated among, and become the basis of, the subsidiary's assets as of the date the "80 percent control test" was met.

As an alternative to reflecting the subsidiary's transactions in the parent's return for the period between the purchase and liquidation dates, a similar result could be achieved by allocating and assigning the parent's basis for the subsidiary's stock to the subsidiary's assets as of the date the "80 percent control test" is satisfied. This allocated basis would then be used by the subsidiary in determining gains or losses on dispositions of its assets during the period up to liquidation and in computing depreciation for such period. The subsidiary's recomputed basis would then pass to the parent without the adjustments provided in section 1.334-1(c) of the regulations. The subsidiary's cost for assets purchased by it during the interim, adjusted for depreciation (if any) for the short period, would become the parent's basis for such purchased assets.

SECTION 334

Basis of Property Received in a One-Month Liquidation

Section 334(c), which applies to the allocation of the adjusted basis of stock to property received in a liquidation under section 333, should be amended to provide that the adjusted basis of the shareholders' stock is decreased by the fair market value of post-1953 securities distributed and the basis of such securities is their fair market value.

The present rules for determining the basis of assets received in a liquidation under section 333 are set forth in the regulations. These rules provide for the allocation of the adjusted basis of the shareholders' stock to the property received according to the respective net fair market values of the property. In determining the adjusted basis of the shareholders' stock to be allocated to property received, basis is increased by gains recognized and decreased by any money received. These rules produce an inequitable result in the situation where post-1953 securities are distributed and such securities result in the recognition of gain to the shareholders to the extent money and securities distributed exceed the corporation's earnings and profits.

For example, assume a company with no earnings and profits has two assets, appreciated post-1953 stock and a building, with respective fair market values of $40,000 and $60,000. The sole shareholder, with a $55,000 stock basis, reports a capital gain of $40,000 upon liquidation under section 333. The adjusted basis of the stock is $95,000 and is allocated $38,000 to the stock and $57,000 to the building. Upon a subsequent disposition of the stock, the shareholder recognizes a gain of $2,000, despite the fact that a $40,000 gain was recognized previously upon distribution from the company. A more realistic result would be obtained if the securities were treated the same as cash when determining the adjusted basis of stock. Thus, the stock received would have a basis of $40,000, and the building, a basis of $55,000.

The illustration points out the need for symmetry between section 334(c) and section 333(e). Section 334(c) should be amended to provide that the basis of post-1953 securities distributed shall be equal to their fair market values and the adjusted basis of the shareholders' stock is decreased by such fair market values.

SECTION 334

Basis of Property Received in Liquidation

Uncertainty exists regarding the expression "cash and its equivalent" as used in regulations section 1.334-1(c)(4). The phrase should be defined by statute, and the statute should provide that certain other liquid assets be allocated face values in order to simplify the determination of basis to be allocated to assets received in corporate liquidations.

Because of uncertainty resulting from administrative practice and the regulations under section 334, Congress should establish statutory meaning for the term "cash and its equivalent" as it is used in allocating basis to assets received in a corporate liquidation. In Revenue Ruling 66-290 (1966-2 C.B. 112), the IRS applied the term to certificates of deposit and savings and loan association accounts, as well as to cash deposits. The ruling stated, however, that the term does not include accounts receivable, inventories, marketable securities, and other similar current assets. *R. M. Smith,* 69 T.C. 25 (1977), held that a receivable for prepaid estimated federal taxes was also a cash equivalent. *Boise Cascade Corp.*, 429 F.2d 426 (9th Cir. 1970), held that the term "cash and its equivalent" excludes marketable securities, inventories, prepaid supplies, and accounts receivable. The decision was followed by the Tax Court in *Madison Square Garden Corporation*, 58 T.C. 619 (1972).

These interpretations are unduly restrictive, and statutory rules for taxpayers are desirable. The definition should not be limited to cash; the basis concept that should apply is the liquidity of the particular assets involved and whether or not they can be converted to cash in a short period of time. Certainly, marketable securities meet this test, and, in most cases, trade accounts receivable and inventory will be converted into cash in a relatively short time and should be treated similarly.

Revenue Ruling 77-456 (1977-2 C.B. 102) and the Tax Court in *R. M. Smith* required that the face amount of accounts receivable must be subtracted from adjusted stock basis before allocating that basis among remaining assets. These precedents suggest an alternative, three-step statutory remedy that would (1) decrease the adjusted basis of stock by the amount of cash and its equivalent, (2) allocate face value to accounts receivable and other current assets whose realization in cash in the ordinary course of business is reasonably certain, and (3) allocate the remaining adjusted basis of stock in proportion to the net fair market values of all remaining assets received in liquidation.

The failure to provide less restrictive statutory rules will continue to foster such unreasonable results as, for example, the recognition of gain or loss upon realization of fully collectible accounts receivable balances existing at the date of liquidation. This is illustrated by the following tabulation, which indicates that the adjusted stock basis exceeds by $10,000 the tax basis of the distributor corporation's assets; that is, a "step-up" of this amount is available.

No gain or loss would be recognized to the distributee corporation upon the full collection of the $15,000 of accounts receivable if such accounts were treated as "cash equivalents" or were allocated their face value in allocating its adjusted stock basis in the distributor corporation among the assets received in the liquidation.

By allocating less than face value to the accounts receivable, the distributee corporation will recognize gain of $866 upon the full collection of these accounts. Such gain results from the mechanical allocation of a portion of the adjusted stock basis to the accounts in an amount that is less than the face value of the receivables (which, in the example, is assumed to be the fair market value of the receivables). Such potential gain would otherwise be reflected in the tax basis of the "other assets" at the liquidation date.

The practical effect of allocating less than face value to the accounts receivable is to create a double inclusion in income to the extent of the difference between the amount of stock basis allocated to the receivables and their fair market value. Clearly, this result is unreasonable and could not have been the intent of Congress in enacting the provision.

	Tax Basis	Fair Market Value: Amount	Fair Market Value: Relative FMV of Noncash or Equivalents
Adjusted basis of stock:	$100,000		
Assets of liquidating corporation:			
Cash	20,000	$ 20,000	
Accounts receivable (face)	15,000	15,000	17⅔%
Other assets	55,000	70,000	82⅓%
Total	90,000	$105,000	100 %
Step-up in basis permitted	$ 10,000		
Allocation (to noncash and equivalents based on relative FMV of assets received in liquidation):			
Cash		$ 20,000	
Accounts receivable		14,134	
Other assets		65,866	
Total		$100,000	
Gain (Loss) on collection of full amount of receivables:			
Receivables		$ 15,000	
Tax basis		14,134	
Gain (Loss)		$ 866	

SECTION 334

Acquisition of Stock From a Related Corporation for Purposes of Section 334(b)(2)

Section 334(b)(3) should be amended to provide that a purchase for section 334(b)(2) purposes occurs on the date ownership is first deemed to occur under the attribution rules of section 318(a).

Although section 334(b)(3) holds that an acquisition of a corporation's stock from a related corporation constitutes a purchase for purposes of section 334(b)(2) if the related corporation itself was acquired by purchase, it appears that *direct* ownership within twelve months of *attributed* ownership is also required in order for the liquidation to qualify for section 334(b)(2) treatment. This is an unnecessarily formal and complex aspect of section 334(b)(2).

Revenue Ruling 80-358 (1980-52 I.R.B. 10) illustrates this issue in a situation in which a corporation acquired by purchase all the stock of a corporation (S), which had a wholly owned subsidiary (T). The ruling holds that the date stock in S is first acquired is also the date that stock in T is deemed to first occur for purposes of determining whether the requisite 80 percent is acquired during a twelve-month period. However, the ruling points out that the *purchase* of the T stock does not occur until actual direct ownership occurs. Therefore, if actual direct ownership of T is not obtained within the twelve-month period beginning when S is acquired, the liquidation of T into the acquiring corporation will not qualify for section 334(b)(2) treatment, even if such liquidation is pursuant to a plan adopted within two years of the date that 80 percent of the stock of S is acquired.

The situation presented in the ruling may be avoided either by liquidating S within twelve months or by liquidating T into S prior to liquidating S into the acquiring corporation.

This complexity can be eliminated by amending section 334(b)(3) so that the date of purchase is the date the acquiring corporation is first considered, under section 318(a), to own stock of the liquidating corporation.

SECTIONS 336 and 337

Gain on Distribution of LIFO Inventory in Certain Liquidations

Sections 336(b) and 337(f), providing for the taxation of LIFO recapture amounts where inventories are distributed in certain liquidations, should be repealed.

Sections 336(b) and 337(f), added as part of the Crude Oil Windfall Profit Tax Act of 1980, in effect provide for a tax on the disposition of LIFO inventories where section 337 applies or on distributions in liquidation where section 334(b)(2) applies. These changes apply to liquidation plans adopted after December 31, 1981. The addition of these changes to the statute was made by amendment in the Senate without benefit of thorough consideration by congressional tax committees. Further, no public hearings were held to allow public input on what we believe represents far-reaching changes in fundamental tax principles that have been in effect for more than twenty-five years.

We believe that the thrust of these sections is punitive, and they should be repealed. LIFO is an acceptable procedure for valuing inventory that prices (among other variations) inventory on hand at year end as if it were acquired in prior taxable years to the extent that quantities do not exceed those of the prior year. To the extent that prior-year quantity is exceeded, the excess is viewed as having been acquired early in the taxable year. Because of inflation, this inventory, maintained on the books at its cost, frequently will have unrealized appreciation, and it is this appreciation that these sections tax.

The Treasury Department, speaking in favor of the legislation, adopted the view that LIFO is essentially a method for deferring profits. We disagree. LIFO is a technique for determining the cost of inventory on hand and the costs included in the computation of gross income.

There is no logical reason to tax unrealized appreciation in inventory while the appreciation in other assets is not similarly taxed. In fact, all appreciation is in effect subjected to tax in these transactions, but the tax is applied at the shareholder level. These sections, if not repealed, would negate the impact of the only provision in the Internal Revenue Code that mitigates the effects of inflation.

SECTION 337

Collapsible Corporations — Application of Section 337

The nonrecognition provisions of section 337 should apply to sales made by an otherwise collapsible corporation if the relief provisions would prevent the application of the collapsible corporation rules for all of its shareholders [section 337(c)(1)(A)].

At present, the benefits of section 337 are denied to a corporation that falls within the general definition of a collapsible corporation under section 341(b) unless section 341(e)(4) applies. This is true even though the limitations contained in section 341(d) may prevent the application of section 341(a), the operative portion of the section, to all of the shareholders. See *Leisure Time Enterprises, Inc.*, 56 T.C. 1180 (1971), and Revenue Ruling 63-125 (1963-2 C.B. 146).

The reason for the limitation found in section 337(c)(1)(A) was to prevent a loophole through which a collapsible corporation could escape tax on the sale of its property, yet have the shareholders pay the tax on their liquidation gain at long-term capital gain rates. The section was designed to prevent more favorable tax treatment upon a corporate sale of assets pursuant to a section 337 liquidation than was available through a sale of stock by the corporation's shareholders (which was subject to section 341). Therefore, there is no logical reason for prohibiting section 337 treatment in any case where section 341 is totally inoperative.

It is recommended that section 337(c)(1)(A) be amended to eliminate this defect and, at the same time, to refer to the special provisions of section 341(e)(4).

SECTION 337

Gain or Loss on Sales or Exchanges in Connection With Certain Liquidations

Section 337 should be amended to provide for nonrecognition of gain or loss upon the sale of property in connection with a partial liquidation if a business has been terminated.

Section 337(a) currently provides that no gain or loss shall be recognized when a corporation sells or exchanges property within a twelve-month period in accordance with a plan of *complete* liquidation, provided that all of the corporation's assets are distributed in complete liquidation.

Section 331 provides that amounts distributed in *partial* liquidation of a corporation (as defined in section 346) shall be treated as part or full payment in exchange for the stock. Therefore, it is possible for a corporation to liquidate certain businesses that then can be sold by stockholders without the corporation's paying tax on the sale of the business. These provisions would apply notwithstanding the continued existence of the corporation that operates a separate business. However, regulations section 1.346-3 points out that, where partial liquidations are followed by a sale of the assets distributed to the stockholders, it will be questioned whether the corporation or the stockholders sold the assets.

Court Holding Company, 324 U.S. 331 (1945), has been used by the Internal Revenue Service to impute gain from sales of distributed assets by shareholders to the distributing corporations. However, *Court Holding Company* had a very unfavorable fact situation. In *Harry H. Hines, Jr.*, 344 F.Supp. 1259 (1973), the Fifth Circuit Court of Appeals did not rely on the *Court Holding Company* case to impute gain to the distributing corporation. This opinion very clearly limited the *Court Holding Company* case to its facts; therefore, that case should not be a deterrent to amending section 337.

