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TAX PLANNING TECHNIQUES FOR INDIVIDUALS

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STUDIES IN FEDERAL TAXATION

TAX PLANNING TECHNIQUES FOR INDIVIDUALS

By Stuart R. Josephs, CPA

Published by the
American Institute of Certified Public Accountants

TAX PLANNING TECHNIQUES FOR INDIVIDUALS

TAX STUDY
NO. 2

TAX PLANNING TECHNIQUES FOR INDIVIDUALS

By Stuart R. Josephs, CPA
Arthur Young & Company

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Tax Planning Techniques for Individuals

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Foreword

In the interim between publication of Tax Study No. 1 ("Tax Guide for Incorporating a Closely Held Business") and Tax Study No. 2, it is an oversimplification to say that a great deal has happened in the field of federal taxation. The most momentous "happening" was, of course, the passage of the 1969 Tax Reform Act.

"Tax Planning Techniques for Individuals" (as well as other studies) had already been conceived and was on the way towards publication when the first tremors of what was to become the Tax Reform Act of 1969 were felt. At this point the Institute's Tax Publications Committee decided that it would be best to withhold publication of all future studies until the changes to be wrought by the passage of the TRA could be assessed.

With hindsight as a guide, I know that this was a very wise decision. Even as the book was being rewritten, aftershocks occurred in the form of regulations, rulings, and so forth, which were being issued by the Internal Revenue Service. For example, changes such as the increased mileage allowance or the updated Treasury tables for valuing life interests have been incorporated into the study even though these are post June 30, 1970, developments — our cut-off date for this publication. However, all post cut-off date changes were limited to those which our publication schedule would allow.

For the monumental effort required to bring out a book of this nature so soon after major legislation, we are deeply indebted to the author, Stuart R. Josephs, CPA, Arthur Young & Company, Milwaukee, Wisconsin. His tireless energy and unselfish devotion to every aspect of this study cannot be praised too highly.

I also wish to acknowledge the efforts of Joel M. Forster, CPA, Manager, Special Projects, Division of Federal Taxation, who has worked very closely with Mr. Josephs on this study. Finally, a word of thanks is in order for Mrs. Katharine Coveleski of the Institute's publications division.

The following members of the Tax Publications Committee of the Division of Federal Taxation assisted in an advisory capacity: Neil B. Glenn, CPA; John N. Kamp, CPA; Robert J. Mooney, CPA; and Raynard M. Sommerfeld, CPA.

GILBERT SIMONETTI, JR., *Director*
Division of Federal Taxation

Introduction

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Chapter 1

Introduction

101 Scope of Tax Study

This tax study is concerned with recognized techniques for minimizing the federal tax impact upon individuals through sound and effective planning. It is not intended to, and cannot, be an all-inclusive, detailed prescription for remedying every tax "illness." However, such a study can serve (and has been so designed) as a compilation of *selected* practices which might alleviate the individual's tax burden.

The thrust of this text will be to spotlight certain areas where these planning techniques can be applied. For purposes of this study, only the highlights of such techniques are described, in view of the direct conflict between practical space limitations and the nature of our subject matter. This broad-brush approach necessarily precludes a self-sufficient technical presentation. Instead, a background discussion accompanies each technique in only enough detail to summarize pertinent opportunities and pitfalls.

In addition, taxation and its mitigation are in a constant state of evolution. Therefore, this discussion must be related to the state of taxation as it existed on June 30, 1970. Further, the individuals under study herein are limited to resident citizens of the United States of America (exclusive of United States possessions), reporting on the calendar year basis and utilizing the cash receipts and disbursements method of accounting. Moreover, tax consequences arising solely from residence in community property states will not be considered.

The tax planning techniques discussed in this study follow the assumed economic life cycle of an individual. First, gross income is produced and exposed to taxation. Accordingly, Chapter 2 is concerned with greater retention of this income by minimizing the income tax

imposed upon it. Resulting estate and gift tax consequences are also considered, where appropriate.

The production of income invariably gives rise to a host of expenditures, some of which can be favorably utilized to further minimize income taxes by providing deductions against income subject to tax. Chapter 3 deals with maximizing many of these deductions through effective planning.

Finally, the financially successful individual may desire to transmit his affluence, to the greatest extent possible, to the objects of his bounty (i.e., family and philanthropies). Implementation of this objective should begin during the individual's lifetime through planning involving transfers of property to these beneficiaries. As described in Chapter 4, these transfers should decrease income, estate, and gift taxes and thereby increase the amount of property available for such transfers.

At the same time, such an individual might also be interested in various tax "shelters." Two of these *modi operandi*, real property and farm operations, are discussed in Chapter 5.

The appendix contains a questionnaire entitled "Check List of Tax Planning Techniques for Individuals."

All statutory references are to the Internal Revenue Code of 1954 unless otherwise indicated.

102 Tax Planning for Individual Taxpayers

Tax planning is essentially a rescue operation which attempts to salvage the greatest financial yield from economic transactions that, presumably, would occur with or without the existence of the Internal Revenue Code. As we shall observe, the Internal Revenue Service and the courts effectively eradicate tax benefits created through transactions which are concocted solely for the purpose of obtaining these benefits.

Consequently, the tax-planning techniques discussed in this monograph revolve around the economic activities typically engaged in by American taxpayers. These activities and their related tax techniques can be broadly classified among the following functional roles:

1. Executives and other employees.
2. Investors.
3. Professional and other self-employed persons.

The balance of this section is devoted to some introductory generalizations regarding tax-planning objectives and opportunities for each of these categories.

102.1 Tax Planning for Executives and Other Employees

Planning for taxpayers in their capacity as executives or employees will be focused upon tax-saving opportunities that may stem from employment-connected transactions. Within this widespread sphere of taxpayer endeavor, a distinction should be drawn (and continually recognized) between those executive-employees who control their employer (e.g., principal shareholders) and those who do not. Obviously, the former category will have far more latitude in arranging employer-employee transactions and any attendant tax benefits.

Taxpayers whose predominant source of income is derived from the performance of services, as employees, can attempt to increase their "take-home pay" through such measures as fringe benefits (see 201.2), partial conversion of ordinary compensation income into long-term capital gains (see 203), and the deferment of income until lower-bracket years such as retirement (see 204).

Employee-taxpayers, of course, should also be concerned with conserving their retained earnings by adopting techniques permitting certain of their necessary expenditures to be shared with the public treasury. In this regard, Chapter 3 may be helpful, particularly 304.

Employees are also naturally involved in other activities, in common with other types of taxpayers — e.g., disposing of their personal residences. Accordingly, other parts of this study may be of equal interest (e.g., see 201.1 and 204.1).

Finally, through a combination of success and longevity, employees may begin to amass wealth so that their tax planning must expand to encompass considerations applicable to investors (see 102.2). Of course, at this phase of their economic cycle, such employees could be placed among the relatively more affluent members of our society and may find useful various techniques described in Chapter 4.

102.2 Tax Planning for Investors

The tax hallmark of this residual category of taxpayer is the derivation of income through employment of capital instead of personal services (the converse of the situation encountered for the other two taxpayer categories discussed herein). Therefore, investors are deemed to earn their income *passively*, as opposed to employment-connected earnings of executives, other employees, and self-employed persons that are *actively* derived through the performance of services.

Taxpayers deriving substantial income through the employment of their capital may find the full spectrum of this tax study to be of interest, except those portions dealing exclusively with employees (102.1) and self-employed persons (102.3).

102.3 Tax Planning for Professional and Other Self-Employed Proprietors or Partners

Self-employed persons are actually a hybrid between employees and investors since self-employment income is produced by combining the performance of services with the deployment of capital. However, by definition, self-employed persons must function in noncorporate capacities. In contrast, employees and investors may usually derive most or all of their income from corporate operations.

The salient tax characteristic of self-employed persons that will be emphasized in this study is their employment by noncorporate business entities, and the consequent tax advantages available to such taxpayers as distinguished from those available to executives and other employees. The different treatment of these two types of taxpayers is occasioned, of course, by the Internal Revenue Code's recognition of the corporation as a taxable "person," completely distinct from its shareholders, executives and other employees. This *total* separation is not to be found in the Code regarding a noncorporate business enterprise and its owners, even though they serve as executives or employees of such a business, since sole proprietorships and partnerships are frequently not viewed as separate entities for income tax purposes.[1]

As a result, tax-planning techniques for self-employed individuals cannot simply be a matter of combining the techniques available for employees and for investors. Rather, they constitute, with regard to business operations, an entirely separate discipline which is beyond the scope of this study.

On the other hand, self-employed retirement plans are quasi-personal in nature and are considered in 305.1.

Last, but certainly not least, it should be stressed that the self-employed may also be involved in other activities, paralleling those of other taxpayers. As was mentioned in 102.1 regarding employees, all

[1] For example, "the development of partnership tax law has frequently been hindered by conflicting theories as to the nature of a partnership. There are two opposing theories: (1) the aggregate approach, and (2) the entity approach . . . " Mertens, *Code Commentary,* Secs. 701-771:2.

types of taxpayers may experience similar situations, such as disposing of a residence or attempting to transmit as much wealth as possible to the objects of their bounty. Therefore, self-employed individuals, in their capacities as United States taxpayers in general, may find other parts of this tax study to be of interest (such as those not specifically dealing with employees as such).

103 Taxes Involved

103.1 Federal Income Tax

The tax imposed by the United States upon the taxable income of individuals, with its steeply graduated rates (ranging from 14 to 70 percent), is certainly a major, if not the predominant factor in the formulation of many economic transactions. Consequently, this same tax is the predominant subject of this study, with planning considerations involving income taxes being devoted solely to federal income tax.

NOTE. The 10 percent minimum tax (see 105.1) is generally ignored in subsequent calculations, considerations, and so forth, involving tax rates. Similarly ignored is the tax surcharge expiring June 30, 1970.

This graduated rate structure is superimposed upon an annual accounting concept. Thus, these rates are *not* cumulatively applied to an individual's lifetime income. The absence of such a unified (or aggregate) income tax system creates planning opportunities for equalizing annual tax brackets (as further discussed in 104). Further planning opportunities may also be present for those situations in which the maximum rate on earned income might be applicable. See 105.2.

103.2 Federal Estate and Gift Taxes

Accumulated net (after income tax) income may be exposed to the United States estate tax upon a taxpayer's death, or subject to federal gift tax if transferred during his lifetime. The consequences of these two transfer taxes constitute appropriate related themes of this tax-planning study. It should be noted that federal estate and gift taxes are not confined to property consisting of accumulated taxable income, but reach many other property interests owned by individuals, without regard to how they were acquired (i.e., whether through prior gift, inheritance, accumulated exempt income, and so forth).

103.3 State and Local Income, Estate, Inheritance, and Gift Taxes

Obviously, consideration of the effects of the various taxes imposed by the host of state and local taxing jurisdictions existing within the United States is beyond the scope of a study of this nature. Of course, state estate and/or inheritance taxes, as well as gift taxes in the states that levy them, can be significant and should not be dismissed lightly. State and local income taxes, even though deductible for federal (and, possibly, state and local) income tax purposes, are also worthy of contemplation.

104 Equalizing Tax Brackets

The progressive rate structure of our federal income, estate, and gift tax system generates enormous motivation to equalize income tax brackets between years, and to equalize estate tax brackets with gift tax brackets.

The Internal Revenue Code of 1954 (Secs. 1301 through 1305) provides some assistance in equalizing income tax brackets. However, it may be possible for taxpayers to achieve more effective equalization of income tax brackets, as well as estate and gift tax brackets, by proper timing of tax-affecting transactions. Income tax equalization, both statutory and man-made (i.e., taxpayer-originated), is discussed in greater detail below. Estate and gift tax equalization will be discussed further in Chapter 2.

104.1 Statutory Income Averaging

Planning Technique

Shift income to a year in which a favorable averaging computation applies to take advantage of a lower effective tax rate.

It may be advantageous to increase a current year's taxable income where favorable base-period average income exists, particularly if the prior years' relatively small average income is attributable to the low income of the older base-period years—which will expire shortly.

Possible Applications

1. Enabling income to be taxed at lower current rates even though not needed for personal or business purposes until future years, when higher rates may prevail.

2. Obtaining income currently which will otherwise be received in future years at higher rates.
3. Transferring income at lower rates to achieve collateral tax benefits.

These applications are exemplified later herein.

Planning Considerations

Standard vs. Itemized Deductions. Since Sec. 1301 requires averageable income to exceed $3,000, it might be advantageous in some situations to forego itemized deductions in favor of the standard deduction in order to qualify for income averaging.

Illustration 1

Line		Single Client's 1970 Tax: Itemized Deductions	Single Client's 1970 Tax: Standard Deduction
1.	Adjusted gross income	$19,635	$19,635
2.	Less deductions and $625 exemption	1,635	1,625
3.	Taxable income	18,000	18,010
4.	Less 120% of average base period income	15,000	15,000
5.	Averageable income	$ 3,000	$ 3,010
6.	Tax on line 3	$ 5,170*	$ 5,115†
		5,115	
7.	Tax savings	$ 55	

*Averaging *not* available.
†Averaging available.

In this situation, a $10 decrease in deductions results in a $55 tax reduction. It should be noted that deductions were decreased through Code-authorized selections, without "waiving" allowable deductions, and thus within the purview of Sec. 63 (which, in general, defines taxable income as gross income less deductions allowed by Chapter 1 of the Code).

NOTE. Sec. 144(d) allows the election of both averaging and the standard deduction. However, Sec. 141 (a) requires the standard deduction, if elected, to be the *larger* of the percentage standard deduction or the low income allowance. See 301.1.

Procedural Aspects. Data regarding the amount of average base-period adjusted taxable income should be readily available for (1)

current year planning and (2) tax return preparation.

Therefore, the maintenance of continuous running averages appears quite advisable. One way of accomplishing this objective is to prepare an advance copy of Schedule G (Form 1040), to the extent possible, when a tax return is prepared.

For example, at the completion of the 1970 return, a blank Schedule G should be modified to reflect 1971 as the current (computation) year and 1967-1970 as the base period. The first two parts of this advance schedule should then be completed with regard to its respective base period. This procedure will thus make the necessary data readily available for 1971 planning purposes.

In addition, this procedure will facilitate preparation of the 1971 return by automatically extracting base-period information from the files in order (1) to determine whether income averaging applies, and, if so, (2) to easily provide the necessary prior years' data for the 1971 Schedule G actually filed with Form 1040.

Planning Techniques Illustrated

EXAMPLE. CPA prepares an advance Schedule G which reveals the following:

	Taxable Income
1966	$ 2,000
1967	10,000
1968	10,000
1969	10,000

Client anticipates his minimum adjusted taxable income to be $15,000 for 1970 through 1974. Therefore, the expected maximum ordinary tax rates (on a joint return basis) will be:

1970	22%	(Income averaging)
1971-1974	25%	(Not eligible)

Thus, the presence of potentially lower current year (i.e., 1970) tax rates affords an opportunity to realize the following advantages (where relevant).

(1) *Accelerate income needed for future personal or business purposes.* Client needs $10,000 for part payment on a personal residence to be purchased on January 2, 1971. He has earned a bonus for services to his employer which can be paid either in December 1970, or January

1971. In view of the tax rates prevailing above, Client should receive his bonus by December 31, 1970.

(2) *Shift income otherwise taxable at higher rates.* On December 1, 1970, Client (as a sole proprietor) consummates a $100,000 installment sale for certain fully depreciated equipment (and provides for 4 percent simple interest per annum payable with each installment of principal, to avoid imputed interest under Sec. 483 and any related effect upon qualification for installment sale treatment). As a result of depreciation recapture under Sec. 1245, the entire gain of $100,000 will be taxable as ordinary income. The buyer wishes to make a 25 percent initial payment January 1, 1971. Client should instead seek to obtain this initial payment on December 1, 1970, to take advantage of the opportunity to average afforded by the low-base-period year 1966, which is about to expire.