The problem that partial liquidations are not covered by section 337 has been further amplified in Revenue Ruling 76-429 (1976-2 C.B. 97). This ruling involved a subsidiary corporation that sold one of its operating businesses and then attempted to liquidate tax free pursuant to section 332. Shortly thereafter, the parent corporation transferred the assets of the remaining business that it had received in liquidation to a newly formed subsidiary. The IRS ruled that the liquidation and reincorporation be treated as a partial liquidation pursuant to section 346. The effect of this treatment was to impose a double tax, first to the subsidiary corporation and then to the parent corporation.

Accordingly, it is recommended that section 337 be amended to provide for nonrecognition of gain or loss on the sale of property in connection with a partial liquidation where an active business has been terminated if the bulk sale rules regarding inventory and the other provisions of section 337 are met and if the distribution fits the requirements of section 346.

SECTION 341

Certain Sales or Redemptions of Stock of Consenting Corporation

The consent under section 341(f) should be expanded to apply to sales to the issuing corporation.

Section 341(f) currently provides relief from the provisions of section 341 in certain situations in which section 341 extends beyond the tax avoidance situation with which it was intended to cope.

A corporation's realization of substantial income prior to the sale or exchange of the corporation's stock avoids the application of section 341. It was apparent that, for the same reason, the section should not apply if it is known at the time of the sale or exchange that the corporation will recognize the gain on the disposition of the collapsible assets.

Subsection (f) resolves this problem by providing that the collapsible corporation provisions do not apply if the corporation consents to a special election assuring that the gain on the disposition of the collapsible assets will be recognized at the corporate level. Subsection (f), by its terms, however, is not applicable to sales of stock to the issuing corporation, thereby excluding a portion of the transaction to which section 341(a) can apply. Since there appears to be no logical basis for this distinction, we recommend that section 341(f)(1) be amended to eliminate the parenthetical phrase exempting sales to the issuing corporation.

SECTION 381

Obligations of Distributor or Transferor Corporations

Section 381(c)(16) should be repealed and section 381(c)(4) should be amended to eliminate inconsistencies that have led to the loss of deductions for obligations of the distributor or transferor assumed by the acquiring corporation.

When an acquiring corporation is determined to have negotiated for the assumption of obligations of the transferor corporation in a reorganization described in section 381(a)(2), section 381(c)(16) provides that the rules of section 381(c)(4) shall apply regarding methods of accounting to be used after the transaction. The application of these rules has led to inconsistent positions on the part of the IRS in which certain obligations such as reserves for warranties and pension costs result in no deduction to either the transferor or acquiring corporation. The IRS has taken the position that the transferor is not entitled to the deduction because the item is not yet accruable for tax purposes; it also takes the position that the acquiring corporation is denied the deduction because it is the financial liability of the transferor corporation.

Section 381(c)(16) should be repealed and section 381(c)(4) should be amended to make it clear that one of the parties to the reorganization should be entitled to the deduction.

Pension, Profit Sharing, Stock Bonus Plans, Etc.

SECTIONS 401 and 415

Conformity of Self-Employed (HR-10) Plans to Corporate Plans

HR-10 plans should provide similar benefits and be subject to similar requirements as corporate plans.

With respect to qualified retirement plan benefits, self-employed persons suffer severe discrimination in comparison with corporate employees.

Because of the effect of escalating inflation, the difference in benefits between HR-10 plans and corporate plans has been increasing at alarming rates. For example, for 1982 the limitation of contributions to a defined contribution HR-10 plan is $15,000, whereas the limitation for corporate plans is $45,475. While the limitation for contributions to a defined benefit HR-10 plan generally is $15,000 (in some cases higher), it does not compare to the maximum benefit level of $136,425 for corporate plans for 1982. It should be noted that the corporate plan limitations are subject to cost-of-living adjustments each year and, as a result, have increased 82 percent from 1975 to 1982. There are also substantial differences in participation, vesting, voluntary contributions, estate taxation of benefits, administration, and so on.

There is no justification for these differences. In fact, because of them, many self-employed persons (including a substantial number of professionals) have incorporated primarily to take advantage of the increased corporate plan benefits. Taxpayers should not be forced to incorporate to avail themselves of comparable benefits.

In 1974, when Congress increased the contribution limitation applicable to HR-10 plans from $2,500 to $7,500, the House committee report explained that such action "was part of the process of moving toward parity in the tax treatment of corporate plans and HR-10 plans."

Unfortunately, this disparity has increased since 1974.

We feel it is appropriate, in the interests of equity and simplicity, to conform HR-10 plans and corporate plans in all respects. All discriminatory rules applicable to HR-10 plans should be eliminated, and both corporate plans and HR-10 plans should be subject to the existing corporate plan provisions.

SECTIONS 402 and 403

Transfers of Interests in Qualified Plans Incident to Divorce Decree

Transfers of interests in qualified plans (corporate and HR-10) incident to a divorce decree should not be considered taxable events but should be treated similarly to transfers of IRA interests, pursuant to section 408(d)(6).

Section 408(d)(6) provides that the transfer of employee interests in an IRA to his spouse incident to a divorce decree does not result in a taxable event and that the account so segregated for the spouse's interests is considered a separate IRA belonging to the recipient spouse. Since interests of working spouses in qualified corporate and HR-10 plans are also subject to division as part of property settlements incident to divorce decrees, it appears equitable and advisable to extend this IRA treatment to all qualified plans.

Sections 402 and 403 should be amended to provide that such transfers of interests in all qualified plans incident to a divorce decree will not result in a taxable transfer and that the interest so transferred will belong to the nonparticipant spouse and become taxable to him or her when it is actually distributed pursuant to the terms of the plan.

We recognize that there are many inherent problems relating to procedures and mechanics of dividing an employee's vested interest in a defined benefit plan, but we feel that these can be solved by detailed administrative rules.

SECTION 415

Cost-of-Living Adjustments for HR-10 Plans and IRAs

It is recommended that section 415(d) be amended to include additional provisions for annual adjustment for cost of living for HR-10 plans and individual retirement accounts.

Section 2440 of ERISA added Internal Revenue Code section 415, which applies limits on benefits and contributions. Trusts become disqualified if the plan provides benefits that exceed the limitations. For defined benefit plans, the benefit limit per participant is the lesser of $75,000 or 100 percent of the average compensation for the highest three years. For defined contribution plans, the contribution limit per participant is the lesser of $25,000 or 25 percent of annual compensation. Subsection (d) requires *annual* adjustments of these limitations by the secretary or his delegate for increases in cost of living in accordance with regulations to be prescribed using procedures similar to those that adjust primary insurance amounts under the Social Security Act (section 415(b) and (c)).

The explanation in the House committee report indicated that new HR-10 limitations were introduced as "part of the process of moving toward parity in the tax treatment of corporate plans and HR-10 plans." The purpose of the cost-of-living adjustments is "to prevent the erosion of the value of an employee's pension due to inflation"; the procedures used in such adjustments of ceilings are to be similar to "those used in adjusting the old age and survivors' benefits under the social security law (but without regard to the timing or amount of any increase specifically authorized by action of the Congress)."

Clearly, the intent of Congress, as expressed above, was to protect the retiree from the ravages of inflation. It appears that the failure to include in this context the limitations on IRA and Keogh contributions should be corrected to maintain the process of moving toward parity and to reduce the impact of inflation upon retirement.

Accounting Periods and Methods

SECTION 471

Inventory Write-Downs

Section 471 should be amended to provide an equitable procedure for valuing inventories and claiming current deductions to reflect the decline in the net realizable value of inventory during the taxable year as a result of excess quantities, obsolescence, style changes, and other indications of subnormal conditions.

The *Thor Power Tool Co.* (439 U.S. 522, 1979) decision has had a significant impact on the inventory valuation methods used by many taxpayers. In that case the Supreme Court interpreted the existing statute to allow deductions for the decline in the value of excess inventories only in the taxable year in which the excess quantities are offered for sale at reduced prices or otherwise disposed of as provided in the regulations. The rules contained in the regulations for determining write-downs are in certain instances more restrictive, or require a greater degree of precision in application, than common business practices today generally provide.

The *Thor* case also contained a factual dispute about allowable write-downs for obsolete, damaged, and defective goods. The IRS contended that such write-downs were allowed because the goods were scrapped by Thor soon after write-down. Thor argued that 40 percent of the obsolete parts remained unscrapped three years later. In this regard, the regulations (section 1.471-2(c)) are ambiguous, and they contain an impractical requirement of an actual offering of the subnormal goods during a period that ends not later than thirty days after the inventory date. In the interest of sound tax administration, there is a need in the law for more certainty, clarification, and recognition of business realities.

The *Thor* decision, in many instances, will result in a significant delay in obtaining tax deductions for inventory write-downs that have occurred economically and have been properly reflected in financial statements under generally accepted accounting principles. This anomaly could lead taxpayers to destroy or otherwise dispose of goods contrary to the dictates of sound business practice solely to secure the benefit of current cash flow from the deductions. The destruction of such items as repair parts could cause the immediate obsolescence of many kinds of consumer and industrial goods, which might result in serious economic consequences. To avoid this problem, we believe the statute should be amended to provide taxpayers with a means of valuing inventories each year at not more than the net realizable value a taxpayer would expect to receive for the goods.

The formula or other methods to be used in computing the inventory write-downs may have to vary by individual taxpayer or industry. We believe, however, that in determining a net realizable value a taxpayer's own facts and recent experience (over the preceding three to five taxable years, for instance) should be used in making the computation.

SECTION 472

LIFO Conformity Repeal

The requirement that LIFO can only be used if it is also used in reports to shareholders, partners, owners, or creditors should be repealed.

Since the enactment of the LIFO provisions in 1939 permitting taxpayers to elect the LIFO method for valuing inventories, the law has required that a taxpayer use the LIFO method in annual reports to creditors, shareholders, or other owners. The legislative history is unclear about the reasons for the conformity.

The LIFO conformity requirement has become burdensome to both the taxpayers and the Internal Revenue Service. In the case of public companies, the IRS has had to make many modifications or exceptions to the requirements during recent years because of increasing disclosure rules mandated by the Securities and Exchange Commission. It has also permitted exceptions in situations where disclosures were mandated by the Accounting Principles Board or the Financial Accounting Standards Board.

Regulations recently adopted by the Treasury Department (section 1.472-2(e)) expressly incorporate the exceptions previously allowed by IRS rulings and, going still further, permit taxpayers to disclose non-LIFO inventory data in footnotes, supplementary financial information, or explanations of their financial statements of income for the taxable year. The regulations also allow taxpayers to report non-LIFO inventory values for balance sheet purposes, permit financial and tax differences in LIFO inventories, allow write-downs to market value where that is less than LIFO cost, and expressly authorize nonconforming reporting in internal management reports and interim financial statements.

The time has now come to repeal the remaining vestiges of conformity requirements, since they serve no useful tax policy purpose. Repeal will greatly simplify preparation of financial statements, freeing the taxpayers and the IRS from having to deal with rules not affecting tax liabilities. It will also enable investors to make more valid comparisons of financial reports by companies in the same industry and will be more helpful to lending institutions in evaluating financial statements of borrowers or potential borrowers. It will also greatly simplify the ability of small businesses to adopt the LIFO inventory method.

Abolition of the conformity requirements has also been recommended by the Treasury Department.

SECTION 472

Preceding Closing Inventory

The requirement in section 472(d) that the inventory as of the end of the year preceding the year LIFO is adopted be restated at full cost for the year should be repealed. It should be replaced by a provision, similar to section 447(f), providing for restoration of income over a period of ten years, beginning with the year of change to LIFO.

Section 472(d) of the code provides that in determining income for the taxable year preceding the year for which the LIFO method is first used the closing inventory is to be valued at cost. Regulations section 1.472-2(c) provides that the actual cost of the goods included in the opening inventory of the taxable year in which the LIFO method is first used is to be determined pursuant to the inventory method employed by the taxpayer in the prior year, except that restoration is to be made for any write-downs to market value that occurred in pricing these inventories. The commissioner is authorized in regulations section 1.472-4 to determine the adjustments appropriate to the taxpayer's adoption of LIFO; he has ruled that an amended return for the preceding taxable year must be filed with the return for the year in which LIFO is first used. See Revenue Procedure 76-6 (1976-1 C.B. 545), which also states that failure to properly restore such inventory to original cost may result in loss of the taxpayer's election to adopt the LIFO method of inventory.

The current requirement that the closing inventory of goods (whether obsolete, damaged, or excessive) for the year prior to adoption of LIFO must be restored to original cost deters many small companies from adopting the LIFO inventory method. By filing the amended return for the prior year and paying the tax in full on the restored amount, the taxpayer, in effect, pays for the future benefits of LIFO up front. Preparation of the amended tax return can also result in an additional burden and increased expense to the small business company.

The amended closing inventory for the prior year becomes, of course, the opening inventory for the first LIFO year. The LIFO benefit will not be realized until the LIFO value of an inventory is lower than the value would have been at the lower of cost or market. In some instances, it may take several years to reach this point. In these cases, the reduced cash flow is such a problem that the taxpayer cannot afford to adopt the LIFO method.

A spread of up to ten years of an adjustment caused by a permissible change in tax accounting method, as provided by Revenue Procedure 80-51 in the case of termination of a LIFO election and certain other changes in inventory valuation method, is not available in the change to LIFO because of the IRS requirement to file an amended return for the prior year and to pay the additional tax. There appears to be no sound basis for not treating the write-down restorations like other accounting method changes dealt with in Revenue Procedure 80-51, such as write-down restorations under the *Thor Power* decision, where the Treasury has permitted taxpayers up to a ten-year period in which to spread the adjustment. See also Revenue Procedure 80-5. The motivation for permitting a ten-year spread was, in the Treasury Department's words, "the most practical way of enforcing the Court's decision."

Elimination of the present requirement to restate, at cost, the ending inventory for the year preceding the year of LIFO election should be accompanied by a provision expressly permitting taxpayers to treat a change to LIFO like other accounting method changes initiated by the IRS under section 481 and restore write-downs to income over a period of up to ten years.

SECTION 473

Qualified Liquidations of LIFO Inventories

Section 473 should be amended to make a similar election (or appropriate indication in the tax return filed) applicable to taxpayers in general, and the circumstances of its application should be expanded to include liquidations of LIFO inventories occurring for reasons beyond the taxpayer's control.

At times of national crisis, involuntary LIFO liquidation provisions have been passed into law for temporary periods. The need for such legislation on a periodic basis results in delayed implementation of the relief provision, since the event usually occurs before Congress acts, as was the case with the current section 473 and the recent oil embargo. It is desirable that Congress enact a provision that would operate automatically according to stated principles and measurable standards affecting all taxpayers.

The proposed remedial legislation would protect all taxpayers from an unintended burden caused by extraordinary events beyond their control, permitting maintenance of the historical LIFO cost. This provision has become increasingly important with the recent widespread adoption of LIFO by taxpayers in a variety of industries and by small as well as large businesses.

The present section 473 was enacted to relieve the oil industry of an unanticipated tax burden caused by penetration of LIFO layers due to the disruption of foreign oil supplies. The scope of this section should be expanded to include the involuntary liquidation of LIFO layers by any taxpayer, regardless of the character of the inventory, as the result of a qualified inventory interruption. A qualified inventory interruption may be defined as an involuntary conversion (as defined in section 1033(a)), strike, embargo, trade or manufacturing interruption, or other event that is beyond the taxpayer's control, provided the interruption prevents the taxpayer from either acquiring or manufacturing replacement inventory for a particular pool. The inability to obtain replacement machinery or other property used in the manufacturing process because of reasons beyond the taxpayer's control would also qualify because it would impair the ability to replace inventories.

The replacement period should expire at the conclusion of the second taxable year after the year in which the termination of the qualified inventory interruption occurs. This time period would permit a taxpayer to meet ordinary business needs and build up sufficient excesses to satisfy the replacement requirement.

Section 473 should be amended to provide for nonrecognition of income upon the occurrence of an involuntary liquidation. Income should only be recognized if replacement does not occur within the statutory time period. At the conclusion of the replacement period, the taxpayer would be required to file amended tax returns for all periods that would have been affected by a failure to fully replace the involuntarily liquidated layer. The recommended deferral of income recognition is similar to the treatment provided in sections 1033 and 1034.

Corporations Used to Avoid Income Tax on Shareholders

SECTION 534

Burden of Proof

Section 534 should be amended to provide that the burden of proof is always on the secretary or his delegate irrespective of either the court in which the case is tried or any pleading by the secretary or his delegate.

Under present law, section 534 shifts the burden of proof to the secretary or his delegate in an accumulated earnings tax case in the Tax Court if the taxpayer files "a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any of the earnings" have not been unreasonably accumulated.

In cases having arisen to date involving the section 534(c) statement, the secretary or his delegate, in answering the taxpayer's petition to the Tax Court, has generally denied the sufficiency of the grounds and adequacy of the facts set forth in the section 534(c) statement and has generally pleaded an affirmative answer. Only in rare instances has the Tax Court found a taxpayer's statement sufficient to shift the burden of proof. Experience has shown that more often than not the taxpayer's statement of facts in support of the stated "grounds" for the accumulation was found wanting.

However, a recent Fifth Circuit Court of Appeals decision overruled the Tax Court and held that section 534 merely requires a statement specific enough to apprise the secretary of the taxpayer's line of defense. The approved statement in that case was a lengthy document that included cost projections and corporate minutes.

It has been a traditional concept of tax procedure that the taxpayer should be allowed to select the forum that is most convenient to him. Accordingly, if the burden of proof can be shifted to the secretary or his delegate in deficiency proceedings, it should also be possible to shift it to the government in refund proceedings.

The tax imposed by section 531 on corporations improperly accumulating surplus is a penalty tax rather than a tax on income. In any proceeding, the burden should be on the secretary or his delegate to show that a penalty is warranted, rather than on the taxpayer to show that a penalty should not be assessed. Accordingly, it is recommended that the filing by a taxpayer of a section 534(c) statement in an accumulated earnings tax proceeding should shift the burden of proof to the secretary or his delegate in all cases irrespective of (1) the court in which the case is tried and (2) any pleading the secretary or his delegate may file with respect to the sufficiency of the statement. The requirement of a statement of facts in a section 534(c) statement should be eliminated.

SECTION 562

Dividends-Paid Deduction

Section 562 should be amended to provide that, in computing the deduction for dividends paid by a personal holding company (PHC), a distribution of property other than cash should be taken into account at the aggregate amount includible in the gross income of the recipient shareholders.

The PHC tax is a penalty on a closely held corporation used by its shareholders to realize a substantial portion (60 percent or more) of its income from such "passive" sources as dividends, interest, and royalties. Accordingly, a PHC is subject to both the regular income tax and PHC tax on its undistributed PHC income (essentially its ordinary taxable income less the sum of deductions for the regular income tax, excluding tax on long-term capital gain and dividends paid). A PHC normally distributes dividends in order to avoid the tax (70 percent) on undistributed PHC income.

Regulations section 1.562-1(a) provides that in computing the dividends-paid deduction of a PHC, a distribution of property other than cash is taken into account at its adjusted basis at the date of distribution. The validity of this regulation has been upheld as reasonable by the Supreme Court in *Fulman* v. *U.S.*, 434 U.S. 528 (1978).

Where a PHC distributes property other than cash in order to avoid PHC tax, a noncorporate shareholder includes the fair market value of the property in gross income. In the case of a corporate shareholder, the distribution is includible in gross income at the lesser of the fair market value or the adjusted basis of the property at the time of the distribution.

When appreciated noncash property is distributed by a PHC, it is clear that the amount taxed to a noncorporate shareholder will be greater than the amount that the PHC may deduct in computing the undistributed income on which PHC tax is imposed. In view of the purpose of the PHC tax, the amount a PHC deducts to arrive at the amount, if any, subject to that tax should be the same as the amount its shareholders include in gross income as a dividend. There is no similar problem, of course, in the case of a distribution of appreciated noncash property to a corporate shareholder, since the dividend is includible in gross income only to the extent of the adjusted basis.

To ensure consistency in determining the tax liability of the PHC and its shareholders, the PHC should receive a dividends-received deduction for noncash property distributed to its shareholders equal to the amount they must include in gross income. There is no justification for any lack of symmetry in this area.

SECTION 565

Dividends Paid After Close of Taxable Year by Personal Holding Companies

Section 565 should be amended to permit a personal holding company (PHC) to make a post-year-end distribution in an amount not exceeding the consent dividend and to have such a distribution treated as a nontaxable return of capital under section 301(c)(2).

Section 563(b) presently provides that in computing its undistributed PHC income, a personal holding company may elect to deduct dividends paid within two-and-one-half months after the end of a taxable year as paid on the last day of that year. The deduction cannot exceed either the undistributed PHC income of the taxable year or 20 percent of the actual dividends paid during the taxable year.

The purpose of section 563(b) is to allow a company additional time after the close of the taxable year to determine accurately its PHC income so it can pay out the dividends required to eliminate the penalty tax. However, the 20 percent limitation in section 563(b)(2) is too restrictive to allow the provision to accomplish this purpose. Many companies do not know the extent or existence of their PHC problem until after year end because of the difficulties in estimating their income and the complexities in determining PHC status before year end. Thus, the requirement that about 83 percent of the required dividends must be paid during the taxable year to use the 20 percent after-year dividend provision is of little assistance to a PHC that is unable to compute its personal holding company income accurately or is unknowingly caught in a PHC trap.

The only relief presently provided for this problem is section 565, which permits the payment of a consent dividend, provided all the shareholders of the corporation consent to include the amount in taxable income on the last day of the corporation's taxable year. This procedure unduly penalizes the shareholders because they are required to pay tax on income not actually available for payment of the tax.

We recommend that section 565 be amended to provide that, when a PHC makes an actual distribution of an amount not exceeding the consent dividend after the close of the consent year and within thirty days following the filing of the corporation's income tax return, the distribution will be treated as a nontaxable return of capital under section 301(c)(2). This change will provide PHC shareholders with the funds necessary to pay their income tax on the consent dividend.

This recommendation is, in substance, identical to section 2 of the miscellaneous revenue bill of 1978 (H.R. 12578), which amended section 563(b), except that it (1) accomplishes the stated goal through an existing statutory procedure, (2) provides a thirty-day grace period for a corporation to make an actual distribution of its undistributed PHC income as reflected on its income tax return, and (3) retains the existing provisions of section 563(b) for those taxpayers who are able to determine their PHC status and income with reasonable accuracy prior to year end.

Estates, Trusts, Beneficiaries, and Decedents

SECTION 642

Unused Credits and Deductions on Termination of an Estate or Trust

Additional tax credits and deductions not used by the estate or trust should be available as carryovers to the beneficiaries succeeding to the property of the estate or trust.

Present law provides for the carryover to the beneficiaries succeeding to the property of a net operating loss, a capital loss, and the excess of deductions over gross income in the year of termination of the estate or trust. It would be equitable for the beneficiaries to be permitted the benefit of any credit or unused deduction – including investment and foreign tax credits and soil and water conservation expenditures – available to the estate or trust and not fully utilized by the time of its termination.

SECTION 642

Separate Shares — Partial Termination

The carryover provision of section 642(h) should be extended to include an apportionment of such carryovers and all other available credits and unused deductions when there is a final termination of a single beneficiary's separate share in a trust having several beneficiaries.

The carryover provision of section 642(h) applies only upon the final termination of an estate or trust. For example, a single trust with three minor beneficiaries provides for a substantially separate and independent share for each child. Each beneficiary is to receive one-third of the trust corpus at age thirty-five. Assume that the first child attains age thirty-five in a year in which the trust has a $3,000 capital loss carryover and a $6,000 net operating loss carryover. The trust is worth $120,000 on the date of distribution. The thirty-five-year-old child receives $40,000 of assets (one-third of $120,000) but does not receive the benefit of the unused carryovers even though the economic losses realized by the trust reduced this child's share by $3,000 (one-third of $9,000). Present law permits a carryover to the beneficiary only when the trust terminates at the time the youngest child reaches age thirty-five.

In addition to the carryover of net operating losses, capital losses, and the excess of deductions over gross income in the year of termination of the separate share interest of a trust beneficiary, the provision for apportionment of carryovers should also include all other credits or unused deductions — including investment and foreign tax credits and soil and water conservation expenditures — available to the trust and not fully used by the time of final termination of a single beneficiary's separate share.

The law should be amended to allow loss carryovers and other credits or deductions to the terminating separate share beneficiary, with a corresponding reduction of the trust's loss carryovers and other credit carryovers and unused deductions.