Similar factors should be considered in connection with timing income from fiscal-year personal-holding-companies and electing small business (Subchapter S) corporations.

Also see 104.2 for other ways of moving income into lower bracket years as well as for the monetary effects of such action.

(3) *Transferring income to achieve collateral tax benefits.* CPA advises Client that one of his wholly owned calendar-year corporations is vulnerable to the Sec. 531 accumulated earnings tax for 1970 and, consequently, it would be advisable to declare a dividend to lessen this exposure. Under the facts assumed above, a dividend payable prior to December 31, 1970, would be of greater benefit than one paid by March 15, 1971 (under the "75 day rule" of Sec. 563(a)).

Limitation. Averaging is inapplicable to downward fluctuations of income. Averaging applies if the current year's income exceeds the average income of the four immediately preceding years by prescribed amounts. (See Technical Resume below.) There are no present statutory provisions, of general applicability, for averaging income in the converse situation, i.e., where the current year's income is substantially below the preceding four years' average income. Thus, two individuals with identical five-year taxable incomes (and tax status) would not pay the same taxes if such incomes were derived in opposing sequences, as shown in Illustration 2, page 12.

Technical Resume

Code Secs. 1301-1305 offer limited relief from the progressive income-tax rates by providing an averaging mechanism under certain restricted

Illustration 2

Year	Individual A	Individual B
1964	$ 10,000	$ 50,000
1965	20,000	40,000
1966	30,000	30,000
1967	40,000	20,000
1968	50,000	10,000
Totals	$150,000	$150,000

circumstances. Generally, these sections provide for the averaging of income over a five-year period where the current year's income exceeds 120 percent of the average of the four prior years' incomes and such excess current year's income also exceeds $3,000. This excess current year's income is known as "averageable income." Only the following two categories of income are not eligible for averaging:

1. Certain premature or excessive distributions from self-employed retirement plans.
2. Accumulation distributions received from trusts which are subject to the throwback rules.

Schedule G (Form 1040) provides a determination of tax, if statutory income-averaging applies, in which only one-fifth of the averageable income is included in a tentative tax computation. (For this purpose, averageable income is not reduced by the above $3,000 eligibility requirement.) The tax attributable to this one-fifth portion is then multiplied by five to obtain the actual tax on this income. Thus, in effect, statutory income averaging permits a fivefold expansion of each income tax bracket that is used to tax averageable income.

Although only the two categories of income mentioned above are not eligible for income averaging, there are certain tests which the taxpayer must meet to be eligible. These technical limitations are as follows.

Eligibility Confined to Members of the Labor Force. Sec. 1303(c) requires an individual (together with his spouse) to have furnished at least 50 percent of his support during each of his four base-period years in order to be currently eligible for income averaging. However, three exceptions to this rule are provided, as follows:

Unemployed Non-Students Over 25: Individuals who have attained age 25 before a computation year ends may elect income averaging, even

though they have not met the above support test, if they were not full-time students during at least four taxable years — beginning after attaining age 21 and ending with the current (computation) year.

Major Accomplishment Rule: Another exception for individuals failing to qualify under the 50 percent minimum support test (above) permits income averaging where more than 50 percent of such an individual's adjusted taxable income for a current (computation) year is attributable to work performed by him in substantial part during at least two of his four base-period years.

Spouse Supported by Others: The final exception to the general (at least 50 percent) support test applies to an individual filing a joint return if not more than 25 percent of the joint adjusted gross income is attributable to such individual.

Marriage-Related Problems. In order to obtain consistency between a current (computation) year and its four prior base-period years, Sec. 1304(c) provides special rules for reconstructing the income of a husband and wife if (1) they filed separate returns for any base-period year or will file separately for the current year or (2) they were married to other spouses during any base-period year.

Other Limitations. A taxpayer who elects to income-average is precluded by Sec. 1304(b) from using the following Code provisions which may also be beneficial to him:

1. Optional tax tables.
2. Alternative capital gains tax computation (203).
3. 50 percent maximum tax rate on earned income (105.2).
4. Exclusion for income earned without the United States or within its possessions.
5. Special five-year "forward" averaging computation for certain lump-sum distributions from qualified self-employed retirement plans (305.1).
6. Special seven-year "forward" averaging computation for portions of lump-sum distributions from qualified employee plans attributable to employer contributions for plan years beginning after 1969 (which are no longer eligible for long-term capital-gain treatment). (See 203.1.)

Miscellaneous Considerations

Required Election Made Through Use of Designated Forms. Sec. 1304(a) permits income averaging only if a taxpayer chooses its benefits

for a particular year. Regs. Sec. 1.1304-1(a) requires this choice to be made by filing Form 1040 for such year, accompanied by Schedule G.

This choice can be made for any year (after 1963) that is still open to claim for refund or credit.

Effect of Net Operating Loss Carrybacks. A carryback to a computation year will reduce averageable income and thus increase the tax for such year. This, in turn, reduces the refund generated by the carryback.

A carryback to a base year, of course, requires a recomputation of such prior year's taxable income and tax to derive the usual refund or credit. The resulting reduction of this base-year's taxable income will also lower the average income for the pertinent base period, thus increasing averageable income for the appropriate current (computation) year. Therefore, the current year's tax should also be recomputed in order to obtain any resulting additional refund or credit.

104.2 Controlling Taxable Income Between Years by Accelerating or Postponing Income and Deductions

Broad Planning Perspective

In situations where statutory income averaging is unattainable or in order to compound its favorable effects, a client can take various steps on his own, with the advice of his CPA, to avoid undue fluctuations of his annual taxable incomes. This leveling-off of income over a span of time will mitigate the harshness of the progressive rates. Of course, it should only be considered where a net economic *(or overall) gain for the client will result.*

Such a smoothing-out process can be accomplished by increasing taxable income through (1) accelerating income and/or (2) postponing deductions.

Conversely, taxable income can be decreased through reversing this process (i.e., by postponing income and/or accelerating deductions).

Directing the Flow of Income and Deductions to Particular Years

Since cash-basis taxpayers recognize income and deductions upon their actual receipt or disbursement, the timing of these transactions —

to the extent within a client's control — will affect the amount of taxable income reportable for particular years. Moreover, the recognition of income may also be affected by the "constructive receipt doctrine." (However, a counterpart "constructive payment doctrine" is *not* generally available for reporting deductions, as explained below.)

The following are several techniques that might be employed towards achieving effective timing of income and deductions.

Accelerating Income. Where business conditions permit, a client can request the receipt of deposits or other advance payments prior to the end of his taxable year. If possible, these deposits should be non-refundable.

If, for some reason, it is not possible for income to be actually reduced to a client's possession, consideration should be given as to whether the constructive receipt doctrine can be invoked to, nevertheless, recognize such income currently.

In this regard, Income Tax Regs. Sec. 1.451-2(a) provides, in pertinent part, as follows:

> Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions . . . .

In the event that a refundable deposit is reported as income upon receipt and is refunded in a subsequent year, the benefits of Sec. 1341 (relief computations under the "claim of right doctrine") would not appear to be available for this later year. Under Sec. 1341 (a)(1), the claim of right doctrine applies where an item is previously included in gross income because of an apparent unrestricted right to such item. Therefore, the restrictions governing a refundable deposit would seem to remove such deposits from the ambit of Sec. 1341.

Postponing Deductions. Although cash-basis taxpayers can obviously and simply defer physical payment of deductible disbursements, such action must also be viewed within the context of realistic financial possibilities. Therefore, the matter of postponing deductions for tax purposes must also be concerned with the inherent business exigencies and legal requirements that would be involved in such a decision.

Postponing Income. There are various situations in which income may be postponed. See the discussion of deferred income in 204 particularly:

204.3 Restricted property
204.6 Installment sales
204.14 Avoiding actual or constructive receipt of unwanted income

Accelerating Deductions. The deductions which we are concerned with here are the four major categories of itemized deductions—namely, medical expenses, contributions, taxes, and interest. The postponement or acceleration of deductions should also be considered in conjunction with the use of the standard deduction, as more fully described in Chapter 3. The timing of business-connected deductions is beyond the scope of this study.

Medical Expenses: Since expenses for medical and dental services rendered, as well as for medicine and drugs purchased, are allowable as deductions when paid, a client can determine, to some degree, the year for deducting such expenses by the mere timing of his payments. Of course, he will have more latitude in exercising this discretion in the case of services performed towards the end of a year (where payment can more easily be extended into the following year).

The existence of the one percent and 3 percent (of adjusted gross income) limitations on the deductibility of medical expenses strongly compels proper attention to the timing of medical payments. Accordingly, they should be concentrated in a year in which the limitations have already been exceeded as opposed to a year in which such payments would be wasted by these statutory obstacles.

However, payments for medical services to be performed in a future year are not deductible in the year of payment. See *Robert S. Bassett*, 26 TC 619, where, in a decision reviewed by the Tax Court, Sec. 23(x) of the Internal Revenue Code of 1939 was construed to allow medical deductions *only* for expenses incurred and paid in the taxable year. The Court held that "expenses are not incurred in the taxable year unless a legal obligation to pay has arisen . . . ." However, deductions were allowed for expenses incurred in prior years and paid in the year under review.

Sec. 213(a) of the 1954 Code contains language substantially identical, insofar as is here pertinent, to its predecessor Sec. 23(x) with respect to the allowance of a deduction for *expenses paid* during a year. Therefore, the Bassett decision could leave taxpayers, who might make such advance medical deposits, in the unfortunate position of being unable to

obtain *any* deduction for these expenditures, *either* in the year of payment *or* in the year in which they are incurred. (See Mertens, *Law of Federal Income Taxation*, Vol. 5, Sec. 31A.07a, footnote 44.)

Contributions: Sec. 1.170-1 (b) states, in part, in regard to the time of making a contribution, that "ordinarily a contribution is made at the time delivery is effected. In the case of a check, the unconditional delivery (or mailing) of a check which subsequently clears in due course will constitute an effective contribution on the date of delivery (or mailing). . . ."

Thus, the year in which contributions can be claimed as deductions is, to a very large extent, within a client's control. Contribution deductions generally are subject to maximum limits of 20 percent and 50 percent of adjusted gross income for "private" and "public" charities, respectively. However, contributions of appreciated property to public charities are only eligible for a 30 percent limitation unless an election to take appreciation into account is made under Sec. 170(b)(1)(D)(iii). In such case, the 50 percent limit will apply.

In any event, a five-year carryover period is available for all excess contributions to public charities. (See 401.4.)

Taxes: The payment of an otherwise deductible tax will permit its deduction in the year paid. In addition, *advance* payments of tax, if pursuant to law (or otherwise "bona fide" because of express administrative approval and consent), are also deductible when paid. [2]

Interest: Payment of current interest (i.e., due and payable) is deductible upon disbursement. (However, interest deductions attributable to investments by noncorporate taxpayers after 1971 will be subject to certain limitations if the deduction exceeds $25,000, as described in 306.1. Prior thereto, all such interest constitutes a tax preference for the new 10 percent minimum tax (effective for years ending after 1969).) (See 105.1). In addition, the deduction of prepaid interest is subject to the following rules prescribed by Rev. Rul. 68-643 (1968-2 CB 76).

(1) Interest paid for not more than 12 months in advance — "a deduction for interest paid in advance on each indebtedness for a period not in excess of 12 months of the taxable year immediately following the

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[2] *First National Bank of Mobile (Lowenstein Est.)*, 12 TC 694, acq. 1949-2 CB 2, aff'd on other grounds, CA-5, 50-2 USTC ¶9372; *Glassell*, 12 TC 232, acq. 1949-2 CB 2; IT 4054, 1951-2 CB 36. Also see Rev. Rul. 56-124, 1956-1 CB 97.

taxable year in which the prepayment is made *will be considered on a case by case basis* to determine whether a material distortion of income has resulted . . . ." (Emphasis supplied.)

Some of the factors to be considered in determining whether the deduction of prepaid interest gives rise to a material distortion of income include but are not limited to:

- Amount of income in the taxable year of payment.
- Income of previous taxable years.
- Amount of prepaid interest.
- Time of payment.
- Reason for prepayment.
- Existence of varying interest rate over the term of the loan.

(2) Prepayment for more than a year in advance — "if interest is prepaid for a period extending more than 12 months beyond the end of the current taxable year, the deduction of such prepaid interest in the taxable year of payment *will be considered as materially distorting income* . . . ." (Emphasis supplied.)

(3) Application of Rev. Rul. 68-643 — "if a material distortion of income has been found to result from the deduction of prepaid interest, the Service will require the taxpayer to change his method of accounting with respect to such prepaid interest *in order to allocate it over the taxable years involved* . . . ." (Emphasis supplied.)

However, this Ruling will not be applied retroactively to prepayments for not more than five years in advance if made (1) prior to November 26, 1968 or (2) on or after November 26, 1968, pursuant to a legal obligation incurred prior to such date (to make said payment).

The Service will no longer follow the contrary decisions in *Fackler* and *Court Holding Co.*[3] Acquiescence in each of those decisions has been withdrawn and nonacquiescence substituted.

For an example of prepaid interest fully deductible when paid, see Rev. Rul. 69-582 (1969-2 CB 29) which involved a $1,200 loan processing fee (points) determined to be interest. Such a deduction was not considered to materially distort income.

Constructive Payments: Since the "constructive receipt doctrine" can be used in determining when income is recognized, the question arises as to whether a "constructive payment doctrine" may be similarly utilized for reporting deductions.

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[3] *John D. Fackler*, 39 BTA 395 (1939) and *Court Holding Co.*, 2 TC 531 (1943).

One commentator's partial response to this query is as follows:

> ... Under the doctrine of constructive receipt a taxpayer on the cash basis is taxed upon income which he has not as yet actually received. Logically it would seem that, where the payee is held to have constructively received an item as income, the payor should be entitled to deduct the same item as constructively paid, but the statute rather than logic is the controlling force in tax cases and so it is not surprising to find such reasoning usually rejected. The difference is that the Code is presumed to reach and tax all income, and the doctrine of constructive receipt is an aid to that end. It must be remembered that the doctrine of constructive receipt was originally designed to effect a realistic concept of realization of income and to prevent abuses. Deductions, on the other hand, are generally considered to be matters of legislative grace, and the terms of the Code permitting the particular deduction must be fully met without the aid of assumptions. "What may be income to the one may not be a deductible payment by the other."
>
> ... *As a practical matter it is clear that a cash basis taxpayer cannot safely rely on a theory of constructive payment to determine when items may be deducted.* The very nature of the theory is such that it evokes little sympathy from courts which are alert to plug loopholes and to increase the effectiveness of the taxing acts. The statement is still frequently found that "constructive payment is a fiction applied only under unusual circumstances" .... [Mertens, *Law of Federal Income Taxation,* Sec. 10.18; emphasis supplied.]

Monetary Factors

Inasmuch as taxation does not exist in a vacuum, completely divorced from other economic facts of financial life, tax planning—while vitally concerned with the tree of tax savings—should always be cognizant of the forest of overall net after-tax economic gain or loss for any suggested transaction. Consequently, adequate compensation for the use of money should be a significant factor in the planning process.

Thus, the acceleration of income may require a compensating monetary adjustment by the client to the payor for his premature payment. If the payor does not require such interest, income acceleration would further benefit the client by supplying him with interest-free funds. Similar monetary relationships pertain to the postponement of deductions.

On the other hand, an interest factor should always be weighed when the deferral of income or the acceleration of a deduction is contemplated. Of course, the inability to secure sufficient compensation for losing the immediate use of the funds involved will lessen the ultimate economic gain to be derived from the potential tax reduction.

However, these nontax consequences can be minimized if the acceleration or deferral period is kept to a minimum. For example, the shift of a property tax payment from January 1, 1971, to December 31, 1970, should have virtually no nontax effect in contrast to a 1969 prepayment of a charitable contribution pledge not due until 1975.

Absorption of Expiring Carryovers

A collateral benefit of controlling the influx of taxable income between years can be obtained by preventing the wastage of expiring carryovers.

EXAMPLE 1: *Net operating loss carryover.* Client sustained a $75,000 net operating loss in 1965 and has used $35,000 of such loss through carrybacks to 1962-1964 and carryovers to 1966-1969. Therefore, 1970 is the last year in which the remaining $40,000 loss can be deducted. However, computations by his CPA in early December 1970 reveal the information shown in Illustration 3 below.

Illustration 3

	Actual (Through November)	*Estimated (December)*	*Total (1970)*	*Estimated (1971)*
Commissions	$25,000		$25,000	$10,000
Interest on redemption of U.S. Series E bonds (acquired in 1958)				15,000
Rent (net lease)				36,000
Adjusted gross income	$25,000		$25,000	$61,000
Interest expense	$ 1,900		$ 1,900	
Property tax		2,000*	2,000	
State income tax	475	1,000*	1,475	
Contributions		2,000	2,000	
Exemption	625		625	
Taxable income	$22,000	$ (5,000)	$17,000	

*Due January 1971

On the basis of these facts, CPA makes the following recommendations:

1. Pay property tax, state income tax, and contributions in January 1971 rather than in December 1970.
2. Redeem Series E bonds in December 1970.
3. Induce the lessee (through a 2 percent discount against the February

1971 rent) to pay the January 1971 rent of $3,000 on December 31, 1970.

Client's ensuing 1970 income tax return should disclose the following results:

Commissions	$25,000
Interest	15,000
Rent	3,000
Gross income	$43,000
Less — net operating loss carryover	40,000
Adjusted gross income	$ 3,000
Less — interest expense, state income tax, and exemption	3,000
Taxable income	$ None

EXAMPLE 2: *Contributions carryover.* Client expects to earn $10,000 in 1970. He has a contributions carryover from 1965 of $7,500 and plans to make contributions of $1,000 in December of 1970. In addition, he intends to redeem Series E bonds in 1971 on which he has elected to defer reporting interest. The bonds will have accrued interest of $5,000 upon redemption in 1971 (as reflected in Illustration 4, page 22).

CPA thereupon suggests the following steps to Client:

1. Redeem the Series E bonds in 1970.
2. Make the $1,000 contribution in 1971.

Client's 1970 return should then reflect the following results:

Salary	$10,000
Interest	5,000
Adjusted gross income	$15,000
Contributions: carryover from 1965	$ 7,500
Allowable (limited to 50% of $15,000)	$ 7,500

CPA's suggestions will enable Client to fully utilize his 1965 carryover and, accordingly, obtain $8,500 in allowable deductions for 1970-1971 as opposed to only $5,000 as originally contemplated. (This $3,500 additional deduction represents, of course, the nondeductible portion of the 1965 carryover that would have expired under the original facts.)

EXAMPLE 3: *Investment credit carryover.* The Tax Reform Act of 1969 repealed the investment credit after April 18, 1969, with certain exceptions. However, unused credits can be carried back three years and

Illustration 4

Line	Actual (Through November)	Estimated (December)	Total (1970)	Estimated (1971)
1. Salary	$10,000		$10,000	$10,000
2. Interest on redemption of Series E bonds				5,000
3. Adjusted gross income	$10,000		$10,000	$15,000
Less: cash contributions to "public" charities:				
4. Paid currently	$	$ 1,000	$ 1,000	
5. Carryover from 1965	7,500		7,500	
6. Total	$ 7,500	$ 1,000	$ 8,500	
7. Allowable (limited to 50% of line 3)			5,000	
8. Carryover to 1971 (line 6 less line 7)				$ None*

* Pursuant to Sec. 170(d)(1)(A), the current payment of $1,000 is first applied against the 50% limitation of $5,000. There thus remains only $4,000 of limitation against which the carryover from 1965 may be allowed. Since the contribution carryover period is only five years, the remaining 1965 carryover of $3,500 cannot be carried to 1971.

Under these facts, the computation required by Sec. 170(d)(1)(A) would prevent *any* carryover to 1971 as follows:

Contribution to public charity paid in 1970	$1,000
Less—50% of 1970 contribution base	5,000
Excess contribution—carryover to 1971	$ None

forward seven years. Only 20 percent of the carrybacks and carryovers otherwise available can be taken into account for years beginning after 1968 and ending after April 18, 1969. If higher, this special 20 percent limitation, which is in addition to the overall limitation of the first $25,000 of tax liability and 50 percent of the excess, can be based upon the highest total amount of carrybacks and carryovers to any preceding year beginning after 1968 (prior to the current year involved). Thus, carrybacks from subsequent years can retroactively increase the 20 percent limitation. Such carrybacks can arise under the binding contract rule or other transition rules set forth in Sec. 49(b) for property placed in service before 1976.

An additional three-year carryover period is available (for a total carryover period of ten years) for unused credits resulting from this 20 percent limitation.

105 Minimum and Maximum Taxes

105.1 Minimum Tax on Tax Preferences

Planning Technique

The impact, if any, of the 10 percent minimum tax should be considered in arranging transactions involving tax preferences. The actual incurrence of minimum tax liability will depend upon (1) the amount of total preferences for the taxable year, (2) the amount of taxable income and resulting income tax available as offsets against these preferences, and (3) prior years' tax carryovers.

Effective for taxable years ending after 1969 (e.g., calendar year 1970), Code Sec. 56 imposes a 10 percent minimum tax on items of tax preference described in Sec. 57. This tax is computed as follows:

1. Total tax preferences for the taxable year.
2. Less:
   (a) Exemption of $30,000 ($15,000 for married taxpayer filing separately)
   (b) Taxes otherwise imposed (including any surcharge) less credits for:
      - Foreign taxes.
      - Retirement income.
      - Investment credit (if any).
   (c) Tax carryovers (excess of prior year's tax (less same credits as under (b) above) over prior year's preferences in excess of $30,000). Such excess taxes can be carried forward for 7 years.
3. Minimum tax base (1 less 2).
4. 10 percent on base.

NOTE. This minimum tax is *not* subject to estimated tax requirements. (See Code Secs. 6015(c) and 6654(f).)

Items of Tax Preference

The tax preferences affecting individuals are:

- The 50 percent deduction for net long-term capital gains (203).
- Accelerated depreciation on real property (203.7).

• Accelerated depreciation on personal property subject to a "net lease" (as defined in Code Sec. 57(c)).

• The excess of allowable depletion over the adjusted basis of the property involved (at year end, without regard to the current year's depletion deduction) (203.8).

• The bargain obtained upon the exercise of a qualified or restricted stock option (203.3).

• The excess of 60-month amortization (under Code Sec. 169) over accelerated depreciation for certified pollution control facilities.

• The excess of 60-month amortization (under Code Sec. 184) over accelerated depreciation for qualified railroad rolling stock leased to a domestic railroad or railroad company.

In addition, "excess investment interest" constitutes a tax preference but only for years beginning before 1972 (i.e., calendar years 1970 and 1971). For later years (i.e., calendar year 1972 and thereafter), the deduction of investment interest against taxable income will be limited as explained in 306.1, Chapter 3. The derivation of excess investment interest is shown in Illustration 5, below.

Illustration 5

Line			
1.	Total investment interest paid (or accrued, if appropriate)		$200,000
	Less net investment income:		
2.	Investment income	$100,000	
3.	Less investment expenses	75,000	
4.	Net investment income		25,000
5.	Excess investment interest (line 1 less line 4)		$175,000

A comparison of present and future treatment of investment interest indicates that the pre-1972 treatment of investment interest as a tax preference is harsher than its post-1971 treatment as a limited deduction for the reasons shown in Illustration 6, page 25.

Investment interest is interest paid (or accrued) on indebtedness incurred or continued to purchase or carry property held for investment.

Investment income (from nonbusiness sources) consists of (1) interest, dividends, rents, and royalties, (2) short-term capital gains, and (3) ordinary gain due to depreciation recapture. No long-term capital gains are included for this purpose.

Illustration 6

	Differences in Treatment of Investment Interest	
	Pre-1972 Tax Preference	*Post-1971 Limited Deduction*
1. Statutory allowance (flat amount exempt from adverse treatment)	None	$25,000 ($12,500 for married persons filling separately)
2. Use of net long-term capital gains to reduce interest subject to adverse treatment	Not available	Available*
3. Carryover of disallowed interest	Not applicable	Lifetime carryover available

*However, such gains are converted into ordinary income for purposes of the 50 percent capital gains deduction and the alternative capital gains tax. On the other hand, they also will not give rise to the capital gains tax preference.

Rents derived from property under a "net lease" entered into before October 10, 1969 are excluded from investment income. A net lease exists if:

1. Rental expenses (which are deductible only under Sec. 162) are less than 15 percent of the rental income from the property; or
2. The lessor is guaranteed a specified return, or in whole or part against loss of income.

Investment expenses consist of property taxes, bad debts, depreciation, amortizable bond premiums, expenses for the production of income and depletion.

However, these expenses must be directly connected with the production of investment income.

To increase net investment income and, hence, absorb more investment interest, depreciation can be computed on the straight line and cost depletion can be used.

Net Operating Losses

Part or all of a particular year's minimum tax is excused for a year which gives rise to a net operating loss carryover to future years. This occurs when a net operating loss is sustained for such year which is not fully absorbed by carrybacks against prior years' income. The amount of minimum tax deferred is the lesser of either the minimum tax itself or 10

percent of the net operating loss carryover. (Sec. 56(b) (1).)

However, if the current year's excess tax preferences (i.e., preferences in excess of $30,000 ($15,000 for married persons filing separately)) produce future tax reductions, the tax is reimposed for that future year to the extent of 10 percent of such reduction. (Sec. 56 (b) (2).)

When a carryover is deemed to consist of both preference and nonpreference items, future income will be considered to be reduced first by the nonpreference items. (Sec. 56 (b) (3).) This priority is beneficial since it will delay reimposition of the minimum tax. If the excess preference items are not consumed within the five-year carryover period, the corresponding 10 percent minimum tax is permanently forgiven (S. Rep. No. 91-552, p. 117).

105.2 Maximum Tax Rates on Earned Income

Planning Technique

The prospective 50 percent maximum tax rate on earned income affects planning decisions in such matters as:

1. *Incorporating a personal service business.*
2. *Advantages of "capital gain compensation.*
3. *Desirability of deferred compensation.*
4. *Mix of earned income and nontaxable fringe benefits.*
5. *Utilization of "tax losses."*
6. *Interaction with general income averaging.*

Special maximum tax rates have been established for "earned taxable income," effective for taxable years *beginning after* December 31, 1970. As a result of this desirable legislation, earned income will be subject to the following maximum marginal rates:

Year	*Maximum Rate*
1970	71.75%* (special maximum rate not effective)
1971	60%
1972 and thereafter	50%

*Includes 2½ percent surcharge.

It should be noted that the *effective* rate on "earned taxable income" (as subsequently defined) will be less than 50 percent (or 60 percent for 1971) because, under the new statutory formula prescribed by Sec.

1348 (a), earned taxable income is, in effect, taxed *first* at the regular graduated rates (up to the 50 percent (or 60 percent maximum) with other taxable ordinary income then taxed at the higher graduated rates (up to the 70 percent regular maximum rate). (This formula is described in greater detail later in this discussion.)

The earned income eligible for these new maximum tax rates must be reduced if tax preferences exceed $30,000 (as further explained below). Furthermore, these maximum rates are not available if income averaging is elected or a separate return is filed by a married individual. (This latter prohibition is intended to "preclude manipulation." See H. Rep. 91-413, Part 1, p. 209.)[4]

These special maximum rates were enacted in order to discourage transactions which create artificial losses or convert earned income into capital gains. This latter endeavor will also be discouraged by the increase in the alternative capital gain tax rates.[5] As a consequence of these companion provisions, which were introduced by the 1969 Tax Reform Act, the tax rate gap between earned ordinary income and long-term capital gains is narrowed as follows:

	*1970**	*1971*	*1972 and Thereafter*
Maximum earned income rate	71.7500%	60.0%	50%
Maximum long-term capital gains rate on gains exceeding $50,000	30.2375	32.5	35
Differential	41.5125%	27.5%	15%

*1970 rates include 2½ percent surcharge.

These new statutory measures will probably be quite influential in "redirect(ing) effort away from activities that are profitable only on an after-tax basis and toward those that are economically justified on a before-tax basis" and "reduce the time and effort devoted to 'tax planning' at the expense of pursuing normal business operations. . . ."[6]

The relatively favorable treatment to be given to earned income in the not-too-distant future is somewhat reminiscent of the earned income

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[4] The committee reports referred to in this discussion are:
H. Rep. No. 91-413, 8/2/69 (Part 1), and 8/4/69 (Part 2);
S. Rep. No. 91-552, 11/21/69.
H. Rep. (Conf.) No. 91-782, 12/21/69.

[5] See introduction to 203, this study.

[6] H. Rep. 91-413, Part 1, 8/2/69, pp. 208, 209.

credit which was introduced in the Revenue Act of 1924 and remained in effect intermittently until its final repeal in 1943.[7]

Planning Implications

1. Incorporation of a personal service business may be less attractive in view of the future spread of only 2 percent between the 48 percent maximum corporate tax rate and the 50 percent maximum earned income rate.

2. The incentive to obtain "capital gain compensation" through such vehicles as qualified stock options (203.3) would appear to be diminished after 1971 since the differential between the maximum rates on ordinary compensation versus long-term capital gains will only be 15 percent (see preceding table on page 27).

Although this 15 percent difference still represents some tax savings, its benefit will be offset by the immediate enjoyment of ordinary compensation as opposed to various restrictive conditions usually surrounding capital gains compensation. Moreover, the 50 percent deduction for net long-term capital gains is a tax preference and could precipitate the 10 percent minimum tax described in 105.1.

3. Deferred compensation may, likewise, be somewhat less desirable because its enjoyment is postponed and the tax advantage of shifting such compensation to lower bracket years could be considerably curtailed. Of course, the rates prevailing in those later years would have to be considered. However, the 20 percent decrease (70 percent less 50 percent) in the maximum rates applicable to current compensation might be a compelling factor in bypassing deferred compensation.

Moreover, with the notable exception of restricted property (see 204.3) and, possibly, non-lump-sum distributions from qualified plans, deferred compensation will be ineligible for the 50 percent maximum rate when ultimately taxed. In some cases, therefore, such compensation might actually be subjected to higher rates than those applicable if paid currently. An example of this ineligible deferred compensation might be a mere contractual right to receive future payments.

4. Of course, other fringe benefits which constitute exclusions from income continue to be advantageous. Examples of such benefits include health and accident plans providing medical care and/or sick pay coverage, group term life insurance, the $5,000 death benefit, and so forth. (See 201.2.)

5. "Tax losses" will be less desirable to the extent that they will offset

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[7] Mertens, *Law of Federal Income Taxation*, Sec. 32.07.

income taxable at only 50 percent instead of 70 percent. In addition, such losses could constitute tax preferences and be subject to the 10 percent minimum tax (see 105.1).

6. Computations appear necessary to determine whether either income averaging (104.1) or these maximum rates will be most advantageous under the particular circumstances of a given taxable year.

Technical Resume

The following terms have been given statutory definitions by Code Sec. 1348(b):

- Earned income.
- Earned net income.
- Earned taxable income.