Partners and Partnerships

Recommended tax law changes concerning subchapter K of the Internal Revenue Code are drawn from *Proposals for the Improvement of Subchapter K*, published by the AICPA Federal Tax Division in August 1979, with certain modifications. Several of these recommendations are interdependent and should be viewed as a whole rather than as separate issues.

SECTION 702

Statutory Limitations Applicable to Partner Level Rather Than Partnership Level

There should be no limitations imposed on a partnership regarding items of income, deduction, and credit that have statutory limitations elsewhere in the code. Such limitations should apply only to the partners.

The regulations under section 702, in general, apply the aggregate theory. Regulations section 1.702-1(a)(8)(ii) states that each partner must also take into account separately his distributive share of any partnership item that, if separately taken into account by any partner, would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately. It would seem logical that the aggregate theory should be followed consistently when specific limitations exist on certain items of income, deduction, or credit.

Following are examples of items to which the aggregate theory is currently applied:

- The investment interest limitation under section 163(d)
- Farm net losses under section 1251
- The limitation on charitable contributions

On the other hand, under section 48(c)(2)(D) the limitation on used property qualifying for the investment tax credit is imposed initially on partnerships.

In the interests of equity, consistency, and simplicity, this type of limitation should only be imposed on partners. This recommendation conforms with a provision of the Partnership Income Tax Revision Act of 1960, which was passed by the House as H.R. 9662. That provision, designated section 702(d), reads, "If any limitation on the amount of the exclusion or deduction of any item of income, gain, loss, or deduction affecting the computation of taxable income, or on the amount of any credit, is expressed in terms of a fixed amount, or a percentage of income, such limitation shall be applied only to the partner and not the partnership."

SECTION 703

Deficiency Elections for Partnerships

Section 703(b) should provide that elections permissible at the partnership level will be considered timely if made in connection with a determination that a partnership in fact exists, notwithstanding the failure to have made such elections on a timely filed partnership return.

Section 761 provides only a brief definition of "partnership." It is possible that an IRS examination may result in the determination that an operational format used by taxpayers was, in fact, a partnership under section 761. When taxpayers have acted in good faith in reporting taxable income or loss predicated on the belief that a partnership did not exist, they should not be penalized for failure to make otherwise allowable elections on a partnership return. Accordingly, the concept of an elective deficiency remedy, similar in intent to section 547 and section 859 regarding deficiency dividends, should be made applicable under section 703(b). It should cover situations in which an IRS determination that a partnership exists would prevent elections at the partnership level that would otherwise have been valid if a timely partnership return had been filed.

SECTION 703

Election to Reinvest Proceeds From Involuntary Conversion of Substantially All Partnership Assets to Be Made by Individual Partners

The code should be structured so that, on an involuntary conversion that causes a partnership to terminate, the partners would be able to elect separately to reinvest the proceeds from the involuntary conversion. This election should be available only where substantially all of the partnership's business assets have been involuntarily converted. Partners not electing to reinvest would be taxed on these proceeds.

Currently, if a building used to carry on partnership business were destroyed by fire, the partnership would have to elect to reinvest these proceeds in similar property to avoid a gain from the involuntary conversion. See *Mihran Demirjian*, 54 T.C. 1691 (1970), aff'd 457 F.2d 1 (3d Cir. 1972), and *Roy P. Varner, et al.*, T.C. Memo 1973-27. If some of the partners do not wish to continue the business, the remaining partners should be given the opportunity to take their share of the proceeds and reinvest them in a similar business under the provisions of section 1033. The partners not electing to reinvest would be subject to tax on their pro rata portion of the computed gain.

SECTION 704

Carryover of Excess Losses Where Partnership Is Terminated and New Partnership Is Formed

In the event that a partnership is terminated under the rules of section 708(b)(1)(B), a partner's losses in excess of basis that are not deductible by reason of section 704(d) should be allowed as a carryover to a successor partnership by that partner.

If a partnership is terminated under the rules of section 708(b)(1)(B) (in which the sale or exchange of 50 percent or more of the total interest in the partnership capital and profits within a twelve-month period automatically constitutes a termination) and a new partnership is formed, a partner in the predecessor partnership who enters the new partnership should be entitled to carry over any losses in excess of his basis from the prior partnership.

The code contains instances in which there could be an involuntary termination of a partnership. For example, if A owned a 60 percent interest in the capital and profits of ABC partnership and sold his interest to D, the ABC partnership would be considered to have been terminated, and a new partnership would be considered to have been formed. As a result, if partners B and C had had losses in excess of the tax basis of their partnership interests that could not be deducted under the limitations of section 704(d), these losses would not be available to them in the reformed partnership. The purpose of this proposal is to allow these losses to be available where a termination leaves partners owning less than a 50 percent interest in the partnership and they enter into a new partnership immediately after the termination in an economic position that is virtually unchanged. Unless such a proposal is enacted, these partners could be disadvantaged by not being able to use their partnership loss carryforwards against future partnership taxable income simply because of the activities of a controlling partner or partners.

The carryover of excess losses should also be available to a successor partner resulting from a nontaxable reorganization or liquidation of a subsidiary to which section 334(b)(1) applies. For example, if corporation A is a 40 percent partner in the capital and profits of the ABC partnership, and corporation A is merged into corporation D in a transaction qualifying under section 368(a)(1)(A), corporation A's excess losses should carry over to corporation D in the same manner as a net operating loss carries over under section 381. Similarly, in a situation in which a subsidiary of a corporation is liquidated and section 334(b)(1) applies to the determination of basis, the nondeducted partnership losses of the subsidiary should carry over to the parent corporation. Thus, when the successor partner (the parent corporation) restores the tax basis to exceed zero, it should be entitled to deduct the losses previously disallowed to the subsidiary.

SECTION 706

Timing of Taxation of Income for a Guaranteed Payment for Services of a Capital Nature

Partners who receive guaranteed payments that are for services of a capital nature should be required to include such payments in income as of the close of the partnership year in which they were paid.

The Tax Reform Act of 1976 requires the capitalization of guaranteed payments under section 707(c) that are for services representing capital expenses. Technically, however, the service partner is not taxed on this income until the partnership is entitled to a deduction for the capitalized amount. Section 706(a) provides that the partner who receives a guaranteed payment must include it in his income to the extent of the deduction of the partnership for the taxable year of the partnership ending within or with the taxable year of the partner. The partnership may deduct the capitalized payments only through a series of depreciation deductions, upon sale of the property, or, perhaps, never (for example, if the payments were for syndication fees). Therefore, the language of section 706(a) could result in an indefinite deferral of the income by the partner receiving the payment.

This result may be avoided by requiring guaranteed payments for services rendered that are capital expenditures to be taxable to the recipient partner as of the close of the partnership year in which the payments are made.

SECTION 706

Closing of Partnership Year as a Result of Death

The taxable year of a partnership should close with respect to a partner who dies, as of the date of his death. If more than twelve months' income is included in the decedent partner's final return as the result of this rule, the rule would not apply except upon an election by the personal representative.

Present law provides that a partnership's taxable year does not close with respect to a partner who dies, unless, as a result of the death, the partnership is terminated or a sale or exchange of the decedent's interest in the partnership occurs on the date of death. This provision prevents bunching of income in the final return of a decedent partner when, otherwise, two partnership years could close in that year. However, the inability to include the income in the decedent's final return often results in the loss of deductions and exemptions that could otherwise be offset against the decedent's share of partnership income to the date of death.

The purpose of this recommendation is, generally, to include in a decedent's final return the partnership income earned, or the losses incurred, to the date of the decedent's death and to eliminate the loss of deductions and exemptions.

SECTION 707

Definition of Common Ownership

The statute should be amended to provide that two partnerships will not be deemed to be controlled partnerships (for purposes of loss disallowance and conversion of capital gain to ordinary income) unless more than 50

percent of the capital interests or profits interests are owned by the same persons, taking into account the ownership interests of these persons only to the extent that the ownership interests are identical with respect to each partnership.

This change would conform the definition of controlled partnerships to that of controlled corporations as provided in sections 1563 and 1551. The aggregate 80 percent common ownership requirement in section 707(b)(2)(B) would be retained.

The present statute could result in disallowance of losses or conversion of capital gain to ordinary income on sales between partnerships when there is only a small amount of common ownership. For example, if the AB partnership is owned 95 percent by partner A and 5 percent by partner B and the BA partnership is owned 95 percent by partner B and 5 percent by partner A, transactions between these partnerships would be subject to the proscriptions of section 707(b), even though (taking into account only the identical interests of each partner in the two partnerships) the common ownership interests amount to only 10 percent.

SECTION 707

Guaranteed Payments Measured by Gross Receipts or Gross Income

Section 707(c) should be amended to include payments measured by a percentage of gross receipts or gross income within the definition of guaranteed payments.

Under section 707(c), a payment is not considered to be a guaranteed payment unless it is determined without regard to the income of the partnership. The Tax Court, in *Pratt* v. *Comm.*, 64 T.C. 203 (1975), aff'd 550 F.2d 1023 (5th Cir. 1977), has held that management fees paid to partners on the basis of a percentage of gross rental receipts did not qualify as guaranteed payments because they were measured by the income of the partnership. The Fifth Circuit Court of Appeals upheld the decision of the Tax Court in *Pratt* on the basis that the management fees were a distributive share of partnership income and not a deduction to the partnership under section 707(a), as contended by the petitioner. In so doing, the court did not have to question the deductibility of the management fee as a guaranteed payment under section 707(c). Had this section been amended as suggested above, the court could easily have disposed of the matter by holding the payments to be guaranteed payments and referring to their required inclusion in the income of the partner in the same year as the partnership deducted them by virtue of section 706(a).

Under the 1939 Internal Revenue Code, amounts paid to partners as salaries or interest were treated as distributions of partnership income. If the payments exceeded the partnership ordinary income, the excess was treated as a distribution out of the partners' capital accounts. To the extent that the excess amount was charged to the capital account of the recipient partner, he was not taxed on that income; however, he was taxed on the portion charged to the capital accounts of the other partners, who, in turn, were entitled to a deduction for like amounts. The 1954 code adopted an entity approach and avoided the problem of the excess payment by treating such payments as partnership expenses. There appears to be no conceptual reason why payments for services of a fixed dollar amount should be treated as partnership expenses, whereas payments measured by a percentage of gross receipts or gross income should not be accorded the same treatment.

SECTION 709

Amortization of Organizational and Reorganizational Expenditures

Organizational and reorganizational expenditures should be amortizable unless partnerships elect to capitalize.

Section 709(b) provides that organizational expenses may, at the election of a partnership, be amortized over a period of not less than sixty months. This election must be made in the return for the taxable year in which the partnership begins business, and all the expenditures subject to the election must be specifically identified.

The rule should be that organizational expenses are amortizable unless an election is made not to amortize. This rule should be applicable to reorganizational expenditures as well as organizational expenditures of both corporations and partnerships. They should be treated uniformly.

SECTION 732

Sales of Partnership Interests

The relief provision of section 732(d), permitting a transferee partner to step up the basis of inventory items and unrealized receivables distributed to him from the partnership when the distribution is made within two years of the date of his acquisition of the partnership interest, should be extended to sales or exchanges of the partnership interests within the two-year period.

A partner who purchases an interest in a partnership that owns inventory items or unrealized receivables and does not have an election under section 754 in effect will realize ordinary income to the extent of his distributive share of partnership income realized from the disposition of such inventory items or unrealized receivables, notwithstanding the fact that a portion of his purchase price was allocable to those items. A partner can avoid this unfair result by making an election under section 732(d) if he receives a distribution of such assets within a period of two years from the time he purchased his partnership interest. No such relief is available with respect to a sale of his partnership interest.

Suppose, for example, that C purchases for $4,000 a one-third interest in the AB partnership. The sole asset of the partnership is an unrealized receivable in the face amount of $12,000 having a zero tax basis. The partnership has no liabilities. Before anything else occurs, C resells his partnership interest for $4,000. The anomalous result under the present law is that C realizes ordinary income of $4,000 upon the sale and has a capital loss of $4,000. The proposed amendment would afford relief against such inequity.

SECTION 736

Definition of the Meaning of Payments Made in Liquidation of the Interest of a Retiring or Deceased Partner

Section 736 should be amended to make clear that the phrase "payments made in liquidation of the interest of a retiring partner or a deceased partner" under section 736(a) will include actual payments made during the partnership's fiscal year and amounts credited to the account of the retiring or deceased partner in excess of his share of the income distributed for that year.

Section 736(a) provides for payments made in liquidation of the interest of a retiring or deceased partner to be considered as a distributive share of the partnership income if the amount is determined with regard to partnership income or as a guaranteed payment described in section 707(c) if the amount is otherwise determined.