It is only "earned taxable income" which is actually subject to the new maximum rates. However, this tax base is determined by reference to "earned net income" which, in turn, is based upon "earned income." Each of these terms are more fully described below.

Earned Income. Items which are included in earned income are wages and salaries, professional fees, and other compensation for personal services.

If a taxpayer is engaged in a trade or business in which both personal services and capital are material income-producing factors, his earned income consists of a reasonable compensatory allowance for personal services actually rendered which, however, cannot exceed 30 percent of his share of the net profits of such trade or business.

In addition, earned income also includes noncapital gains and net earnings derived from the sale or other disposition of property, or the transfer of any interest therein, or from the licensing of the property's use by an individual whose personal efforts created such property. (For this purpose, property does not include goodwill.) This provision benefits authors, inventors, and others deriving income through their creative personal efforts.

Items which are *not* included in earned income are the following:

1. Lump-sum distributions from qualified employee or self-employed retirement or annuity plans which are eligible for either capital gain treatment or the special averaging computations under Sec. 72(n).
2. Premature or excessive distributions from qualified self-employed retirement or annuity plans to which the penalty provisions of Sec. 72 (m) (5) apply.

3. "Any deferred compensation within the meaning of Sec. 404. . . ." However, a significant exception is made for deferred compensation in the form of restricted property (discussed in 204.3).

Since Sec. 404 deals with the deduction for both qualified and nonqualified deferred compensation plans,[8] all distributions from qualified plans might not be considered earned income — including those taxable as ordinary income. However, this interpretation would render superfluous the statutory exclusions regarding lump sum distributions, and so forth (described above).

In order to impute meaningful purpose to this congressional treatment of such lump sum distributions, future regulations should specify that all non-lump-sum distributions from qualified plans shall be deemed earned income for purposes of computing the maximum tax rate on earned income.

Earned Net Income. Earned net income is simply "earned income" less allocable deductions allowable under Sec. 62 such as:

1. Nonemployee business expenses, including contributions on behalf of self-employed persons to qualified retirement plans.
2. Travel and transportation expenses of employees.
3. Business expenses of outside salesmen.
4. Moving expenses.

Earned Taxable Income. Earned taxable income is determined as shown in Illustration 7, page 31.

Tax preferences are those set forth in Code Sec. 57 for purposes of the 10 percent minimum tax and are described herein at 105.1. Since excess investment interest constitutes a tax preference only for years beginning before 1972, it only affects the earned taxable income determination for 1971.

Computation of Maximum Tax on Earned Income

The maximum tax on earned income is applied by computing the actual tax under the three-phase statutory formula prescribed by Sec. 1348 (a) as shown in Illustration 8, page 31.

EXAMPLE. Loophole's 1972 joint federal income tax return discloses the data shown in Illustration 9, page 32. The computation of his 1972 joint tax liability under the maximum tax formula, and the resulting tax savings thereunder, are set forth in Illustration 10, page 32.

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[8]Mertens, *Code Commentary,* Sec. 404:1.

Illustration 7

Line		
1.	Percentage of earned net income to adjusted gross income (cannot exceed 100%)	______%
2.	Total taxable income multiplied by Line 1 percentage	$______
3.	Less reduction for tax preferences in excess of $30,000, if any (computed below)	______
4.	Earned taxable income	$______

Reduction for Tax Preferences

This reduction is computed as follows:

Line		
(a)	Total tax preferences for current taxable year	$______
(b)	Average of total tax preferences for current taxable year and the four preceding taxable years	$______
(c)	Greater of line (a) or (b)	$______
(d)	Less	30,000
(e)	Reduction for tax preferences	$______

Illustration 8

Phase		
1.	Tax on highest amount of taxable income on which the marginal tax rate does not exceed 50%	$______
2.	50% of earned taxable income in excess of Phase 1 taxable income	______
3.	Tax on other taxable income (described below)	______
	Total tax, reflecting maximum rate on earned income (sum of Phases 1, 2, and 3)	$______

The Phase 3 tax on other taxable income is determined as follows:

(i)	Tax on total taxable income (computed without regard to new Sec. 1348)	$______
(ii)	Less tax on earned taxable income (similarly computed)	______
(iii)	Tax on other taxable income	$______

Illustration 9

Salary	$110,000	
Less allocable travel expense	10,000	
Net salary		$100,000
Lump sum distribution from qualified profit-sharing plan	$90,000	
Less 50% capital gain deduction on eligible portion (assumed to be only $80,000)	40,000	50,000
Interest income		50,000
Adjusted gross income		$200,000
Less itemized deductions and exemptions		20,000
Taxable income		$180,000

In addition, his returns for 1968-1971 reveal the following tax preferences:

Accelerated depreciation:		
On real property	$20,000	
On personal property subject to a net lease	10,000	
Bargain purchase of stock under a qualified stock option	30,000	
Total prior years' preferences		$ 60,000

Illustration 10

Tax Computation

Earned income	$110,000	
Earned net income	$100,000	
Earned taxable income:		
Line		
1. Percentage of $100,000 to $200,000 (adjusted gross income)		50%
2. $180,000 (total taxable income) multiplied by 50%		$90,000
3. Less tax preferences (computed below)		10,000
4. Earned taxable income		$80,000

Reduction for Tax Preferences

(a)	Current year preferences (LTCG deduction)	$40,000
(b)	5-year average preferences ($40,000 plus $60,000*, or $100,000; divided by 5)	$20,000
(c)	Greater of (a) or (b)	$40,000
(d)	Less	30,000
(e)	Preference reduction	$10,000

Statutory Formula

Phase 1

Tax on $52,000, which is highest amount of taxable income on which marginal rate does not exceed 50%		$18,060

Phase 2

Earned taxable income	$80,000	
Less – Phase 1 taxable income	52,000	
Excess	$28,000	
50% of excess		14,000

Phase 3

Tax on $180,000 (total taxable income)	$97,180	
Less – tax on $80,000 (earned taxable income)	33,340	
Difference		63,840
Total tax under formula		$95,900
Less – regular tax on total taxable income (above)		(97,180)
(Savings)		($ 1,280)

*See Illustration 9. Pre-1970 years have been included in the five-year average solely for illustrative purposes. In actuality, the five-year average may not be fully operational until 1974. For 1971 through 1973, the amount determined on line (b) above might simply be the average of preferences for only post-1969 years.

Minimizing Income Subject to Tax

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Chapter 2

Minimizing Income Subject to Tax

The measurement of net income, on a periodic basis, has thus far defied precise and universally accepted criteria. Hence, present statutes are conceptually unable to tax "true" net income. In addition, in view of various economic, political, social, financial, practical, and other factors, various kinds of income, or increases in net worth, have been removed from the tax base or are able to be so removed through taxpayer action. These factors have also provided reduced capital gain rates for certain types of favored income as well as permitted the otherwise prevalent tax rate to be lowered by the shift of income to a different bracket—either of the same taxpayer (e.g., to a future year with a smaller tax base) or to another taxpayer who has a lesser tax base. Finally, there is some statutory attempt to equate taxation with the *cash* ability to pay as, for example, in the case of installment sales, involuntary conversions, and nontaxable exchanges.

As is evident, not all forms of tangible enrichment are subject to tax. Furthermore, disparity of treatment exists for some of the remaining ingredients that comprise our tax base. Accordingly, this chapter, as well as Chapter 5, will be concerned with maximizing a client's retention of income by minimizing its exposure to our taxing system through the use of various statutory and man-made (i.e., taxpayer-originated) shelters.

201 Exempt Income

Complete exemption from taxation is obtained, primarily, through congressional authorization. However, there are also some limited opportunities for securing further exemption in selected situations through taxpayer-precipitated processes.

201.1 Sale or Exchange of Residence

Planning Technique

Where possible, a contemplated sale of a home at a gain should be arranged to qualify for the limited exclusion granted by Sec. 121 (discussed below) and/or the deferment of gain permitted by Sec. 1034 (see 204.1).

Except as discussed in Chapter 3, losses sustained on sales or exchanges of personal residences are not normally deductible in accordance with Regs. Sec. 1.262-1(b)(4). In contrast, gains realized upon such sales or exchanges are usually taxable. However, the Code harbors two major relief provisions which can materially mitigate the resulting tax, even though computed at favorable capital gain rates. One of these relief measures which can provide clients who are at least 65 years old with a limited tax exemption for such gains is discussed in further detail immediately below. The second relief provision permits these gains to be deferred to the extent that the proceeds realized from the sale are reinvested in a new residence within a specified time. This latter provision is described at greater length in 204.1.

Planning to Qualify Under Sec. 121

Sec. 121 contains an age and holding period requirement (as to ownership and use), which may be met through sufficient passage of time. Therefore, if financial and family circumstances permit, a proposed sale should be delayed until these requirements are satisfied. An exclusion from gross income is provided for a limited amount of gain received from the sale or exchange of a personal residence in the case of taxpayers who have reached age 65 before the sale or exchange occurs. To be eligible for this treatment, they must have owned and used the property involved as their principal residence for five out of the last eight years before the sale or exchange.

EXAMPLE. Mr. and Mrs. Astute Bear, whose child has grown up and moved out, no longer need their jointly owned family homestead which they purchased 20 years ago for $10,000. Their home is currently worth $20,000. The older Bears desire a less expensive home, an apartment, or a rental property. Therefore, Sec. 1034 *cannot* be used to defer the gain that would be realized upon the homestead's sale.

However, Papa Bear (a famous handball coach) has just turned 64 while his spouse is 60. Accordingly, a CPA advises them, solely from a tax

standpoint, to delay the sale of their home to Goldilocks for one year (until Mr. Bear is 65).

A similar one-year delay should be planned if Mr. Bear is over 64 but has owned and used this property as his principal residence for only four years.

NOTE. Since the property is jointly held, these age, ownership, and use requirements can be satisfied by only one spouse if a joint return is filed for the year of sale (Regs. Sec. 1.121-5(a)).

Amount of Exclusion Limited. The application of Sec. 121 is limited so that a full exclusion is provided only for the gain attributable to the first $20,000 of adjusted sales price, which is defined by Regs. Secs. 1.121-3(d) as the amount realized less "fixing-up expenses" (for work performed on the residence to assist in its sale). Therefore, if the adjusted sales price does not exceed $20,000, the entire gain is excluded from income.

Where such sales price exceeds $20,000, only a portion of the gain is excluded. In this latter case, the exclusion is determined by the following equation:

$$\text{Excludible gain} = \text{total gain} \times \frac{\$20{,}000}{\text{(adjusted sales price)}}$$

Illustration 1

Line		
1	Gross selling price	$ 30,800
2	Less — selling expenses	400
3	Amount realized	$ 30,400
4	Less — fixing-up expenses	400
5	Adjusted sales price	$ 30,000
6	Adjusted basis of residence	$ 15,400
7	Gain realized (line 3 less line 6)	$ 15,000

The excludible gain of $10,000 is determined by applying the above equation, as follows:

$$\text{Excludible gain} = \$15{,}000 \times \left(\frac{\$20{,}000}{\$30{,}000} \right)$$

Procedural Pitfalls

Basic Requirements Regarding Necessary Election. To prevent taxpayers from reusing this provision and obtaining numerous exclusions for gains on personal residences, Sec. 121(b)(2) provides that this exclusion is available to a taxpayer *and* his spouse only once in their lifetimes.

Therefore, this exclusion is elective and may be made or revoked at any time before the expiration of the period for making a claim for credit or refund of tax, generally about three years after the year of the sale or exchange.

EXAMPLE. Before their marriage, a taxpayer and his spouse each owned and used a separate residence. If after their marriage both residences are sold, whether or not in a single transaction, an election under Sec. 121(a) may be made with respect to a sale of *either* residence *(but not with respect to both residences);* assuming that the age, ownership, and use requirements are met at the time of sale (Regs. Sec. 1.121-2(b)(1)).

How to Elect: Regs. Sec. 1.121-4(b) prescribes a statement of election, together with other information indicating compliance with Sec. 121, *signed* by the taxpayer and his spouse (where necessary). However, the IRS states, in the 1970 edition of "Your Federal Income Tax" that such election requirements are satisfied by attaching a completed copy of Form 2119 "Statement Concerning Sale or Exchange of Personal Residence" *to the tax return,* presumably for the year of sale or exchange. Form 2119 does *not* require a signature for this purpose.

If a taxpayer is married at the time of the sale or exchange, Sec. 121(c) requires a dual election (or revocation) with his spouse (to whom he was married at the time of the sale or exchange).

Should the taxpayer's spouse die after the sale or exchange, her personal representative (e.g., executor) must join in any subsequent election. However, Regs. Sec. 1.121-4(a) states that "for purposes of making an election under Sec. 121(a), if no personal representative of the deceased spouse has been appointed at or before the time of making the election, then the surviving spouse shall be considered the personal representative of such deceased spouse . . . . "

PLANNING SUGGESTION. As a precaution, a signed statement pursuant to Regs. Sec. 1.121-4(b) should accompany a claim for refund or an amended return where this election is retroactively exercised within the subsequent "three-year" period.

Prior Election and Subsequent Remarriage. As previously indicated, a spouse must join in an election, which can only be exercised once by either a client *or* his spouse. Regs. Sec. 1.121-2 (b)(2) contains examples which illustrate the effect of an election made in a prior marriage, its subsequent revocation, and other timing factors which can provide some

planning opportunities in appropriate, albeit limited, similar factual situations.

Revocation of Election. Regs. Sec. 1.121-4(c) requires a signed statement of revocation together with other pertinent information. The statement must be signed by the taxpayer and (where required) by his spouse or their personal representatives, and filed with the district director with whom the election was filed.

Further, Regs. Sec. 1.121-4(a) states that "any election previously made by the taxpayer may be revoked only if the personal representative of the taxpayer's deceased spouse joins in such revocation."

PLANNING SUGGESTION. If factually warranted, consideration should be given to the feasibility of a positive testamentary direction to join in any such future revocation.

Certain revocations also require the filing of a consent to a one-year extension of the statutory period for assessment of any deficiency (to the extent that such deficiency is attributable to the revocation of the election). This additional requirement is imposed if the revocation is filed when the statutory assessment period for the year of the election will expire within one year. Such consent must be filed before said expiration (Regs. Sec. 1.121-4 (c)).

Tax Return Filing Requirements. Sec. 6012(c) requires gross income to be calculated *without* regard to any exclusion under Sec. 121 for the purpose of determining tax return filing requirements.

Special Rules

In applying Sec. 121, special rules are prescribed by Sec. 121(d) to cover the following situations:

1. Property jointly held by husband and wife. (See example, page 38)
2. Sale of property previously owned by deceased spouse.
3. Tenant-stockholders in cooperative housing corporations.
4. Effect of involuntary conversions.
5. Property partially used as personal residence.
6. Marital status.
7. Relationship to involuntary conversions (Sec. 1033) and other relief provisions (Sec. 1034).

See Regs. Sec. 1.121-5 for detailed explanation of these special rules. There is also another special rule for principal residences that are repossessed and resold within one year (Regs. Sec. 1.1038-2).

201.2 Employment-Connected Fringe Benefits

Planning Technique

Higher bracket employees (including employee-stockholders) should attempt to induce their employers, at raise time or otherwise, to furnish suitable fringe benefits as part of, or preferably, in addition to, other compensation.

There are various economic benefits that an employee may receive from his employer for services rendered. Of interest here, though, are those benefits which have the following characteristics.

Not Taxable to the Employee. Although representing personal or living expenses paid by an employer on his employee's behalf, fringe benefits are, nevertheless, not taxable to the employee.

Deductible by Employer. Such expenses are deductible by the employer even though not usually deductible by the employee — if paid by the latter.

Value to the Employee. The ultimate value of a fringe benefit to an employee will depend upon his top tax bracket. At a minimum, however, it will normally be worth somewhat more than its face value.

EXAMPLE. To an employee in a 50 percent tax bracket, the intrinsic value of a fringe benefit is twice its face value. He would have to spend $500 of pre-tax compensation to pay for a fringe benefit which costs his employer $250.[1]

Availability. Taxwise, fringe benefits are available to all employees although, as a practical matter, benefits offered to employee-stockholders of closely held corporations require extra attention. (This special care in the case of particular benefits is more fully described below.)

The courts are divided as to whether partners can qualify for fringe benefit treatment. For a favorable Fifth Circuit decision, see *Anne L. Armstrong*, 394 F2d 661. At the same time, beware of such contrary precedent as *Cliff C. Wilson*, 376 F2d 280 (Court of Claims) and Rev. Rul. 80, 1953-1 CB 62.

Sole proprietors and investors, lacking an employer, will not have any fringe benefit advantages.

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[1] See Studies in Federal Taxation No. 1, *Tax Guide for Incorporating a Closely Held Business* (Garian, AICPA), Ch. 2 at 209.

Generally Accepted Fringe Benefits. Those apparently most widely used in practice today are:

1. Reimbursement of medical expenses.
2. Wage continuation (sick pay) plans.
3. Life insurance protection.
4. Other death benefits.
5. Meals and lodging furnished for the employer's convenience.
6. Rental value of parsonages.
7. Courtesy discounts to employees.

The remainder of 201.2 is devoted to presenting various planning techniques inherent in each of these benefits.

Reimbursement of Medical Expenses

Planning Technique

Request employer to include employee in medical reimbursement plan to prevent taxation of all compensation expended for medical purposes.

Without a medical reimbursement plan, income used to pay medical expenses is taxable to the employee to the extent of 3 percent of his adjusted gross income or if he elects the standard deduction.

With a plan, the employee is *not* taxed on any of his compensation that is used to defray medical costs.

Plan Coverage. In addition to the employee, a plan can also provide reimbursement for medical expenses of the employee's (1) spouse and (2) dependents, as defined for federal income tax purposes (under Sec. 152). (See Sec. 105(b).)

All expenditures for medical care are eligible for reimbursement. The definition of medical care is the same as it is for purposes of claiming medical deductions (set forth in Sec. 213(e)). (See 303).

As a matter of self-insurance economics, the employer may prudently wish to set maximum limitations upon his reimbursement obligations. These limitations could be (1) annual and/or (2) overall (cumulative), for duration of employment.

In addition, the employee, his spouse, and dependents could be treated individually and/or jointly in establishing such limits.

Discrimination Is Permissible. "A plan may cover *one* or more employees, and there may be different plans for different employees or

classes of employees . . . ." (Regs. Sec. 1.105-5(a); emphasis supplied.) To the same effect, see *Bogene, Inc.* (TC Memo 1968-147) where the supporting legislative history is effectively recited.

Employee-Stockholders. The Internal Revenue Service's vigilant policing of possible abuse cases in this area has created a rather thin line between taxable stockholder dividends and nontaxable employee medical reimbursements. Exemplifying this distinction is *Alan B. Larkin* (CA-1, 394 F2d 494; affirming 48 TC 629) on the one hand, and *Bogene, Inc.* (supra) on the other.

SUGGESTION. The *Bogene* opinion contains a highly informative, analytical comparison of the *Bogene* and *Larkin* plans; it furnishes cogent guidance in determining the contents of plans for your clients. Among the areas judicially scrutinized are:

- Discretion as to coverage and benefits.
- Eligibility for benefits.
- Family relationships.
- Purpose of plan.
- Limitations upon benefits.
- Relationship of benefits to stockholdings.

In *Bogene,* the Tax Court also held that the employer's deduction of an employee's medical expenses is authorized by Regs. Sec. 1.162-10 (a).

Wage Continuation (Sick Pay) Plans

Planning Technique

Request employer to institute a wage continuation (sick pay) plan so that employee can avail himself of the limited *exclusion for any wages (or payments in lieu of wages) received for periods in which employee is absent from work because of injury or sickness.*

Wage continuation plans, as well as medical expense reimbursement plans, are considered to be "accident and health" plans and thus are both governed by the standards established in Regs. Sec. 1.105-5. Consequently, discrimination is also permissible in the case of wage continuation plans. For the same reason, the prior planning pointers regarding employee-stockholders are equally appropriate here.

Furthermore, financial limitations are just as relevant for wage continuation plans as they are for medical reimbursement plans.

Although not required by the Code, such limitations might be expected as a matter of prudent economics. Since an employee's future wages may change, wage continuation limitations might be expressed in terms of a maximum time period instead of maximum dollar amounts. (For example, a plan could provide that wages would be discontinued if the employee's absence extended beyond 00 weeks or his retirement age, whichever occurs first.)

Businessmen are not alone in viewing financial limitations as a realistic attribute of a wage continuation plan. For example, consider the following excerpt from the Tax Court's opinion in *Levine* (50 TC 422 (1968)):

> . . . It is utterly incredible in view of its limited income and other circumstances that [the employer] would have undertaken the comparatively staggering financial burden of continuing to pay wages to its employees over an indefinite extended period of years of illness. While it is true that a bona fide plan for sick pay might have provided for a longer period on behalf of the president than would have been adopted for other employees, we do not believe that such period would have covered so extended a span of years as is before us now if he were not the principal stockholder . . . .

Needless to say, this reasoning led the Court to classify the payments in issue as taxable dividends rather than excludible sick pay.

Limited Exclusion. Even where a valid plan exists, the sick pay exclusion is still subject to the following statutory limitations:

1. Sick pay received for the first 30 calendar days of absence:
   - Weekly rate of sick pay cannot exceed 75 percent of regular weekly rate of wages.
   - Exclusion cannot exceed $75 per week.
   - No exclusion for sick pay attributable to the first seven calendar days unless the employee was hospitalized for at least one day during the period of absence.
2. Sick pay received for absence *after* initial 30-day period. Exclusion cannot exceed $100 per week.

NOTE. In addition, amounts received under two or more plans must be combined in computing these exclusions (regardless of whether such plans are maintained by the same *or different* employers). (Regs. Sec. 1.105-4(e)(6)(v).)

Planning Technique

Employer-provided life insurance protection can be received by employees at relatively favorable tax cost under either of the following arrangements: (1) group term life insurance or (2) split-dollar insurance.

Group Term Life Insurance. Sec. 79 provides an exception to the general rule that life insurance premiums paid by an employer on an employee's life are taxable to the employee if the proceeds are payable to the employee's beneficiary.[2]

Under this exception, the cost of providing $50,000 (or less) of group term coverage is *not* taxable to the employee. Only one maximum $50,000 exclusion is available annually, regardless of the number of employers involved.[3]

Although coverage in excess of $50,000 gives rise to taxable income, the reportable value of this additional benefit is determined by reference to rather favorably low insurance costs listed in Regs. Sec. 1.79-3(d) (2).

Estate Tax Aspects. Upon the employee's death, the face value of his group term protection will be includible in his gross estate *unless* he can divest himself of all incidents of ownership in the policy.

PLANNING SUGGESTION. Assign incidents of ownership if terms of Rev. Rul 69-54 can be met. This ruling[4] recognizes such assignments as effective for estate tax purposes under the following conditions:

1. *Both* the group policy and the state law *permit* an employee to make an absolute assignment of all of his incidents of ownership in the policy.
2. Upon termination of employment (when coverage ceases), an assignee acting alone could convert to an individual policy of equal face amount.
3. An employee makes an irrevocable assignment of *all* of his incidents of ownership in the policy, *including the conversion privilege.* (Thus, the insured can not cancel coverage by terminating his employment.)

Before assigning the incidents of ownership under Rev. Rul. 69-54, the following points should be considered.

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[2] Regs. Sec. 1.61-2 (d)(2)(ii)(a).
[3] H. Rep. No. 749 (88th Cong., 1st sess.) p. A-30 (1963).
[4] Originally issued as Rev. Rul. 68-334.

(a) Is "permit" in condition (1) above used affirmatively or passively? There has been some question as to whether these assignments must be *specifically permitted* by the policy and state law (including a state court decision). (The effect of a state insurance department ruling has not yet been determined.)

However, the Court of Claims has recently construed this ruling (Example 2, in particular) as recognizing assignments unless assignment of the conversion privilege is prohibited by either the group policy or local law. Since the Court concluded that local (New York) law, for the year at issue, neither prohibited nor approved group policy assignments, it recognized such an assignment for federal estate tax purposes.[5]

Nevertheless, 24 states have enacted statutes expressly permitting such assignments.[6]

(b) Can one assignment suffice? The IRS has not indicated (1) whether an assignment can be designed to continually apply to subsequent renewal of coverage by the employer; (2) the effect of a continuous group policy; or (3) if future assignments will be necessary when coverage is renewed.

(c) Are there any contemplation-of-death problems? The Service has also not expressly precluded the application of Rev. Rul. 67-463 which requires insurance proceeds attributable to premiums paid by a decedent within three years of death to be included in gross estate, even though he relinquished all incidents of ownership prior to this three-year period.[7]

Since group premiums would not have been paid by a deceased employee, the ruling's relevance appears remote. In addition, any such application would require all proceeds to be included in the decedent's estate and thus completely nullify the result obtainable under Rev. Rul. 69-54.

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[5] *Landorf, et al., Exr.*, 408 F2d 461 (cert. not authorized). Also see *Gorby*, 53 TC 80 (10/27/69), acq. IRB 1970-18, 5 (5/4/70), regarding a California decedent.

[6] See reference to 23 states with final enactments at CCH, *Estate and Gift Tax Reporter*, Vol. 2, ¶8242. Wisconsin's pending legislation, as indicated therein, has also been subsequently enacted.

[7] Rev. Rul. 67-463 has not had judicial support. It has been invalidated by *First National Bank of Midland, Tex., Co-exr. (Est. Mathers)* 70-1 USTC ¶12,666, (rev'g DC, Tex.) cert. not authorized. This ruling has also been rejected by a Michigan District Court in *Gorman*, 288 F. Supp. 225, which the Government will not appeal. See *Nance* (DC, Ariz.) 68-1 USTC ¶12,529, which the Government has appealed to CA-9.

Planning Technique

Where group coverage is not feasible, or for additional protection, employees should seek split-dollar arrangements.

Split-Dollar Insurance. Split-dollar insurance falls outside of our fringe benefit definition since (1) the employee is taxed on the value of the economic benefits received from his employer and (2) the employer cannot deduct any premiums paid under this arrangement.

Under a split-dollar program, in essence, earnings on employer-financed cash values are used to provide current life insurance protection to the employee, who may also obtain the benefit of any policyholder's dividends. The annual value of these benefits constitutes taxable income to the employee, in the view of the IRS, and is computed as shown in Illustration 2, below.

Illustration 2

One-year term cost of declining life insurance protection*	$
Policyholder's dividend applied for employee's benefit	______
Total benefits received under arrangement	$
Less premium paid by employee	______
Taxable income	$ ______

Source: Rev. Ruls. 64-328 (1964-2 CB 11) and 66-110 (1966-1 CB 12).

* Cost ascertainable through tables published in Rev. Ruls. 55-747 (1955-2 CB 228) and 66-110. Actual premium rates, if lower, can be substituted under conditions specified in Rev. Ruls. 66-110 and 67-154 (1967-1 CB 11).

This computation does not generally produce an undue tax detriment. For example, consider the limited amounts of additional taxable income realized by a 45-year-old employee who is insured for $100,000 in Illustration 3, page 49.

PLANNING SUGGESTION. The chart shown in Illustration 3 indicates that $24 of the first-year premium ($609 total premium less $585 value of coverage) is, in effect, wasted for tax purposes since it cannot be carried to the next year as a reduction of the $162 additional taxable income. This result can be prevented if the total amount of employee premiums is divided by the number of years in the policy's term to ascertain an average annual premium payment. In this way, *all* employee premiums will be *fully* utilized to reduce the additional taxable income generated by employer-provided insurance coverage. Furthermore, this procedure would stabilize the employee's insurance expense over the policy's term.

Illustration 3

(i) Policy Year	(ii) Employee's Coverage*	(iii) Value of Coverage†	(iv) Employee's Premium†	(v) Additional Taxable Income‡
1	$93,000	$585	$609	None
2	85,000	578	416	$162
3	76,000	568	210	358
5	64,000	548	None	548
10	35,000	439	None	439
15	30,000	613	None	613
20	25,000	776	None	776

Source: Rev. Rul. 64-328.
* Nearest thousand
†Rounded to the nearest dollar
‡Column (iii) less column (iv)

If worthwhile, averaging should be discussed with the insurance company's representative when formulating a split-dollar plan. Leveling loans from the employer or insurance agent represent another averaging device. However, interest paid thereon may not, possibly, be deductible because of Sec. 264(a)(3). Interest-free loans (from employer) could (possibly) create still further taxable income.[8]

Comparative Evaluation — Group Term and Split-Dollar Insurance

Income Tax. Group term life insurance is an attractive fringe benefit since *constant* coverage can be obtained at less expensive group rates. Its expense is further reduced since the premiums are usually deductible, as compensation, by the employer. And, as previously explained, this benefit produces relatively little or no taxable income for the employees.

However, Regs. Sec. 1.79-1(b) (1) (iii) contains various requirements regarding the composition of an acceptable group of *employees* (in their capacity as such). (Generally, a group must cover at least ten full-time employees except as permitted under Regs. Sec. 1.79-1(b)(1)(iii)(d).) These requirements preclude individual selections of coverage, both as to insured employees and amount of protection.

[8] See *Goldstein,* "Business Uses of Life Insurance," 24 NYU Inst. on Fed. Tax (1966), p. 474, for additional discussion of this interest problem. Interest-free loans are also discussed in 202.5.

On the other hand, consider the following pros and cons of split-dollar insurance:

Pros	*Cons*
1. Extremely flexible as to individual selectivity.	1. Premiums based on higher individual rates.
2. Employee's tax cost fairly nominal.	2. No employer deduction for use of funds (which provide employee's benefits).
3. Employee's protection highest during policy's early years when his need may be greatest.	3. Declining employee coverage. However, this can be remedied if the employer pays its share of the proceeds as a death benefit (under a separate plan). Or, declining coverage can be alleviated if the employee is entitled to policy dividends and they are used to buy additional term insurance.

A somewhat related avenue that might also be explored in this context is the interest-free loan. See 202.5.

Employee's Estate Tax. Gifts of life insurance are desirable since its pure protection value (1) would not be subject to either gift or estate tax; and (2) constitutes a nonspendable asset during the employee's lifetime.

Pure protection value is determined as follows:

Total face value of policy, subject to estate tax in absence of gift	$100,000
Less gift tax value (interpolated terminal reserve value plus unexpired premium)	60,000
Pure protection value	$ 40,000

Both group term and individual permanent insurance can be excluded from an employee's gross estate under the following conditions:

1. The proceeds are payable to beneficiaries *other than* the employee's creditors or his estate (i.e., executor, administrator, etc.).[9]
2. The employee has relinquished all incidents of ownership in the insurance policy.[10]

This exclusion would apply regardless of whether the insurance was financed entirely by the employer (e.g., group term), through a split-

[9] Regs. Sec. 20.2042-1 (b).

[10] Regs. Sec. 20.2042-1 (c).

dollar arrangement, or by funds borrowed separately from an employer.

However, unlike *individual permanent insurance, transferring incidents of ownership in a group term policy may* not always *be possible.* (See prior discussion of Rev. Rul. 69-54.)

NOTE. Continued premium payments by the employee under a split-dollar arrangement or by funds separately borrowed from an employer could, nevertheless, require insurance proceeds to be included in his gross estate, to the extent attributable to premiums paid within three years of his death. This result appears less likely for proceeds financed by an employer.