Regarding partnerships that report on the cash basis, it is uncertain whether these payments actually must be made prior to the end of the year in order to be deducted by the partnership that year. If they are required to be paid, this can be an impossible situation when the amount is based on a distributive share of partnership income. For example, assume that A is to receive 10 percent of the partnership income for 1975 as a section 736(a) payment. During the year A is paid $20,000, and the partnership actually earns $250,000. A is due an additional $5,000, which is credited to his account by the partnership for its year ending December 31, 1975, and is paid to him by the partnership on April 15, 1976. As a cash basis partnership, the partnership cannot deduct the remaining $5,000, even though it was a payment to A for 1975. This situation creates problems not only for A but for each member of the partnership.

To remedy this situation, section 736 should be amended to clarify that "payment" includes any payments made during the partnership's fiscal year for distributions relating to that fiscal year and for any such amounts properly credited to the account of the retiring or deceased partner for his share of the partnership income for that year in excess of those amounts already distributed to him.

SECTION 736

Timing of Step-Up in Basis Under Section 734

The step-up in basis provided under section 734 should be made at the time the agreement is consummated to liquidate a partner's interest irrespective of the time when actual payments are made and taken into income by the recipient.

Payments made to a retiring or deceased partner in exchange for his interest in partnership property are treated as distributions by the partnership in liquidation rather than as a distributive share of partnership income or as a guaranteed payment. As such, the distributee partner recognizes gain under the provisions of section 731. That is, if the payments are made in cash, as opposed to property, gain is recognized when the cash received exceeds the distributee partner's basis in the partnership. Regulations section 1.736-1(b)(6) provides that, where the total of section 736(b) payments is a fixed sum, a distributee partner may elect to report and to measure the amount of any gain or loss by the difference between the amount treated as a distribution in that year and the portion of the partner's adjusted basis for his partnership interest attributable to this distribution.

The interaction between this section and section 734 can create a very complex situation. Under section 734(b) a partnership may elect to step up the basis of the partnership property in the case of a distribution of property to a partner by the amount of any gain recognized by the distributee partner. Hence, if a partner elected to recognize gain under the provisions of regulations section 1.736-1(b)(6), the partnership would be adjusting its basis in its property on an annual basis. The annual computations could become a tremendous mechanical burden.

To avoid this situation, the partnership should be allowed to make the appropriate adjustment under section 734(b) in the year the partner retires or dies, based on the total amount to be distributed to him, as agreed to by the partnership.

SECTION 736

Payments to a Retiring Partner or a Deceased Partner's Successor-in-Interest

Section 736(b)(2)(A) should be amended to provide that payments in exchange for an interest in partnership property will not be considered section 736(b)(2) payments to the extent of the lesser of the partner's interest in potential section 751 gain or the amount of the actual gain the partner would have realized if he had sold or exchanged the interest.

Under present rules, section 736(b)(2)(A) treats payments made in liquidation of retiring partners' or deceased partners' interest in a portion of section 751 property (namely, unrealized receivables) in excess of their partnership basis as payments under section 736(a). The effect of this is to tax as ordinary income the payments received for the partner's interest in the property, much as the IRS would tax the amount of ordinary income the partner would have reported if he had sold or exchanged his interest.

It is recommended elsewhere in this publication that section 741 should be amended to provide that ordinary income recognized on the sale or exchange of a partnership interest be the lesser of the actual gain realized and the potential section 751 gain on the sale. Changes in the definition of section 751 property should also be made to simplify the calculation of potential section 751 gain and to determine ordinary income on the sale or exchange of a partnership interest by reference to the potential section 751 gain, in a manner similar to the operation of the section 1245 depreciation recapture rules.

So that a retiring or deceased partner's successor-in-interest need not report more ordinary income on liquidation of his interest in partnership property than if he had sold the interest, it is necessary to amend section 736(b)(2)(A) to provide that payments in exchange for an interest in partnership property will not include amounts paid for the partner's interest in potential section 751 gain property (as redefined) to the extent of the lesser of the partner's interest in the potential section 751 gain property and the actual gain the partner would have realized if he had sold his partnership interest at fair market value. The amounts so excluded would be treated as section 736(a) payments.

The present rules regarding inclusion of partnership goodwill in payments for partnership property should continue.

SECTION 741

Recognition of Limited Gain on Distribution or Sale of Partnership Interest in Corporate Liquidation

Gain should be recognized upon the distribution of a partnership interest in a corporate liquidation, or a sale of a partnership interest pursuant to a section 337 liquidation, to the extent of any recapture amounts, such as those under sections 1245 and 1250, that would have been taxed if the distributor corporation owned its proportionate share of partnership assets directly.

The issue frequently arises of whether a corporation's distribution of its partnership interest to its shareholders, incident to a partial or complete liquidation of the corporation, results in the recognition of gain to the distributing corporation. Section 336 provides that no gain or loss will be recognized to a corporation in partial or complete liquidation, except as provided in section 453(d), which relates to the disposition of installment obligations. Sections 1245 and 1250, however, contain provisions to override section 336. On the other hand, section 741 provides that the sale or exchange of a partnership interest results in a capital gain or loss to the partner, except as otherwise provided in section 751 (relating to unrealized receivables, which are defined to include section 1245 and section 1250 property, and to inventory items that have appreciated substantially in value). Section 751 does not contain provision to override section 336.

Thus, the potential for abuse exists because the depreciation recapture provisions of section 751 appear to apply only to a transaction described in sections 741 and 751 and because a distribution of a partnership interest under section 336 would be outside the scope of the partnership depreciation recapture provisions.

Several years ago a technical advice memorandum was issued in at least one instance requiring full recognition of section 751 gain upon the distribution of a partnership interest by a corporation in liquidation. Allowing section 751 to override section 336 could result in large tax liabilities due solely to an asset's ownership in partnership form. It is inappropriate that ownership of a partial interest in an asset would result in vastly different tax consequences from outright ownership of that asset. Additionally, section 332 liquidations, as described in section 381(a)(1), would no longer be possible without recognition of gain to the distributing corporation if a partnership interest is involved.

To provide consistency and certainty in this area, gain should be recognized upon the distribution of a partnership interest in a corporate liquidation or sale pursuant to section 337 only to the extent of any recapture amounts, such as those under sections 1245 and 1250, that would have been taxed had the distributing corporation owned its proportionate share of partnership assets directly. The amount of gain so recaptured should result in appropriate increases in the basis of partnership assets in the hands of the distributee.

SECTION 741

Recognition and Character of Gain or Loss on Sale or Exchange

Section 741 should be amended to provide that –

1. **Gain or loss recognized on the sale or exchange of a partnership interest will be capital gain or loss and that ordinary income to be realized on such a sale or exchange will be the lesser of the actual gain and the partner's interest in potential section 751 gain.**
2. **Any gain to be realized as a result of the application of section 731(a) will be taxed as ordinary income to the extent of the partner's potential section 751 gain reduced by any amounts previously reported as ordinary income attributable to application of section 731(a).**

Under present rules, a transferor of a partnership interest by sale or exchange recognizes capital gain or loss measured by the difference between the amount realized and the adjusted basis of the transferor's partnership interest. However, the amount realized from the sale or exchange of the partnership interest does not include any portion of the consideration received that is attributable to the partner's interest in section 751 partnership property (regulations section 1.741-1(a)). The net result of these rules is that the partner is deemed to have made two sales, namely, a sale of his partnership interest and a separate sale of his interest in section 751 property.

The net effect is that a selling partner may realize ordinary income in excess of his economic gain on the sale of the partnership interest. The difference is represented by a capital loss. Furthermore, the rule applies even if the partner has an economic loss on the transaction. Any ordinary income realized from the sale of the section 751 property increases the capital loss that is realized.

The rule has been criticized primarily for (1) complexities in determining whether there is any section 751 property and (2) the unfairness of requiring the reporting of ordinary income in excess of economic income realized on the sale, coupled with the limitations on the amount of capital losses that a taxpayer may report.

Congress could simplify matters by enacting the concept of potential section 751 gain in lieu of the present definition of section 751 property.

Potential section 751 gain would be defined as the net amount of ordinary income the partnership would have to report if it sold all its assets at fair market value. This concept is discussed in our recommendation concerning section 751.

Ordinary income recognized on the sale or exchange of a partnership interest should be limited to the lesser of (1) the actual gain realized by the partner and (2) the partner's interest in the partnership's potential section 751 gain attributable to the partnership interest sold. This would be similar to the depreciation recapture rules under section 1245. This can be implemented by eliminating the current requirement of separating the consideration received for the sale of the partnership interest into two sales prices: a sales price attributable to the partnership interest (capital asset) and a sales price attributable to section 751 property (noncapital asset).

A reduction of a partner's share of liabilities is deemed to be money distributed to the partner pursuant to section 752(b). Section 731(a)(1) provides that gain is to be recognized to the extent that the distribution of money exceeds the adjusted basis of the partner's partnership interest. Such gain is characterized as the distributee partner's gain from sale of the partnership interest. Ordinary income should be realized on the sale of a partner's interest in a partnership to the extent of a partner's potential section 751 gain; however, since gain required to be reported under section 731(a) can occur in more than one year and since the partner still has his interest in the partnership, the amount of potential section 751 gain applicable to that partner should be reduced by previously reported amounts of potential section 751 gain.

SECTION 743

Addition of Gift Tax to Basis

Section 743(b) should be amended to include a transfer by gift as a qualifying transfer for purposes of applying the section 743(b) adjustment.

The optional adjustment to basis of partnership property pursuant to an election under section 754 is designed to reflect basis in partnership assets on transfer of a partnership interest when the transferor's basis does not carry over to the transferee, such as in the transfer of a partnership interest by sale or exchange or on death under section 743(b). Although transfer of a partnership interest by gift involves carryover of the donor's basis, the adjustment to basis in the hands of the transferee as a result of the gift tax paid can be substantial. Accordingly, it is recommended that transfer of a partnership interest by gift be covered by the section 754 election, subject to an exclusion for de minimis gift taxes, in order to enable the additional basis to be reflected in partnership assets on behalf of the transferee.

SECTION 751

Unrealized Receivables and Inventory Items That Have Appreciated Substantially in Value

The definition of unrealized receivables and inventory items should be eliminated from the code and in lieu thereof a concept of potential section 751 gain should be enacted (as section 751(c)). Potential section 751 gain of a partnership would be defined as the net amount of ordinary income the partnership would have to report if it sold all its assets at fair market value.

The present rules defining section 751 property are complex and confusing and appear to have no consistent rationale. The basic purpose of section 751 (especially as used in connection with section 741) is to prevent a seller of a partnership interest from converting his share of potential ordinary income to capital gain. Because this is similar to the rationale of section 341 relating to collapsible corporations, section 751 is referred to as the collapsible partnership section.

The stated purpose is not, in fact, achieved. Section 751(a)(1) provides for absolute recognition of ordinary income attributable to unrealized receivables. Section 751(c) provides that unrealized receivables include not only receivables but also, among other things, depreciation recapture potential under section 1245(a) or section 1250(a). The inclusion of depreciation recapture potential in the term "unrealized receivables" creates problems for taxpayers.

Section 751(a)(2) provides for the recognition of gain attributable to appreciated inventory only if the inventory has appreciated substantially. Section 751(d) provides that inventory items are considered to have appreciated substantially if their fair market value exceeds (1) 120 percent of their adjusted basis to the partnership and (2) 10 percent of the fair market value of all partnership property excluding cash. Here again, the term "appreciated inventory" has a different meaning from what taxpayers would normally attribute to the term "inventory." Inventory items include not only traditional inventory items as defined in section 1221(1) but also any partnership property that is not a capital asset or section 1231 property. Inventory items also include items of partnership property that, if held by the selling or distributee partner, would be considered the type of property included in the definition of inventory items. The effect of this is to change the character of the property in the hands of the partnership to the character the property would have were it held by the partner.

Under the present rules, a seller of a partnership interest can realize ordinary income for his interest in unrealized receivables, while no recognition is given for yet unrecognized ordinary losses attributable to depreciated inventory or section 1231 property.

Under this recommendation, all unrealized ordinary income and losses (including net section 1231 losses) would be netted. If there is a net gain, it would be classified as potential section 751 gain of the partnership. Each partner will be deemed to have his share of the potential section 751 gain, as under the present rules determining his share of section 751 property.

Section 732 should be amended to provide for definitions of unrealized receivables and inventory items, as presently contained in section 751(c) and (d), and subsections 751(c) and (d) should be eliminated from the code.

SECTION 751

Exempt Admission of a Partner or Change in Partner's Interest From Sale or Exchange Rules

The admission of a new partner to an existing partnership or the increase of an existing partner's percentage interest in a partnership should not be considered as a sale or exchange of the existing partners' interests and should not cause the existing partners to recognize gain as a result of a reduction in their share of liabilities.

Section 751(b), as presently constituted, appears to apply literally every time a partner's interest in a partnership is reduced, either by the admission of a new partner or the increase of another partner's interest in the partnership, even though the partner whose interest was reduced in fact received nothing from the partnership. The reduction of the partner's interest in the partnership results in his having a reduced interest in the partnership assets (including section 751 gain property) as well as a reduced share of partnership liabilities. Under section 752(b), this reduction of share of liabilities is deemed a distribution of money to the partner whose interest was reduced.

Regulations section 1.751-1(g), example (2), makes it clear that a reduction of a partner's share of liabilities pursuant to section 752(b) is money distributed to a partner for purposes of section 751(b). Since the distribution occurred in connection with the partner's surrender of his interest in partnership property, section 751(b) would appear to apply.

The code should be amended to provide that, where a partner's interest is reduced in a partnership as a result of the admission of partners or the increase of other partner's interest, the money deemed distributed to the partner as a result of application of section 752 will not be deemed to have been received by that partner in exchange for his interest in section 751 property.

SECTION 754

Provision of Separate Elections to Apply Sections 734 and 743

Section 754 should be changed to provide for separate elections with regard to choosing to adjust basis of partnership property as provided in sections 734 and 743. An election to apply the benefits of one of the sections should not be binding with regard to application of the other section. In addition, the election under section 743 should be made at the partner level, while the election under section 734 continues to be made by the partnership.

Section 734 allows a partnership to adjust the tax basis of its assets if a partner is redeemed for an amount different from his tax basis in the partnership. The adjustment under section 743 applies when there has been a transfer of a partnership interest; it applies only to the transferee partner's basis in partnership assets. Other than the fact that the basis of partnership assets is adjusted as a result of these two sections, there is no other relationship between them. It is illogical to tie a redemption of a partnership interest to a partner's transfer of his interest to a third party.

This election, once made, is irrevocable without the consent of the commissioner. Often, the computation of the adjustment under section 734 is complicated because the redeemed partner may not be sure of his tax basis in the partnership or may not wish to disclose it. If a prior election under section 754 had been made to provide a benefit to a new transferee partner, this election could cause a real burden in future years if there is a redemption from a partner not wishing to disclose his adjusted basis in the partnership.

A separation of these elections would avoid this potential conflict. Because the election under section 743 affects only the basis of the transferee partner, the election should be optional to him and should not be a binding election made by the partnership.

Tax Based on Foreign Income

SECTION 864

Force-of-Attraction Doctrine

The limited vestige of the force-of-attraction doctrine should be repealed so that U.S.-source business-type income that is in no way related to the activities of a U.S. trade or business should not be treated as effectively connected income subjected to U.S. tax [section 864(c)(3)].

Prior to the enactment of the Foreign Investors Tax Act in 1966, the taxation of a foreign taxpayer was based on the force-of-attraction principle, under which, if the foreign taxpayer was engaged in trade or business in the United States, all U.S.-source investment and unrelated business income was "attracted" to and treated as part of the trade or business and thereby subjected to U.S. tax at regular rates.

The Foreign Investors Tax Act abandoned this principle as of January 1, 1967, and substituted therefor the "effectively connected" concept, under which a foreign taxpayer engaged in a U.S. trade or business is taxed at regular rates only on his business income (although the "effectively connected" concept does attract to U.S. tax certain items of foreign-source business income). U.S.-source income not connected with a U.S. business, usually investment income referred to in the IRC as "fixed and determinable annual and periodical gains, profits and income," is only taxed at regular rates when that income is "effectively connected" with the conduct of a trade or business in the United States; otherwise it is not "effectively connected" and is taxed at a flat rate of 30 percent on gross income (or lower treaty rate where applicable).

Under section 864(c)(3), however, not effectively connected U.S.-source income that does not fit into the definition of fixed and determinable annual and periodical gains, profits, and income is treated as "effectively connected" and taxed at regular rates. Thus, even though such income is not factually "effectively connected" with a U.S. trade or business, it is still taxed as such. To this degree, there still exists the anachronistic "force-of-attraction" principle.

This rule is illustrated by example (3) of regulations section 1.864-4(b), paraphrased below:

> Foreign corporation X is engaged in the business of buying and selling of electronic equipment and has a branch office in the United States to sell electronic equipment to customers in the United States and elsewhere. The home office of foreign corporation X also is in the business of buying and selling vintage wines. However, the U.S. branch is not equipped to sell and does not participate in the sale of vintage wines. By virtue of the activity of its sales branch, foreign corporation X is engaged in trade or business in the United States. However, sales that do not relate to the U.S. branch are still treated as effectively connected income. Thus, if the home office directly makes sales of the vintage wines in the United States without routing such sales through its U.S. branch, that income is considered effectively connected with the conduct of a trade or business in the United States.

U.S. tax policy made great strides forward when it adopted the "effectively connected" concept, since such concept is more in keeping with economic and business realities. In the above example, for instance, since the wine sales are not in any way the result of economic or business activities of the U.S. branch, there is no reason, as a matter of policy, for the United States to tax the income from the wine sales. Accordingly, section 864(c) should be eliminated or the Internal Revenue Code should be amended to completely efface the force-of-attraction doctrine.

SECTION 904

Carryback and Carryover of Excess Foreign Income Taxes

The two-year carryback and five-year carryover provisions of the excess of foreign income taxes paid or accrued over the applicable limitations of section 904 should be changed to allow a three-year carryback and a fifteen-year carryover [section 904(c)].

Section 904(c) provides that any foreign income taxes that are paid or accrued to any foreign country and that exceed the applicable limitations of section 904(a) are carried back two years and then forward five years.

The carryover concept of excess deductions and credits is employed in other areas of the Internal Revenue Code. With respect to the normal types of net operating losses and unused investment tax credits, three-year carryback and fifteen-year carryover periods have been determined by Congress to be the most appropriate, and the Internal Revenue Code so provides. For some reason, however, the three-year carryback and fifteen-year carryover periods have never been extended to section 904(c).

To provide consistency in the Internal Revenue Code, the three-year carryback and fifteen-year carryover provisions for net operating losses and unused investment tax credits should be adopted with respect to excess foreign income taxes. Such conformity would be achieved by amending the foreign tax carryback provisions from two years to three years and the foreign tax carryover provisions from five years to fifteen years.

SECTION 904

Correction of Unintended Diminution of Foreign Source Income

Section 904(f)(2) should be amended so that, when an overall foreign loss is part of a net operating loss carryback or carryforward, the overall foreign loss will be reduced (but not below zero) by the amount of the net operating loss allocable under section 862(b) to foreign source income.

If a taxpayer has an operating loss (including an overall foreign loss) for a taxable year, regulation 1.861-8 requires that the carryover of the loss be allocated to foreign source income. Section 904(f) converts an identical amount of foreign source income into U.S. source income. Accordingly, the combination of regulation 1.861-8 and section 904(f) converts from foreign source income into U.S. source income an amount equal to twice the overall foreign loss. The purpose of the recommendation is to eliminate this double effect by eliminating from the definition of overall foreign loss the amount used to reduce U.S. source income under section 862(b).

Gain or Loss on Disposition of Property

SECTION 1032

Gain on Lapse of Warrants on Corporation's Own Stock

Amounts received by a corporation for warrants and options on that corporation's own stock should be treated in the same fashion as the proceeds of the sale of such stock whether or not the options or warrants are ultimately exercised and stock issued [section 1032(a)].

Regulations section 1.1234-1(b) and Revenue Rulings 72-198 (1972-1 C.B. 223) and 77-40 (1977-1 C.B. 248) hold that income results upon the expiration of warrants issued after April 24, 1972, on a corporation's own stock.

Because the sale of the stock itself would not result in income, neither should the sale of the warrants or options. The present IRS interpretation puts a premium on form at the expense of substance. For example, corporation X sells its common stock for $10 a share and three years later buys the stock back at $8 a share as the result of a decline in the market value of the stock. Under section 1032, no gain is recognized to corporation X. Corporation Y sells options on its stock, allowing the holder thereof to buy the stock at $10 per share, and receives $2 for each optioned share. Three years later, the stock having declined to $8, the warrants expire unexercised. Corporation Y would be deemed to have realized a gain of $2 per share for tax purposes, even though for financial accounting purposes the $2 would be treated as part of capital surplus in the same fashion as the $2 realized by corporation X.

SECTION 1032

Exchange of Parent Corporation's Stock for Property

The nonrecognition of gain or loss provided under section 1032(a) where a corporation exchanges its stock for property should also apply where a subsidiary acquires property in exchange for stock of its parent transferred to it for the purpose of making such exchange.

Where a corporation acquires property in exchange for its stock, no gain or loss is recognized to the corporation by virtue of section 1032(a), and the basis of the property acquired is its cost, that is, the value of the stock given. If the property is then transferred to a controlled subsidiary as a capital contribution or in exchange for stock of the subsidiary, the exchange would result in no gain or loss to the parent or to the subsidiary (see sections 351, 118, and 1032(a)), and the parent's basis for the property would pass to the subsidiary under section 362(a).

If, however, the parent transfers its stock to the subsidiary, and the subsidiary directly acquires the property in a transaction in exchange for such stock of the parent, there may be adverse tax consequences, although the substance of the transaction is the same as in the case where the parent acquires the property and transfers it to the subsidiary. The tax uncertainty is whether the parent's stock has any basis in the hands of the subsidiary. If there is no basis, the subsidiary would have a taxable gain equal to the value of such stock upon the exchange of the stock for property. This difference in tax treatment should not exist, particularly where the parent's stock is transferred to the subsidiary for the purpose of making the acquisition.

To eliminate this inconsistent treatment, it is recommended that section 1032(a) be amended to make its provisions applicable where a subsidiary exchanges its parent's stock for property, provided such stock was transferred to the subsidiary expressly for the purpose of such exchange. A subsidiary would qualify for this treatment only if it were controlled by the parent within the meaning of section 368(c). This would also make section 1032 consistent with the "A," "B," and "C" reorganization provisions which permit use of the parent's stock by a subsidiary in a tax-free reorganization.

Capital Gains and Losses

SECTION 1201

Capital Gains of Corporations: Alternative Tax

When net long-term capital gains exceed taxable income, the alternative tax rate should be applied to taxable income [section 1201(a)].

The tax liability of a corporation having an excess of ordinary deductions over ordinary income (an ordinary loss) and a net long-term capital gain in excess of the ordinary loss is based upon the lesser of –

1. The tax computed by applying the normal tax and surtax rates to taxable income (net long-term capital gain reduced by ordinary loss).
2. The alternative tax rate of 28 percent on the amount of gain.

Irrespective of which calculation provides the lower tax, the ordinary loss is absorbed by the net long-term capital gain. In some instances, the taxpayer receives no benefit from the ordinary loss.

For example, a corporation has a taxable income of $175,000, made up of a net long-term capital gain of $200,000 and an operating loss of $25,000. Its tax is $56,000 (the lesser of the alternative tax rate of 28 percent applied to the entire net long-term gain and the normal tax and surtax of $61,250 on taxable income). If the corporation has realized only the net long-term gain, its tax is still $56,000. Clearly, no benefit is received from the $25,000 operating loss.

The 28 percent maximum alternative tax should be applied to taxable income if such income is less than the net long-term capital gain. In the foregoing example, this treatment would result in an alternative tax of $49,000.

SECTION 1212

Treatment of Capital Losses

Individual taxpayers should be allowed to carry back capital losses.

Section 1212 of the Internal Revenue Code allows corporate taxpayers to carry back capital losses to the three years preceding the year of the loss to the extent of capital gains in those years. Individuals, however, can only deduct capital losses to the extent of capital gains in the same year plus a limited deduction against ordinary income. Individual capital losses in excess of these amounts may not be carried back to prior years but are allowed an unlimited carryover to future years. Under existing law, if an individual sustains capital losses in one year and capital gains in a following year, he can carry over the capital losses and deduct them against the subsequent capital gains. An inequity results, however, if the capital gains precede the capital losses, because an individual cannot carry back capital losses and deduct them against the prior capital gains.