See the previous discussion of Rev. Rul. 67-463, regarding premiums paid in contemplation of death, in connection with assignments of group term life insurance.

A precise judgment as to which form of insurance fringe benefit is preferable, or whether split-dollar should supplement group term insurance, can only be made by the practitioner having full knowledge of his client's circumstances, including such vital (and perhaps obvious) facts as comparative insurance rates, insurability problems, the group size required by Sec. 79, and so forth.

PLANNING SUGGESTION. Consider feasibility of life insurance trust to derive additional estate tax savings upon beneficiary's death.

Further estate tax savings can be obtained, at the beneficiary's[11] death, if the life insurance proceeds can be diverted from her outright ownership (and thus excluded from her gross estate). This diversion may be possible if the beneficiary's financial position enables these proceeds to be used only as a source of income and as a *limited* source of capital.

Under such circumstances, a life insurance trust can be established to receive gifts of the unmatured policies.

The trust indenture could provide (in part) that the beneficiary would have the noncumulative right to annually withdraw the greater of $5,000 or 5 percent of the trust's principal. Therefore, at her death, only the amount of trust principal subject to this right (which would not yet have lapsed) would be included in her estate. (Sec. 2041(b) (2) would exclude the value of the rights which have previously lapsed.)

If this provision is not required by the beneficiary's financial position and/or personal desires, it can be deleted in order to accomplish still further estate tax savings.

[11] For purpose of illustration, the employee's beneficiary is assumed to be his surviving spouse.

CAUTION. Income taxes *cannot* be saved by shifting the employee's premium payments, if any, to the trust (through funding with other income-producing properties). Under Sec. 677(a)(3), trust income used for this purpose would, nevertheless, be taxable to the employee.

The existence of an employee's insurance trust should not have any effect on continued premium payments by the employer. These payments, of course, represent the basic fringe benefit involved here.

However, both employer and employee premium payments may have gift tax consequences which, along with other tax ramifications of life insurance trusts, are beyond the scope of this broad-brush study.[12]

Future estate tax can also be avoided if, for example, the children merely succeed their mother as life income beneficiaries, with corpus distributable upon their deaths to their children (i.e., the donor-insured's grandchildren). The extent to which a trust can thus be perpetuated is, of course, subject to any applicable local rules against perpetuities.[13]

If a client has previously created a life insurance trust, consideration should be given to the extent to which it can, and should, be utilized as the recipient of life insurance which has been provided as a fringe benefit; and whether this utilization, if any, should be achieved through lifetime gifts or testamentary transfers. In other situations, similar consideration should be given as to whether such a trust should be established for this purpose.

Other Death Benefits

Planning Technique

Where possible, employees should arrange with their employers for the direct payment of death benefits to their beneficiaries (including their estate). Five thousand dollars of such benefits are not subject to income tax. The desirability of contractual arrangements depends upon the parties' relationships and the employees' estate tax exposure.

Income Tax Aspects. The $5,000 exclusion applies to benefits paid by an employer, by reason of an employee's death, *if* the employee did *not*

[12] For further discussion, see A.S. Moses, Jr., "Irrevocable Life Insurance Trusts Can Be Attractive Estate Planning Tool," *Journal of Taxation* (April 1963), p. 206. Also see P. E. Bomze and H. Yohlin, "Some Unresolved Gift and Estate Tax Problems of the Unfunded Irrevocable Insurance Trust," *Taxes Magazine* (CCH) (Sept. 1963), p. 521.

[13] See A. J. Casner, "Extent of Tax Avoidance Possible Under Present Law by Use of Generation-Skipping Transfers," in the article entitled, "American Law Institute Federal Estate and Gift Tax Project," *Tax Law Review* (May 1967), p. 573.

have, immediately before death, a nonforfeitable right to receive such benefit while living (e.g., *accrued* salary, bonuses, vacation pay, etc.). This exclusion is also available for lump sum distributions from qualified deferred compensation trusts *regardless* of whether the employee had such nonforfeitable rights. (These lump sum distributions also qualify for the long-term capital gain treatment and for the special averaging described in 203.1).

Only one $5,000 exclusion per employee is available, regardless of the number of employers or beneficiaries. (Regs. Sec. 1.101-2(a) (3).)

Regs. Sec. 1.101-2(a)(1) states that this exclusion shall be available "whether or not . . . made pursuant to a contractual obligation of the employer . . . ."

Planning Technique

The existence of such a contractual obligation on the part of an employer, whether or not in excess of $5,000, *may give rise to a corresponding contractual right, on the part of the employee, which might be taxable for estate tax purposes.*

On the other hand, death benefits (regardless *of amount) that are* not *paid under contract are usually excludible from the employee's gross estate. Alternatively, such contracts may also be excludible if the employee had no post-employment benefits.*

Estate Tax Implications. "Where the employer is under no binding obligation to make payment at the time of death, it is fairly clear that any payments made are not includible in the employee's gross estate . . . ."[14]

"However, a pattern of voluntary payments may lead to employee expectations and reliance, from which a binding obligation can be inferred. The linking of such an obligatory payment with post-retirement amounts payable to the employee himself will result in includibility under [Code] Sec. 2039 (a). Cf. Regs. Sec. 20.2039-1 (b), Example (4)."[15]

The Tax Court's view of such an inferred contract, as provided in Estate Tax Regs. Sec. 20.2039-1 (b) (2), Example (4), is expressed in the following excerpt from its *Barr* decision.

> . . . The repeated reference (in both subsections (a) and (b)) [of Sec. 2039] to the requirement for some form of contract or agreement, indicates that the rights of both the decedent and the survivor must be

[14] Sporn, "Tax Planning for Employee Death Benefits," 26 NYU Inst. on Fed. Tax (1968), p. 1243, citing *Barr*, 40 TC 227 (1963), acq. 1964-1 CB (Part 1) 4.

[15] Sporn, loc cit.

enforceable rights; *and that voluntary and gratuitous payments by the employer are not taxable under Sec. 2039.* This is expressly recognized in Example (4) of the regulations. However, this same example does state that where the terms of an enforceable retirement plan have been modified by consistent practice of the employer, the annuity received pursuant to such modifications will be considered to have been paid under a "contract or agreement." *We do not think that the latter statement was intended to mean that where there was no enforceable arrangement, contract, or agreement whatever, the mere consistency of an employer in making voluntary or gratuitous payments would be sufficient to supply the essential "contract or agreement." Congress, for reasons satisfactory to it, has made the existence of some form of "contract or agreement" an indispensable prerequisite to the application* of Sec. 2039 . . . . (*Barr*, p. 235; emphasis supplied.)

The Service had also contended that the death benefits paid to Mrs. Barr were taxable under the generic Sec. 2033 entitled "Property in Which the Decedent Had an Interest." The Tax Court held that Sec. 2033 was inapplicable, reasoning, in part, as follows:

> . . . It will be observed that this section relates only to *interests in property* which the decedent had at the time of his death. And, as the Supreme Court pointed out in the leading case of *Knowlton v. Moore*, 178 U.S. 41, the justification for the government's power to subject such interests to the federal estate tax rests on the principle that such interests pass from the decedent at death, and that the estate tax is an excise tax on the privilege of transmitting property at death to the survivors of the decedent. . . . . *Both this Court and others have recognized that there is a distinction between* rights *of an employee to death benefits, and, on the other hand, mere hopes and expectancies on the part of an employee that death benefits may be* paid. . . . [Emphasis supplied.]

Death Benefit Contracts Payable to Beneficiary May Be Excluded From Gross Estate. This is possible if deceased employee had no employment benefits. In the *Estate of Firmin D. Fusz, et al.*,[16] an employment contract had provided for a salary payable to the decedent and monthly payments to his widow for her life if he died during the contract's term. Neither decedent nor anyone other than his widow received, or was entitled to receive, any post-employment benefits.

The government asserted that the commuted value of the widow's payments was includible for estate tax purposes under Sec. 2039. In a reviewed decision with one dissent, the Tax Court held that Sec. 2039 does not apply where, under the contract, agreement, or otherwise, the

[16] *Fusz*, 46 TC 214 (1966), acq. 1967-2 CB 2.

deceased employee was not receiving or entitled to receive, any post-employment benefits at the date of his death. As stated by the Court, though, no other estate tax sections were construed.[17]

However, in a subsequent case involving the same issue,[18] the Court of Claims held that Secs. 2036 and 2038 (described at the conclusion of 202.2) and Sec. 2033 (the generic gross estate section), as well as Sec. 2039, were inapplicable.

The following points were also considered by the courts in the *Kramer* decision and other cases.

Controlling vs. Noncontrolling Interest: The *Kramer* case involved a closely held family corporation, with all stock owned by the decedent's children (and son-in-law). If the decedent had a controlling interest, however, he might be viewed as having sufficient power to activate the provisions of Sec. 2036 and/or 2038.

Disability Provisions as Employment Benefit: A crucial factor in the *Kramer* decision, which has significant planning overtones, revolved around the interpretation of a contract clause dealing with the employee's incapacity to act in his designated position. In such event, he was to remain with the employer "as an adviser and counsellor and to assist the officers and employees in formulating plans and programs for the continuation of the business, for the remainder of his life" at an annual salary of $12,000.

The Court, *within the context of the particular facts (as stipulated)*, considered this clause to constitute an employment arrangement. Thus, the $12,000 annual salary was not a post-employment benefit, such as a retirement annuity, which would cause the widow's payments to be subjected to immediate estate tax.

Disability Provisions as Post-Employment Benefit: In contrast, the Court of Claims had earlier held in *Bahen*[19] that disability compensation benefits, contingently payable to an employee as part of a deferred compensation plan, were retirement benefits and required the inclusion in his estate of the total proceeds under the plan paid to his widow.

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[17] "Respondent expressly abjures any claim that other estate tax provisions may be applicable. While we are, of course, not bound by this action, we have determined under the circumstances of this case to confine our decision to Sec. 2039 and consequently we express no opinion with respect to such other provisions." (Footnote 2 of opinion).

[18] *Carrie Kramer, et al.* (Ct.Cls.), 406 F2d 1363, cert. not authorized.

[19] *Est. of J. W. Bahen* (Ct.Cls.), 305 F2d 827.

Separate Retirement Plans for Decedent and Beneficiary Do Not Prevent Estate Taxation: A separate death benefit plan for the widow in *Bahen* which, alone, would not be includible in the employee's estate was nevertheless taxed when considered together with an includible deferred compensation plan.[20]

These cases uphold the Sec. 2039 regulations which specify that "the term contract or agreement includes *any arrangement, understanding or plan, or any combination of arrangements, understandings or plans* arising by reason of the decedent's employment . . ." [21] and that all rights and benefits accruing to an employee and others by reason of his employment, except rights and benefits under qualified plans exempt from estate tax (see 203.1), are considered together in determining whether or not Sec. 2039 applies. *Its scope cannot be limited by indirection.* [22]

In those situations where an employee has a choice, his decision as to whether his death benefits should be contractually "guaranteed" depends, of course, upon the economic "realities" anticipated after his death — to the extent that they can be gauged. Thus, the need for such a contract may be greatly diminished in the case of a closely held family corporation or a wholly owned corporation. Accordingly, if "safely" permitted by business and personal conditions, a client might consider foregoing a death benefit contract in order to exclude such benefits for estate tax purposes.

However, it should be noted that the *Barr* case (above), in which the IRS acquiesced, did not involve a closely held family corporation as the payor of the benefits (actually, Eastman Kodak Co.).

PLANNING SUGGESTION. If possible, avoid circumstances that may give rise to a "constructive agreement." [23]

Don't overlook the Tax Court's interpretation of Example (4) (Regs. Sec. 20.2039-1 (b) (2)) as set forth in its *Barr* decision, if challenged on this point by an estate tax examiner. Also, do not overlook the IRS's *acquiescence* in *Barr*.

Consider all aspects (tax, financial, and personal) in determining

[20] For a recent decision to the same effect, see *James Gray, Exr. u/w of H. Gray*, CA-3, 410 F2d 1094.

[21] Regs. Sec. 20.2039-1 (b) (1) (ii).

[22] See Example (6), Regs. Sec. 20.2039-1 (b) (2).

[23] See Examples (4) and (6), Estate Tax Regs. Sec. 20.2039-1 (b) (2), as well as Regs. Sec. 20.2039-1 (b) (1) (ii).

whether it would be desirable for employee to forego retirement benefits in order that contractual death benefits to his beneficiary might escape estate tax at his death.

Planning Technique

In planning further for death benefits, consider feasibility of gifts of contractual death benefits, whether donee should be employee's life insurance trust, and transferring non-contractual benefits to such a trust after employee's death.

Our preceding discussion of life insurance suggested techniques for achieving estate tax savings in several situations, as follows:

Taxable Situation	*Estate Tax Savings Technique*
(1) At the employee's death	Inter vivos gifts by employee prior to death;
(2) At beneficiary's death	Life insurance trust[24] established prior thereto;
(3) At death of members of future generations	Prolonged (or perpetual)[25] life insurance trust,[26] previously established.

PLANNING SUGGESTION. Practitioners should determine the extent to which any or all of these techniques can and should be used, on behalf of employee-clients, in connection with employer-provided death benefits.

Meals and Lodging Furnished for Employer's Convenience

Planning Technique

Meals and lodging can be furnished tax free to employees under prescribed circumstances.

The value of meals and lodging furnished to an employee by his employer is not taxable to the employee if they are furnished for the

[24] Such trusts attempt to save estate taxes through the use of generation-skipping transfers. (See discussion of estate taxes of future generations in connection with consideration of employer-provided life insurance, p. 52).

[25] The extent to which such a trust can be perpetuated depends of course upon any local laws, etc., against perpetuities.

[26] See footnote 24.

employer's convenience on its business premises. (Sec. 119.)

NOTE. Supper money, unlike other meals furnished for an employer's convenience, does not have to be furnished on the employer's business premises pursuant to O.D. 514, CB No. 2, 90 (1920), which reads as follows:

> "Supper money" paid by an employer to an employee, who voluntarily performs extra labor for his employer after regular business hours, such payment not being considered additional compensation and not being charged to the salary account, is considered as being paid for the convenience of the employer and for that reason does not represent taxable income to the employee.

Rental Value of Parsonages

Planning Technique

Practitioners with clergymen or religious institutions as clients should recommend maximum utilization of the benefits provided by Sec. 107.

Sec. 107 permits a clergyman to exclude from income either (1) the rental value of a home, including utilities, furnished to him as part of his compensation or (2) a compensatory rental allowance, to the extent used to rent or provide a home.

To qualify for this exclusion, Regs. Sec. 1.107-1(a) requires that the home or rental allowance must be provided as remuneration for services which are ordinarily the duties of a minister of the gospel (as generally determined under the rules of Regs. Sec. 1.1402(c)-5, relating to the self-employment tax).

Courtesy Discounts to Employees

Planning Technique

Employers can promote goodwill by granting discounts to employees.

Courtesy discounts on purchases are not taxable to employees if they are (1) offered to employees generally, (2) of relatively small value, and (3) offered merely to promote employee health, good will, contentment, or efficiency.[27]

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[27] Employment Tax Regs. Sec. 31.3401 (a)-1 (b) (10), and "Your Federal Income Tax" (1970 ed.), IRS Publication 17, p. 32.

On the other hand, "Your Federal Income Tax"[28] states that if property is purchased from an employer at a reduced price, *as additional compensation*, the difference between the property's fair market value and its purchase price is includible in income.

201.3 Exempt Investment Income

Planning Technique

The tax exemption granted municipal bond interest should be considered when making investment decisions.

Interest. Sec. 103 (a) (1) grants exemption from federal income tax for interest on obligations of states, territories, and possessions of the United States; their political subdivisions; and the District of Columbia. This rather well-known exemption has become a distinct factor in setting the yield rate on these municipal bonds for marketing purposes.