To eliminate this inequity, the capital loss carryback provisions of section 1212 should be amended to provide individuals the same carryback provisions currently allowed corporations. Such amendment will eliminate litigation and controversies involving the determination of the year of a loss.

SECTION 1212

Treatment of Capital Losses—Carryback Election

Taxpayers entitled to a carryback of a capital loss should be provided an election to forego a carryback of the loss.

The Tax Reform Act of 1976 changed the net operating loss carryback and carryover provisions of the Internal Revenue Code to allow taxpayers entitled to a carryback of a net operating loss to elect not to carry back the loss in favor of a carryover only. It is recommended that section 1212 be amended to provide all taxpayers a similar election to forego a carryback of a capital loss in favor of a carryforward only.

Readjustment of Tax Between Years and Special Limitations

SECTION 1313

Meaning of "Determination"

The definition of "determination" for purposes of mitigation of the statute of limitations should be broadened to cover any situation where a taxpayer has paid a deficiency in tax and the statute of limitations has expired [section 1313(a)].

A "determination" now is limited in the case of deficiencies to court decisions, section 7121 closing agreements, and special agreements "signed by the secretary or his delegate." In other situations, a "determination" can only take place as a result of a claim for refund. To prevent sections 1311 through 1315 from being a trap for the unwary, it should be provided that if a taxpayer has paid a deficiency in connection with the tax for any year, the "determination" of such deficiency shall be deemed to take place when the statute of limitations on filing a claim for refund expires (unless a claim for refund is filed before the expiration of such time).

SECTION 1313

Related Taxpayer Definition

The related taxpayer definition set forth in section 1313(c) should be broadened to include all taxpayers subject to a correlative adjustment.

Under present law, the provisions of section 1311 provide relief in cases where an inconsistent position is taken by the government or by a taxpayer regarding either inclusion of income or allowance of a deduction that has already been taken into account in computing the taxable income of another taxpayer. The relief provisions are applicable in these cases only if the taxpayers involved meet certain relationship provisions specified in section 1313(c).

This provision has resulted in inequities that are due to the narrow relationships stated in section 1313(c). This provision should be broadened to permit the relief provisions regarding mitigation of the statute of limitations to apply to all taxpayers to whom a correlative adjustment would alter the income tax liability of a year that is otherwise closed.

Election of Certain Small Business Corporations as to Taxable Status

SECTIONS 1371–1379

Recommended tax law changes concerning subchapter S of the Internal Revenue Code are included in *Proposal for Complete Revision of Subchapter S Corporation Provisions*, published by the federal taxation division of the AICPA in February 1978.

Cooperatives and Their Patrons

SECTION 1382

Deficiency Dividends for Cooperative Organizations

If the taxable income of a cooperative organization is increased upon examination by the Internal Revenue Service, it should be permitted to declare and pay a deficiency dividend and increase the amount of its patronage dividend deduction by the amount of such deficiency dividend.

The legislative history relating to the rules covering the taxation of cooperatives clearly indicates that Congress intended to obtain a single current tax with respect to the income of cooperatives. The patronage dividends-paid deduction of section 1382 generally leads to that result. However, in the event of an increase in taxable income resulting from an Internal Revenue Service examination, there is no mechanism under present law to permit an additional patronage dividends-paid deduction for the year in question. The end result is an unintended tax liability which must be paid by the cooperative organization out of funds otherwise allocated to current patrons.

To correct this situation, section 1382(d) should be amended to extend the payment period for patronage dividends to include the date of the redetermination, plus an appropriate grace period when an examination causes an increase in the taxable income of a cooperative organization.

Tax on Self-Employment Income

SECTION 1402

Definition of Retired Partner's Net Earnings From Self-Employment

Section 1402(a)(10) should be amended to –

1. **Eliminate the requirement that the payments provided for by the plan must continue at least until the partner's death.**
2. **Eliminate the section 1402(a)(10) absolute prohibition against any obligation to the former partner (other than for retirement payments) or term repayments of capital.**
3. **Change the section 1402(a)(10) restriction calling for "no services" by the retired partner to "no substantial services."**

Under present law, retired employees who receive pensions or similar payments from their employers are not subject to social security taxes on such payments; also, as a general rule, employee plans provide that retiring employees can choose from alternative pay-out arrangements. Similarly, retired partners who receive retirement payments from their firm are not subject to self-employment taxes on such payments if they meet the requirements of section 1402(a)(10). Because section 1402(a)(10) requires that such payments continue at least until the death of the retired partner, alternative pay-out arrangements are effectively proscribed. Since retirement payments to partners pursuant to section 1402(a)(10) are essentially the same as employee retirement pay-outs, it would be equitable for partners to be able to choose their method of payment, as do employees. Therefore, the requirement that payments must extend until death to be excluded from self-employment income should be eliminated.

Allowing retiring partners to choose a less-than-lifetime term for their payments is desirable to provide security for retirees, since the partnerships that most often provide pensions are service or professional partnerships with limited capital and, specifically in the case of smaller firms, an uncertain period of existence.

With respect to the prohibition of section 1402(a)(10) against obligations other than those for retirement payments, smaller firms with limited credit and financial resources frequently must pay out the capital and other interests of a retired partner over a period of years because of economic necessity. The need for stability in such enterprises should not be in conflict with the desirability of providing retirement payments to former partners, and, accordingly, the requirements of section 1402(a)(10)(B) and (C) should be eliminated.

In addition, it is common for such retirement payment agreements to provide for consultation rights and noncompetition phraseology, especially in view of the significance of individualized involvement in smaller firms. It is, therefore, recommended that the absolute restriction of section 1402(a)(10)(A) on the rendition of any services by a retiree be mitigated by changing the term "no services" to "no substantial services." Substantial services can be defined by statute or regulations and can be referenced to social security benefit standards.

Legislation amending section 203(f)(1) of the Social Security Act passed during 1980, allowing retired partners who do not perform substantial services to receive social security benefits. Prior to this legislation, the definition of net earnings from self-employment contained in the Social Security Act was identical to that contained in the Internal Revenue Code. Legislation amending IRC section 1402(a)(10) to conform to language contained in section 203(f)(1) of the Social Security Act could solve the problems presented above.

Estate and Gift Taxes

SECTION 2014

Credit for Foreign Death Taxes

The limitation on the amount of foreign death taxes that can be credited against the federal estate tax should be determined on an overall basis.

The credit against the federal estate tax for foreign death taxes paid is subject to a limitation computed on a per country basis. This limitation can result in double taxation, so that estates with foreign investments may be taxed more heavily than similar estates subject only to domestic tax.

Under the equivalent income tax provisions, as revised by the Tax Reform Act of 1976, the foreign tax credit must be computed on an overall basis. It is suggested that, similarly, the credit for foreign death taxes should be determined on an overall basis in order to conform the tax treatment in the income and estate tax areas and, in addition, to reduce the incidence of double taxation.

An example illustrates the two different limitation methods. A U.S. citizen died leaving a gross estate of $2.5 million. Of this estate, $200,000 was subject to estate taxes amounting to $74,000 in country A and $1.5 million to estate taxes amounting to $675,000 in country B. The remaining $800,000 of assets in the gross estate were subject solely to U.S. federal estate taxes. Assuming no deductions or lifetime transfers, the federal estate taxes payable on the gross estate amounted to $1,025,800. The foreign tax credit limitation would be as follows.

	Limitation	*Actually Paid*	*Available Credit*
1. On a per country basis			
Country A			
$\frac{\$200{,}000}{\$2{,}500{,}000} \times \$1{,}025{,}800$	$ 82,000	$ 74,000	$ 74,000
Country B			
$\frac{\$1{,}500{,}000}{\$2{,}500{,}000} \times \$1{,}025{,}800$	615,500	675,000	615,500
	$697,500	$749,000	$689,500
2. On an overall basis			
$\frac{\$(200{,}000 + 1{,}500{,}000)}{\$2{,}500{,}000} \times \$1{,}025{,}800$	$697,500	$749,000	$697,500

SECTION 2504

Valuation of Gifts Made in Prior Years

Once the statute of limitations has expired, adjustment of the value of gifts made in prior years should be prohibited, whether or not a gift tax was paid, providing that a gift tax return was required and filed and the gift was reported [section 2504(c)].

Section 2504(c) of the code now prohibits the commissioner from adjusting the value of a prior gift after the statute of limitations has run only if a tax was paid or assessed on the prior gift.

The period for adjustment for the value of a gift should close after a reasonable time because the record relating to the value becomes stale. That is the fundamental rationale for the existence of a statute of limitations in all instances.

With the enactment of the unified rate and credits for gift and estate taxes, the adjusted gifts made after December 31, 1976, become a part of the basis for estate tax. In addition, the application of the unified credit to gift taxes will substantially increase the number of gift tax returns showing no liability. The controversies over value will be extended to prior gifts, which will prolong the period of administration and problems that are created by making retroactive appraisals and determinations of value.

Taxpayers should be allowed to rely on the facts shown on gift tax returns for which the statute of limitations has expired even though no tax was actually paid or assessed. In this light, it is illogical to permit valuation adjustments that affect gift and estate taxes merely because the gift in question was not sufficient to exceed the allowable exclusions, deductions, and credits.

Additionally, section 2504(c) should apply for the purpose of computing a deceased donor's estate tax liability. There should be a statute of limitations on the valuation of gifts for purposes of the adjusted taxable gifts computation of section 2001(b)(1)(B).

Employment Taxes

SECTION 3121

FICA Tax on Nonresident Aliens

Nonresident aliens who are employed only temporarily in the United States, as well as their employers, should be excepted from the definition of employment under section 3121(b), as has been done under section 861(a)(3), which exempts such individuals from income tax.

Section 3101 imposes a tax on the employment income of every individual, and section 3111 imposes an equal excise tax on every employer. Section 3121(b) defines employment generally to include all services performed within the United States by an employee for the person employing him irrespective of the citizenship or residence of either. Thus, the code subjects a nonresident alien who performs services in the United States to social security taxes, regardless of the length of his stay in the United States. Moreover, the code subjects a nonresident foreign employer with all its offices outside the United States and no business activities within the United States (except for temporary visits by its employees) to social security tax with respect to compensation for services performed within the United States by its employees.

Section 861(a)(3) of the code provides for an exemption from federal income tax on the employment income of a nonresident alien for services performed in the United States if the following three tests are met:

1. The individual is temporarily present in the United States for a period or periods not exceeding a total of ninety days during the taxable year.
2. His compensation for services performed in the United States does not exceed $3,000 in the aggregate during the taxable year.
3. The compensation is for labor or services performed as an employee of, or under a contract with, *(a)* a nonresident alien, foreign partnership, or foreign corporation not engaged in a trade or business within the United States or *(b)* a domestic corporation if the services are performed for a place of business located outside of the United States.

The present law is considered unfair by both foreign employers and foreign employees. Consequently, most foreign employers and employees will not voluntarily comply, and enforcement is practically impossible, inasmuch as the Internal Revenue Service is unaware of most of the foreign individuals and foreign employers subject to the tax. Also, with proper planning, a nonresident alien can reap substantial benefits from our social security system by making a minimum contribution in each quarter for ten years. Therefore, we recommend that temporary visitors and their foreign employers be excepted from the definition of employment under section 3121(b) of the code.

Procedure and Administration

SECTION 6046

Returns Involving Organization or Reorganization of Foreign Corporations and Acquisition of Their Stock

Section 6046 should be amended so that taxpayers only need to file the required information return by the due date of their income tax return and so that the requirement for filing the same information required under section 6038 be eliminated.

The provisions of Internal Revenue Code section 6046 require (1) each U.S. citizen or resident who becomes an officer or director of a foreign corporation of which 5 percent or more in value of the stock is owned by a U.S. person (as defined in section 7701(a)(30)), (2) each U.S. person who acquires stock with a value equal to 5 percent or more of the value of the stock of a foreign corporation, or (3) each U.S. person who acquires an additional 5 percent or more in value of the stock of a foreign corporation to file a return for the organization or reorganization of the foreign corporation and the acquisition of the foreign corporation's stock on or before the ninetieth day after the U.S. citizen, resident, or person becomes liable to file the return. Because of the complexity of the legal requirements in many foreign countries, the starting date of the ninety-day period is unclear. Moreover, the need to obtain accurate information from attorneys and accountants in the particular foreign country often results in indeterminable delays, creating difficulties in meeting the due date of the return.

The provisions of section 6046 duplicate information required annually under section 6038. This section requires every U.S. person to furnish information with respect to a foreign corporation if the person owns either more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of a foreign corporation.

It is therefore recommended that section 6046 be revised to read, "... any return required by subsection (a) shall be filed on or before the due date of the income tax return, including extensions, of the U.S. citizen, resident, or person for the year liability to file a return is required under subsection (a)." It is also recommended that section 6046(f) be redesignated as (g) and that (f) be made to read as follows:

(f) exception from filing –

(1) The return required by subsection (a)(1) shall not be required by an officer or director in respect of a foreign corporation which is controlled by a U.S. citizen, resident or person within the meaning of Section 6038(d)(1).

(2) The return required by subsection (a)(2) shall not be required by a U.S. person who controls a foreign corporation within the meaning of Section 6038(d)(1).

SECTION 6154

Installment Payments of Estimated Tax by Corporations

Section 6154(a) should be amended to raise the minimum amount required for corporations to pay estimated income tax.

Section 6154(a) provides that corporations that reasonably expect their estimated tax for the year to be $40 or more shall make payments of estimated tax.

The complexities of computation and the burden of payment requirements upon small businesses with limited resources, coupled with the expense of professional advice in order to understand and comply with these statutory requirements, necessitate the amendment of this section of the Internal Revenue Code.

It is therefore recommended that corporations be required to pay estimated income tax only when income tax payments are reasonably expected to exceed $1,000. This change will not materially affect revenue collections but will help reduce paperwork, filing requirements, and technical complexity throughout our tax system.

SECTION 6164

Extension of Time for Payment of Taxes by Corporations Expecting Carrybacks

Section 6164 should be amended to include not only net operating loss carrybacks, but also carrybacks arising from net capital losses, unused investment credits, unused work incentive program credits, and foreign tax credits.

In a taxable year out of which a net operating loss carryback is expected to arise, section 6164 permits a corporation to obtain an extension of time for payment of taxes due from the previous year. The purpose is to avoid requiring a corporation to pay taxes for a prior year when there is good reason to expect that a current net operating loss carryback would decrease the amount owing from the prior year.

This same purpose justifies amending the section to allow an extension of time for payment of the previous year's taxes when a carryback is expected to arise as a result of net capital losses, unused investment credits, unused work incentive program credits, and foreign tax credits.

SECTION 6411

Tentative Carryback Adjustments—Foreign Tax Credits

Tentative carryback adjustments should be permitted for unused foreign tax credits in the same manner as now provided for operating losses, investment credit carrybacks, work incentive program credit carrybacks, and capital losses (in the case of corporations).

Section 6411 now permits taxpayers with net operating losses, unused investment credit carrybacks, work incentive program credit carrybacks, and corporate capital losses to file applications for tentative carryback adjustments (so-called quick claims) within twelve months of the close of the year in which the carryback arose. The amount of tax decrease resulting from the carryback must be refunded or credited within ninety days, subject to the right of the IRS to disallow the application in the case of material errors or omissions. The tentative allowance is subject to adjustment upon audit of the taxpayer's return. This provision originally applied only to net operating loss carrybacks and was extended to unused investment credit carrybacks in 1966, net corporate capital losses in 1969, work incentive programs in 1971, and incremental research credit in 1981.

The tentative adjustment procedure is designed to relieve taxpayers entitled to tax refunds from the economic burden of waiting until the audit of their tax returns is completed. Since examination of returns involving foreign income and tax credits is likely to be even more protracted than the usual audit, it appears logical that tentative adjustments of unused foreign tax credits also be permitted.

SECTION 6425

Quick Refunds (Forty-Five Days) of Certain Corporate Quarterly Overpayments

Section 6425 should be amended to allow a corporate taxpayer to file for a "quick refund" (forty-five days), prior to the end of the taxable year, of certain overpayments of estimated installments.

Section 6425 provides that a corporation may, after the close of the taxable year and on or before the fifteenth day of the third month thereafter, and before the day on which it files a return for such taxable year, file an application for an adjustment of an overpayment of estimated income tax for such taxable year. Within a period of forty-five days from the date on which an application for an adjustment is filed, the IRS may credit the amount of the adjustment against any part of the corporation's tax liability and shall refund the remainder to the corporation provided the amount of the adjustment equals or exceeds (1) 10 percent of the amount estimated by the corporation on its application as its income tax liability for the taxable year and (2) $500.

Section 6425 was added in 1968 to try to avoid corporate overpayments as a result of the phase-out of the $100,000 exemption and the increase of the 70 percent test to 80 percent.

However, there is no present provision that would allow a corporate taxpayer to request a "quick refund" of the overpayment of a specific estimated installment; the corporation must wait until the close of its taxable year. This does not permit prompt refund of overpayments needed by a corporation faced by a sharp reduction of income from sudden business reversals.

Therefore, section 6425 should be amended to allow a corporate taxpayer to file for a "quick refund" (forty-five days) of certain overpayments of estimated installments prior to the end of the taxable year. The same 10 percent and $500 limitations applicable to past year-end applications (Form 4466) should apply to these refunds.

SECTION 6501

Limitations on Assessment and Collection — Transferee and Fiduciaries

Section 6501(c)(4) should be amended to provide for an extension by agreement of the statute of limitations for the estate tax as is now provided for other taxes.

Section 6501(c)(4) provides generally for extension by agreement between the secretary or his delegate and the taxpayer of the time for the assessment of tax. However, the estate tax provided in chapter 11 is excepted from this general rule. In many cases the estate tax is still in controversy at the end of the applicable assessment period, and provision for extension by agreement for perhaps an additional year or two would facilitate more expeditious settlement of the controversy.

SECTION 6601

Interest on an Underpayment on Form 7004

It should be made clear that, where a corporation has obtained an extension of time for filing its income tax return under section 6081(b), interest will be charged on an underestimate only to the extent that the correct first installment exceeds the amount actually paid as a first installment.

A corporation is entitled to an automatic extension of time for filing its income tax return upon the filing of Form 7004 and the payment of one-half the estimated amount of its tax. Interest is quite properly charged where the corporation's estimate of its tax is less than the tax ultimately shown on its return. However, the amount of such interest is computed on an inequitable basis. The IRS takes the position that interest should be computed as if the Form 7004 were a final return. Thus, it computes interest on the excess of the final tax over that shown on Form 7004.

The effect of the present practice is that an interest charge would be asserted under the following circumstances where no actual underpayment was involved:

Tax estimate per Form 7004	$100,000
Installment paid with Form 7004	$ 75,000
Tax per Form 1120 (final tax)	$150,000

Under these circumstances, the Treasury's position is that interest should be computed for three months on $25,000 (the difference between half the final tax and half the amount shown on the Form 7004).

The historical practice, before the enactment of section 6081(b), was to charge interest only on the difference between the correct first installment and the amount paid as a first installment. The historical practice should be the present law.

SECTION 6653

Underpayment of Tax Due to Negligence

Where there is an underpayment of tax due to negligence, the 5 percent penalty should be imposed only on the tax effect of the negligently reported items [section 6653(a)].

Under section 6653(a), a penalty of 5 percent of the total amount of any underpayment plus 50 percent of the attributed section 6601 interest is imposed where any part of the underpayment is due to negligence or intentional disregard of rules and regulations (but without intent to defraud). It seems extremely harsh to impose any negligence penalty on the total underpayment when other adjustments to taxable income unrelated to negligent reporting may have produced the greater portion of the underpayment. Therefore section 6653(a) should be amended to impose the penalty on negligent underpayment only on that portion of the underpayment that is the result of negligent reporting. The portion of the underpayment due to negligent reporting shall be the excess of (1) the tax computed after correctly reflecting the negligently reported items over (2) the tax computed without correctly reflecting the negligently reported items. All items unrelated to negligent reporting shall be correctly reflected in both (1) and (2) in the above computation.

SECTIONS 6654 and 6655

Failure to Pay Estimated Income Taxes

Sections 6654(a) and 6655(a) should be amended to provide that the addition to the tax provided in those sections should not be imposed where the failure to pay is due to reasonable cause and not willful neglect.

Section 6654 provides for an addition to the tax where an individual has failed to make timely payment of estimated tax. Section 6654(d) provides four exceptions to the imposition of the addition.

Section 6655 is comparable to section 6654 in providing for an addition to the tax when a corporation has failed to make timely payments of estimated tax. Section 6655(d) provides three exceptions to the imposition of the addition.

While the exceptions in sections 6654(d) and 6655(d) are most helpful and provide taxpayers with safe-harbor rules that eliminate the burden of periodic tax computations, a reasonable-cause provision should be included to handle the situations when a taxpayer may be subject to a situation for reasons virtually beyond its control.

For example, an individual could become very ill, suffer a stroke or heart attack, and be incapable of handling normal business affairs. This would not be acceptable to avoid the underpayment of estimated tax penalties.

The IRS could mistakenly refund an overpayment the taxpayer had clearly marked to apply to next year's estimated tax, and the taxpayer could unwittingly cash the refund rather than return it for credit.

Virtually every other Internal Revenue Code section that provides for a penalty has a reasonable-cause provision (section 6651 regarding filing return and paying tax, section 6677 regarding foreign trusts, section 6652 regarding information returns, section 6678 regarding furnishing of statements, section 6656 regarding deposit of taxes, etc.).

It is recommended, therefore, that sections 6654(a) and 6655(a) be amended to provide similar reasonable-cause provisions.

SECTION 6654

Exceptions to Penalty for Underpayment of Estimated Tax

Section 6654(d)(4) should be amended to provide an exception to underpayment of estimated tax penalty where the taxpayer was not required to file a return for the prior year because of insufficient gross income.

Section 6654(d) provides for exceptions to the penalty provisions for underpayment of estimated tax. Section 6654(d)(4) relieves the taxpayer from any penalty if the taxpayer pays an amount equal to the current-year tax on the basis of the current-year rates, exemptions, and status but otherwise on the basis of the facts shown on the return and the law applicable to the preceding year. The regulations indicate that a return must have been required for the preceding year.

This can be a trap for taxpayers who were not required to file a return for the prior year but have taxable income for the current year. Such taxpayers could include young people filing for the first time and older people with unusual nonrecurring income, perhaps due to the sale of assets.

SECTION 6694

Understatement of Taxpayer's Liability by Income Tax Return Preparers

Section 6694 should be amended to make it clear that only the code and regulations are indicated in the term "rules and regulations" and rulings are not included.

Regulations paragraph 1.6694(2)(3) provides that the rules and regulations that are to be taken into account for the purposes of section 6694(2) of the code include those revenue rulings that have been published in the *Cumulative Bulletin*.

Regulations are governed by stringent procedures, calling for public review and comment. Regulations are issued in proposed form and are subject to comment by interested parties and even public hearings. On the other hand, rulings are the Internal Revenue Service's opinion about the application of the law to a usually limited and sometimes extreme set of facts. While subject to the government's internal review procedures, they are not required to undergo public scrutiny before issuance.

The committee reports on the Tax Reform Act of 1976 provide that the same rules for negligent or intentional disregard of the rules and regulations under section 6653(a) should apply to the return preparer rules under section 6694(2). The terminology "rules and regulations" is the same under sections 6653 and 6694. In *Lang*, 64 T.C. 404, 406-7 (1975), a case involving section 6653(a), the court stated that revenue rulings are simply the contention of one of the parties to the litigation and entitled to no greater weight. While regulations are only rarely declared invalid, rulings are frequently either revoked or ignored by the courts.

On May 11, 1980, Internal Revenue Service Commissioner Jerome Kurtz wrote to Congressman Danielson in connection with the then pending amendments to the Administrative Procedures Act, stating in part, "Revenue Rulings may be cited as precedent by both taxpayers and Service personnel. However, they are not intended to, and do not have the force and effect of regulations." This is correct, and rulings should not be equated with regulations under section 6694.

The practical problems of applying the thousands of published rulings, issued at the rate of approximately 500 a year, impose an unrealistic burden on preparers.

SECTION 6696

Rules Applicable With Respect to Sections 6694 and 6695

Section 6696 should be amended by repealing section 6696(b) to allow tax return preparers to appeal the assessment of preparer penalties to the Tax Court.

Section 6696(b) provides that the deficiency procedure for income, estate, gift, and certain excise taxes shall not apply with respect to the assessment or collection of the return preparer penalties of sections 6694 and 6695. As a result, tax return preparers must pay any assessed penalties, file claims for refund, and then bring suit in either the district courts or the Court of Claims.

Due to the formalized procedural rules of these courts, a return preparer generally would have to employ legal counsel to contest the penalty. The legal costs in such a case would amount to far more than the penalty. However, the informal rules of the Tax Court, especially the Small Case Division, would permit the tax return preparer to represent himself in contesting the penalty.