Illustration 4, page 60, presents a vivid demonstration of the net yields obtainable from tax-exempt versus taxable bonds. Similar comparisons should be made by investors in formulating their portfolios.

Industrial Development Bonds: Prior to May 1, 1968, industrial development bonds were included under the umbrella of the municipal bond exemption even though they were used to attract new industries to a particular geographical area instead of to finance customary public improvements such as schools and highways. However, this exemption has been eliminated for interest on industrial development bond issues of more than $1 million which are issued after April 30, 1968 (except for certain bonds issued before January 1, 1969 which satisfy several statutory requirements). An issuing governmental unit can elect a $5 million exemption limit under specified conditions.

Planning Technique

Ownership of income-producing stocks should be spread within a family to obtain multiple $100 exclusions.

The merits of a gift program are portrayed elsewhere in this study from the standpoint of deflecting income to lower brackets. (See 202.2.) Where these gifts consist of dividend-producing stocks, additional $100

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[28] *Ibid.*

Illustration 4

Tax-Exempt vs. Taxable Income

Under federal income tax rates effective in 1970 the comparable yields are:

(Taxable income in thousands)

JOINT RETURN	$8 to $12	$12 to $16	$16 to $20	$20 to $24	$24 to $28	$28 to $32	$32 to $36	$36 to $40	$40 to $44	$44 to $52	$52 to $64	$64 to $76	$76 to $88	$88 to $100	$100 to $120	$120 to $140	$140 to $160	$160 to $180	$180 to $200	Over $200	
SINGLE RETURN	$4 to $6	$6 to $8	$8 to $10	$10 to $12	$12 to $14	$14 to $16	$16 to $18	$18 to $20	$20 to $22	$22 to $26	$26 to $32	$32 to $38	$38 to $44	$44 to $50	$50 to $60	$60 to $70	$70 to $80	$80 to $90	$90 to $100	Over $100	
% Tax Bracket	24	27	30	34	39	42	45	48	52	54	57	59	62	65	67	69	71	73	74	75	
TAX-EXEMPT YIELDS																					TAX-EXEMPT YIELDS
3.00%	3.95	4.11	4.29	4.55	4.92	5.17	5.45	5.77	6.25	6.52	6.98	7.32	7.89	8.57	9.09	9.68	10.34	11.11	11.54	12.00	**3.00%**
3.10	4.08	4.25	4.43	4.70	5.08	5.34	5.64	5.96	6.46	6.74	7.21	7.56	8.16	8.86	9.39	10.00	10.69	11.48	11.92	12.40	**3.10**
3.25	4.28	4.45	4.64	4.92	5.33	5.60	5.91	6.25	6.77	7.07	7.56	7.93	8.55	9.29	9.85	10.48	11.21	12.04	12.50	13.00	**3.25**
3.40	4.47	4.66	4.86	5.15	5.57	5.86	6.18	6.54	7.08	7.39	7.91	8.29	8.95	9.71	10.30	10.97	11.72	12.59	13.08	13.60	**3.40**
3.50	4.61	4.79	5.00	5.30	5.74	6.03	6.36	6.73	7.29	7.61	8.14	8.54	9.21	10.00	10.61	11.29	12.07	12.96	13.46	14.00	**3.50**
3.75	4.93	5.14	5.36	5.68	6.15	6.47	6.82	7.21	7.81	8.15	8.72	9.15	9.87	10.71	11.36	12.10	12.93	13.89	14.42	15.00	**3.75**
4.00	5.26	5.48	5.71	6.06	6.56	6.90	7.27	7.69	8.33	8.70	9.30	9.76	10.53	11.43	12.12	12.90	13.79	14.81	15.38	16.00	**4.00**
4.10	5.39	5.62	5.86	6.21	6.72	7.07	7.45	7.88	8.54	8.91	9.53	10.00	10.79	11.71	12.42	13.23	14.14	15.19	15.77	16.40	**4.10**
4.25	5.59	5.82	6.07	6.44	6.97	7.33	7.73	8.17	8.85	9.24	9.88	10.37	11.18	12.14	12.88	13.71	14.66	15.74	16.35	17.00	**4.25**
4.40	5.79	6.03	6.29	6.67	7.21	7.59	8.00	8.46	9.17	9.57	10.23	10.73	11.58	12.57	13.33	14.19	15.17	16.30	16.92	17.60	**4.40**
4.50	5.92	6.16	6.43	6.82	7.38	7.76	8.18	8.65	9.38	9.78	10.47	10.98	11.84	12.86	13.64	14.52	15.52	16.67	17.31	18.00	**4.50**
4.75	6.25	6.51	6.79	7.20	7.79	8.19	8.64	9.13	9.90	10.33	11.05	11.59	12.50	13.57	14.39	15.32	16.38	17.59	18.27	19.00	**4.75**
5.00	6.58	6.85	7.14	7.58	8.20	8.62	9.09	9.62	10.42	10.87	11.63	12.20	13.16	14.29	15.15	16.13	17.24	18.52	19.23	20.00	**5.00**
5.10	6.71	6.99	7.29	7.73	8.36	8.79	9.27	9.81	10.63	11.09	11.86	12.44	13.42	14.57	15.45	16.45	17.59	18.89	19.62	20.40	**5.10**
5.25	6.91	7.19	7.50	7.95	8.61	9.05	9.55	10.10	10.94	11.41	12.21	12.80	13.81	15.00	15.91	16.94	18.10	19.44	20.19	21.00	**5.25**
5.40	7.11	7.40	7.71	8.18	8.85	9.31	9.82	10.38	11.25	11.74	12.56	13.17	14.21	15.43	16.36	17.42	18.62	20.00	20.77	21.60	**5.40**
5.50	7.24	7.53	7.86	8.33	9.02	9.48	10.00	10.58	11.46	11.96	12.79	13.41	14.47	15.71	16.67	17.74	18.97	20.37	21.15	22.00	**5.50**
5.75	7.57	7.88	8.21	8.71	9.43	9.91	10.45	11.06	11.98	12.50	13.37	14.02	15.13	16.43	17.42	18.55	19.83	21.30	22.12	23.00	**5.75**
6.00	7.89	8.22	8.57	9.09	9.84	10.34	10.91	11.54	12.50	13.04	13.95	14.63	15.79	17.14	18.18	19.35	20.69	22.22	23.08	24.00	**6.00**
6.10	8.03	8.36	8.71	9.24	10.00	10.52	11.09	11.73	12.71	13.26	14.19	14.88	16.05	17.43	18.48	19.68	21.03	22.59	23.46	24.40	**6.10**
6.25	8.22	8.56	8.93	9.47	10.25	10.78	11.36	12.02	13.02	13.59	14.53	15.24	16.45	17.86	18.94	20.16	21.55	23.15	24.04	25.00	**6.25**
6.40	8.42	8.77	9.14	9.70	10.49	11.03	11.64	12.31	13.33	13.91	14.88	15.61	16.84	18.29	19.39	20.65	22.07	23.70	24.62	25.60	**6.40**
6.50	8.55	8.90	9.29	9.85	10.66	11.21	11.82	12.50	13.54	14.13	15.12	15.85	17.11	18.57	19.70	20.97	22.41	24.07	25.00	26.00	**6.50**
6.75	8.88	9.25	9.64	10.23	11.07	11.64	12.27	12.98	14.06	14.67	15.70	16.46	17.76	19.29	20.45	21.77	23.28	25.00	25.96	27.00	**6.75**
7.00	9.21	9.59	10.00	10.61	11.48	12.07	12.73	13.46	14.58	15.22	16.28	17.07	18.42	20.00	21.21	22.58	24.14	25.93	26.92	28.00	**7.00**

For example: A couple filing a joint return in the $28,000 to $32,000 net taxable income bracket must find a taxable investment with a return of 6.90 percent to equal a tax-exempt security with a return of 4.00 percent.

Source: "Tax-Exempt Bonds & the Investor," Investment Bankers Association of America (March 1965).

exclusions may be possible — depending upon the number of donees and their prior investment portfolios.

EXAMPLE. Client owns 200 shares of $100 par value Golden Machines Corporation 5 percent preferred stock, which would be reflected in his 1970 joint return as follows:

Dividends received	$ 1,000
Less — exclusion	100
Taxable dividends	$ 900

Client is advised by a CPA to give 20 shares each to his wife, four children, and their spouses on January 4, 1971. These gifts would result in the following reporting on each of the five 1971 joint returns involved:

Dividends received	$ 200
Less — exclusion	200
Taxable dividends	$ None

As a minimum objective, the full use of the separate $100 exclusion by both *husband and wife should be attained — in the absence of personal reasons to the contrary.*

NOTE: Married couples residing in community property states can usually achieve such maximum exclusions without the necessity of gifts.

In order to remove the value of the underlying stock from Client's estate, CPA also recommends that these gifts *not* be in the form of either a joint interest in such stock (with right of survivorship), or a tenancy by the entirety, which will be owned by Client and a donee. Under Sec. 2040, the value of such jointly owned stock would not be excludible from Client's gross estate.

However, Sec. 2040 would not apply to stock held by Client and a donee as tenants in common.

Technical Resume

Sec. 116 authorizes an exclusion of $100 for dividends received from qualifying corporations, which are generally taxable domestic corporations. Accordingly, dividends from the following sources would be ineligible for this exclusion:

1. Foreign corporations, including your share from a controlled foreign corporation.
2. So-called exempt organizations (charitable, fraternal, etc.) and exempt farmers' cooperative organizations.

3. Regulated investment companies except to the extent designated by the company to be taken into account as a dividend for these purposes.
4. Real estate investment trusts.
5. Corporations deriving 80 percent or more of their income from U.S. possessions and 50 percent or more of their income from the active conduct of a business therein. (1970 Form 1040 Instructions, page 9.)

201.4 Increasing Basis of Property

Planning Technique

Use expiring carryovers to step up the basis of property tax free through wash sales.

In 104.2 (Chapter 1), the acceleration of income and/or the postponement of deductions were discussed as a means of preventing the wastage of expiring net operating loss, investment credit, and contribution carryovers. For various business and/or personal reasons, such acceleration or postponement may not always be possible.

In such event, these otherwise unusable carryovers can, nevertheless, be utilized by increasing the basis of property through currently taxable dispositions in order to reduce any future lifetime gains (or increase any future lifetime losses). The current tax generated by the basis increase should not, of course, be more than an amount sufficient to absorb the tax "value" of the expiring carryover. In order to protect the client's investment position in the property disposed of, substantially identical property can be acquired at or near the time of the disposition.

In effect, the expiring carryover would be absorbed through gains resulting from wash sales which, unlike wash sale losses, are *not* deprived of recognition for income tax purposes by Sec. 1091.

EXAMPLE. Client has an unused net operating loss carryover of $40,000 that expires in 1970. His projected taxable income for 1970 is $17,000, constituted as follows:

Commission income		$25,000
Charitable contributions	$2,000	
Property tax	1,400	
State income tax	1,500	
Interest expense	2,475	
Exemption	625	8,000
		$17,000

However, for reasons beyond his control, Client is unable to follow any of CPA's suggestions for accelerating any 1971 income or postponing any 1970 deductions.

CPA thereupon suggests that Client sell and repurchase his stock in Universal Airlines, since it has the attributes shown in Illustration 5, below.

Illustration 5

Unrealized appreciation	
Current market value	$50,000
Less Client's original basis (cost)	4,000
Unrealized appreciation	$46,000
Future disposition	
(1) To be sold in five years (1975) to finance expected business and personal projects.	
(2) Estimated 1975 gain:	
Estimated 1975 market value	$80,000
Less original basis	4,000
Estimated gain	$76,000

CPA's recommendation can thus decrease this estimated 1975 gain by $46,000, without incurring any tax in 1970, as shown in Illustration 6, below.

Illustration 6

1975		
Estimated selling price		$ 80,000
Less — basis (cost) of stock (repurchased in 1970)		50,000
Estimated gain		$ 30,000
Less — gain previously estimated		76,000
Decrease in estimated gain		$(46,000)
1970		
Additional long-term capital gain		$ 46,000
Commission income		25,000
Gross income (revised)		$ 71,000
Less:		
Capital gain deduction (50% of $46,000)	$ 23,000	
Net operating loss carryover	40,000	63,000
Adjusted gross income (revised)		$ 8,000
Less — itemized deductions and exemption		8,000
Taxable income		$ None

Planning Technique

A complex trust or estate beneficiary can acquire property from the fiduciary at a stepped-up basis, without *any correlative recognition of gain, or the generation of any other type of income, to either the beneficiary or fiduciary. Thus, the beneficiary's taxable gain will be reduced upon his subsequent disposition of the property.*

Accordingly, appreciation in the property's value at the time of its distribution by the fiduciary will forever escape income tax.

Under Regs. Sec. 1.661 (a)-2 (f), the following consequences occur where property is paid, credited, or required to be distributed in kind by a complex (i.e., income accumulation) trust or an estate:

1. No gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of the distribution, unless the distribution is in satisfaction of a right to receive a distribution in a specific dollar amount or in specific property other than that distributed.
2. In determining the amount deductible by the trust or estate and includible in the gross income of the beneficiary the property distributed in kind is taken into account at its fair market value at the time it was distributed, credited, or required to be distributed.
3. *The basis of the property in the hands of the beneficiary is its fair market value at the time it was paid, credited, or required to be distributed, to the extent such value is included in the gross income of the beneficiary.* To the extent that the value of property distributed in kind is not included in the gross income of the beneficiary, its basis in the hands of the beneficiary [is the same as the uniform basis of the property in the hands of the fiduciary]. [Emphasis supplied.]

Illustration 7, page 65, shows how a beneficiary can acquire property from a fiduciary at a stepped-up basis without any correlative recognition of gain.

CAUTION. Regs. Sec. 1.661 (a)-2 (f) is equally applicable in the reverse situation (i.e., distribution of *declined*-in-value property). *Therefore, such distributions should be avoided in order to prevent the beneficiary's acquisition of property with a stepped-down basis — while the corresponding loss is not recognized by either fiduciary or beneficiary.*

Line	*Fiduciary's Treatment*	
1.	Distributable net income*	$ 50,000
2.	Fair market value of property distributed to beneficiary	$ 50,000
3.	Distributions deduction (lesser of lines 1 or 2)	$ 50,000
	Beneficiary's Treatment	
4.	Amount includible in beneficiary's income (line 3)	$ 50,000
5.	Value of property distributed *that is deemed to be included in beneficiary's income* (lesser of lines 2 or 4)	$ 50,000
6.	Basis of property to beneficiary (line 5)	$ 50,000
	Untaxed Appreciation	
7.	Basis of property to beneficiary (line 6)	$ 50,000
8.	Less — basis of property *to fiduciary*	10,000
9.	Untaxed appreciation resulting from stepped-up basis	$ 40,000

Note: Also see Rev. Rul. 64-314 (1964-2 CB 167) which illustrates the application of these regulatory provisions where several assets are distributed in kind.

* Excludes appreciation on property distributed (line 2 less line 8).

201.6 Appreciated Property Acquired From a Decedent

Planning Technique

Where permissible, action should be taken to control or determine estate tax values in order to obtain best combined results for present estate tax and possible future income taxes of successor owners.

Appreciation in the value of property completely escapes income tax upon the owner's death since the successor owner's basis, under Regs. Sec. 1.1014-1(a), is generally equal to the value placed upon such property for federal estate tax purposes. This estate tax value is determined as of the date of death or pursuant to the alternate valuation date granted by Sec. 2032 (summarized below).

While a higher value tends to produce additional estate tax, it also secures a higher basis for income tax purposes and can thus serve to reduce *future* income taxes.

The measurement of the impact of this relationship between present

estate taxes and possible future income taxes involves consideration of such factors as:

1. The effective estate tax rate.
2. The likelihood of the property's future disposition in a transaction subject to income tax.
3. The estimated income tax rate that will be effective at such future time.
4. The cost of using money to presently pay additional estate taxes in order to reduce a possible future income tax.

PLANNING SUGGESTION. (1) Weigh the interrelationship between present estate taxes and possible future income taxes in those situations where the valuation of property is not, entirely, objectively or externally ascertainable. (2) Take appropriate action to control or determine estate tax values. (See elaboration below.) (3) Don't, in any event, report unrealistic values because of apparent tax advantages.

Controlling Estate Tax Values

Examples of situations in which valuation can be affected by subjective judgment or other internal actions include:

1. An executor's evaluation of a closely held corporation's goodwill.[29]
2. Prior administrative (or judicial) determinations, as discussed below.
3. A partner's execution of a binding buy-and-sell agreement.[30] Such an agreement will restrict the seller's opportunity to dispose of the property covered thereunder in any other manner.

> . . . In order for a restrictive agreement to affect the value of the property to be included in the decedent's estate such agreement must make it impossible for the decedent during his life, or his executor after decedent's death, to unilaterally avoid having to either offer or sell the decedent's property interest to the other contracting party before disposing of the property to an outsider. . . . [31]

These agreements have not been given such controlling effect, judicially, in valuing property for gift tax purposes.

The funding of the buyer's obligation under such an agreement is beyond the scope of this study.

Effect of Prior Determinations. The estate tax valuation of closely held stock and other such gray area property can be affected by final Internal

[29] Rev. Proc. 59-60, 1959-1 CB 237.
[30] *Est. of O. B. Littick,* 31 TC 181, acq. 1959-2 CB 5.
[31] Mertens, *Law of Federal Gift and Estate Taxation,* Sec. 9.06.

Revenue Service (or court) determinations regarding the value of inter vivos transfers of such stock, either as charitable contributions or as taxable gifts. Of course, the strength of these prior precedents varies inversely with the lapse of time between the estate tax valuation date and the inter vivos transfer valuation date.

Therefore, the possibility of such official estate tax valuations could be a nonpersonal factor in deciding whether gifts should be made and might also be a factor in evaluating any Revenue Service proposals as to their value.

Advantages: A final determination of the value of closely held stock given to charity, and claimed as an income tax deduction, might tend to be lower than a determination first made for estate tax purposes (in the absence of prior charitable gifts).

Further, the existence of charitable gifts made in years still open for income tax refunds (or credits) could have some deterrent effect upon the assertion of an estate tax value that is higher than the value claimed for the contributed stock in the decedent's income tax returns for the open years.

Disadvantages: Conversely, the allowance of such a charitable contribution as an income tax deduction could establish a minimum valuation for estate tax purposes, which may be difficult for an executor to overcome. *Hence, the two-way effect of lifetime charitable contributions on estate tax values and, in turn, on possible future income tax gains or losses and/or depreciation deductions, should not be overlooked.*

Other Benefits: A prior determination regarding the value of both taxable as well as charitable gifts of closely held stock and other such property can also provide some degree of certainty as to the worth, in the eyes of the taxing authorities, of the remaining property to be valued for estate tax purposes. This knowledge can be of assistance in estimating the estate tax liability and planning for its satisfaction.

Further aspects of taxable gifts and their relationship to estate taxes are discussed in 202.2 and 405.

A Technical Glimpse of Sec. 2032

Under Sec. 2032, *all* properties in gross estates exceeding $60,000 (Estate Tax Regs. Sec. 20.2032-1(b)) can be valued as follows:

1. Property disposed of within six months of death:
   Value on date of disposition.

2. Property *not* disposed of within six months of death:
   Value on date six months after death.

CAUTION. A 12-month alternate valuation period applies for decedents dying before 1971.

However, any property, interest, or estate affected by mere lapse of time is valued at the date of death, subject to adjustment for differences in value (not due to time lapse) as described under (1) or (2) above.

Election Required. Sec. 2032 (c) requires an election to be exercised in a timely filed estate tax return (Form 706). It is recommended that *all* election designations be completed as provided on Form 706.

NOTE. In appropriate hindsight circumstances, take cognizance of Rev. Rul. 61-128 (1961-2 CB 150) where the "general information election box" was not utilized, although property values were shown under the "alternate value" captions and the tax based thereon. The Service permitted the use of Sec. 2032 under these facts.

201.7 Insurance Reimbursements for Certain Living Expenses

Planning Technique

When considering an insurance program, individuals can obtain tax-exempt income in the event of a casualty which results in loss of use of their residence through insurance covering certain resulting extraordinary living expenses.

Insurance proceeds received as reimbursement for living expenses incurred on behalf of a taxpayer and members of his household, resulting from the loss of use or occupancy of the taxpayer's principal residence, are excludible from gross income in either of these circumstances:

1. Such residence is damaged or destroyed by fire, storm, or other casualty.
2. Access to the residence is denied by governmental authorities because of the occurrence, or threat of occurrence, of such a casualty.

The exclusion is subject to the limitations exemplified below:

"Actual living expenses" incurred by taxpayer and household members while residence cannot be used	$3,000
Less "normal living expenses" which they would have incurred during the same period	2,000
Limitation on amount of exclusion	$1,000

PLANNING SUGGESTION. In order to avoid any controversy with the IRS as to what constitutes actual and "above-normal" living expenses, a client should obtain insurance coverage only for additional (above-normal) living expenses. In a policy of this type, the insurance company computes the insured's average daily living expenses and reimburses him only for expenses in excess of the predetermined figure.

The following excerpt[32] should offer guidance in this area:

> ... The additional living expense insurance coverage is intended to reimburse the insured for certain excess living expenses incurred during a period in which his residence may not be used. Generally, these expenses include the additional costs actually incurred for renting suitable housing and extraordinary expenses for transportation, food, utilities, and miscellaneous services.
>
> However, the exclusion is intended to be limited to *reasonable* expenses in excess of normal living expenses, which, for purposes of this provision include *only* those required to maintain the insured and his household in the same standard of living that they enjoyed before the loss occurred. ... [Emphasis supplied.]

202 Deflected Income

The overall tax impact upon the broad socio-economic unit consisting of a client, his family, and his business interests can be reduced through the deflection of income to the lower brackets within this broad grouping. Since this technique does not require the sacrifice of any income flowing to the group as a whole, retained income in total should rise due to the decreased tax expense.

The two major routes that can be traveled to reach this goal are (1) incorporation of income-producing properties and (2) gifts to family members.

202.1 Incorporation of Income-Producing Properties

Planning Technique

Expose taxable income to lower corporate rates, where feasible. Incorporation may also be beneficial in valuing property for estate and gift tax purposes.

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[32] S. Rep. No. 91-552, 11/21/69, pp. 272-273.

The evident attractiveness of diverting the unneeded income of higher bracket individuals to corporate taxation can be discerned from the following comparison:

Marginal Basic Tax Rates for 1970

		Individual		
Taxable Income	*Corporate*	*Joint Return*	*Single* °	*Head of Household* °
0 - $25,000	22%	14%-36%	14%-50%	14%-43%
Over $25,000	48%	36%-70%	50%-70%	43%-70%

° Rates reduced after 1970. See Code Sec. 1.

There are advantages and disadvantages of incorporating income-producing properties, which are discussed extensively in Studies in Federal Taxation No. 1, *Tax Guide for Incorporating a Closely Held Business.* A parallel analysis here would obviously be beyond the scope of our coverage. Of course, that study is primarily concerned with incorporation of properties productive of business income. Nevertheless, many of the principles considered therein apply with equal vigor to non-business-income-producing assets as well.

The incorporation of such passive investments generally creates a "personal holding company," whose pitfalls are described in 204.2 of Tax Study No. 1. However, this usually undesirable result can be avoided if the new corporation:

1. Is fed a properly balanced diet, consisting of acceptable mixtures of various kinds of business and investment income; and/or
2. Pays dividends to the extent required by the Code's personal holding company provisions.

CAUTION. Personal holding companies are exempt from the accumulated earnings tax by virtue of Code Sec. 532 (b) (1). Thus, a corporation may escape personal holding company classification (see (1) above) only to find that it may be exposed to the accumulated earnings tax.

In this regard, Sec. 533 (b) states that "the fact that any corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders." For the effect of this presumption and the definition of such companies, see Regs. Sec. 1.533-1 (b) and (c), respectively.[33]

[33] See *Rhombar Co., Inc.*, CA-2, 386 F2d 510, aff'g 47 TC 75 (1966), acq. 1967-2 CB 3.

On the other hand, accumulated earnings tax rates are considerably less than personal holding company rates, as shown by the following comparison:

	Accumulated Earnings Tax	*Personal Holding Company Tax*
First $100,000 of accumulated taxable income	27-1/2%	
Accumulated taxable income in excess of $100,000	38-1/2%	
Undistributed personal holding company income		70%

For further consideration of the impact of the accumulated earnings tax on the question of incorporation, see 204 of Tax Study No. 1.

Sheltering Personal Holding Company Income

In many cases the dividends required to avoid personal holding company tax will be considerably less than the corporation's taxable income and thus permit at least partial income sheltering.

The personal holding company problem is most acute when the income under consideration is comprised of such passive investment income as interest or dividends. Even in this case, partial sheltering may be possible through recourse to the relief procedure illustrated below.

EXAMPLE. Client transfers stock and a leasehold to his newly created corporation. Just prior to the end of its first taxable year, the corporation's records disclose the information shown in Illustration 8, below.

Illustration 8

Line	*(i)* *Per Records*	*(ii)* *Adjusted Ordinary Gross Income*	*(iii)* *Adjusted Income From Rents*
1. Dividends	$ 40	$	$
2. Gross rents	150		150
3. Ordinary gross income	190	190	
4. Capital gains	10		
5. Gross income	200		
6. Less depreciation, interest, and real property taxes (allocable to gross rents)	100	100	100
7. Net income	$100	$ 90	$ 50

Personal Holding Company Test. In the example, personal holding company income is computed as follows:

(a) Dividends (column (i), line 1)	$40
(b) Adjusted income from rents (column (iii), line 7)	50
(c) Total personal holding company income	$90
(d) Adjusted ordinary gross income (column (ii), line 7)	$90

The corporation is a personal holding company since line (c) is at least 60 percent of line (d).

This result could be avoided if adjusted income from rents is eliminated from personal holding company income. This can be accomplished by satisfying *both* of the following requirements:

1. Adjusted income from rents constitutes 50 percent or more of adjusted ordinary gross income.

This test is met as follows:

		% to total
Column (iii), line 7	$50	55.5%
Column (ii), line 7	$90	100%

2. Dividends paid, and so forth, must at least equal excess of non-rent personal holding company income over 10 percent of ordinary gross income.

This test is *not* met as follows:

(a) Non-rent personal holding company income (column (i), line 1)	$40
(b) Less 10% of ordinary gross income (column (i), line 3)	19
(c) Excess of (a) over (b)	$21
(d) Dividends paid, etc.	None

Upon reviewing these calculations,[34] CPA advises client to pay a $21 dividend prior to year end and thus avoid personal holding company classification for the year.

[34] Based upon the example in S. Rep. (Supplemental) No. 830, Part 2, p. 249, explaining the operation of Sec. 543 (a) (2), as amended by the Revenue Act of 1964.

Planning Technique

Incorporation could provide more realistic valuations where property would otherwise be difficult to value. Also, discounts from underlying asset values may be possible as a result of corporate ownership.

More Realistic Values Through Greater Ease of Transfer. The incorporation of property facilitates the transfer of ownership interests and thus establishes greater flexibility for their disposal than that possible for unincorporated property. This market could provide meaningful comparisons for determining the fair market value of property, transmitted by death or by gift, which is necessary in ascertaining any respective estate or gift taxes.

The extent to which incorporation can be used in determining fair market value depends upon the activity of the particular market. Listed securities frequently traded in a nationally recognized stock exchange, of course, present virtually no valuation problems. At the other extreme, a comparative market test alone may not suffice for inactively traded closely held stock. (See following discussion of discounted values.)

The inability to otherwise attain fair and realistic valuation of an unincorporated business would be another factor to favorably consider in deciding whether or not to incorporate and eventually "go public."

Discounted Values. Although fair market value is usually based upon selling or bid and asked prices, additional valuation criteria are permitted "if it is established"[35] that such prices do not reflect fair market value. Generally, these additional criteria apply if the sales activity is unreliable or if the quantity of shares involved is significant. In most instances, the use of such criteria, if permissible, can result in reduced values, although the opposite may be true in the case of a controlling interest. These criteria are discussed in further detail, as follows:

Unreliable Sales Activity: "Where sales at or near the date of death are few or of a sporadic nature, such sales alone may not indicate fair market value . . . ."[36] Hence, discounts for lack of marketability have been allowed.[37]

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[35] Estate Tax Regs. Sec. 20.2031-2 (e).

[36] Estate Tax Regs. Sec. 20.2031-2 (e).

[37] *The Central Trust Company, Exr., et al.* (Ct. Cls.), 305 F2d 393.

Blockage Rule: Where the selling price or bid and asked prices do not reflect fair market value, the blockage rule may apply:

> . . . In certain exceptional cases, the size of the block of stock to be valued in relation to the number of shares changing hands in sales may be relevant in determining whether selling prices reflect the fair market value of the block of stock to be valued. If the executor can show that the block of stock to be valued is so large in relation to the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations. . . .
>
> On the other hand, if the block of stock to be valued represents a controlling interest, either actual or effective, in a going business, the price at which other lots change hands may have little relation to its true value.[38]

Of course, in this latter circumstance, a *premium* value is invariably ascribed to the controlling interest.

In *Schnorbach, Exr.,* v. *Kavanagh,*[39] the "blockage rule" was held inapplicable in the absence of an existing open market. Nevertheless, the Court considered the lack of an active market, which could immediately have absorbed the amount of stock in issue, as an evidentiary fact in determining fair market value.

Thus, the distinction may be slight between an allowance for the depressing effect of a large block of unlisted stock and a blockage allowance for listed stock.

One of the primary areas for the enlargement of the blockage rule "is where a portion of stock previously unlisted and closely held is offered through underwriters and, in part, sold by them over the counter. This situation, of course, may also involve a listed stock, but more often does not . . . ."[40]

NOTE. In determining the fair market value of a holding company, consider applying the blockage theory (where appropriate) to the stock held in its investment portfolio.

Applying the blockage rule tends to invite scrutiny since Regs. Sec. 20.2031-2 (e) requires complete data to be submitted with the estate tax return in support of any blockage allowance claimed.

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[38] Estate Tax Regs. Sec. 20.2031-2 (e).

[39] *Schnorbach, Exr.,* v. *Kavanagh* (DC, Mich., 1951), 102 F. Supp. 828.

[40] Mertens, *Law of Federal Gift and Estate Taxation,* Sec. 8.06, footnote 24, citing *Ivens Sheer,* 10 TC Memo 671.

In addition to the above regulatory provisions, the value of closely held real estate and other investment companies might be reduced by a discount for income taxes and other disposal costs.[41]

Pitfalls of Incorporating From the Transfer Tax Viewpoint

Incorporation of properties also requires long-term consideration as to their future ownership since, as stated in Tax Study No. 1 (at 215):

> . . . If the business is initially divided up into multiple corporations and the results prove unsatisfactory, it will be easy to later merge the brother-sister corporations in a tax-free transaction. But if only one corporation is formed, it will be difficult to later divide it up into brother-sister corporations in a tax-free transaction . . . .

For example, assume that the client owns two office buildings and desires to devise each building separately to his two children. He also wishes to incorporate these buildings during his lifetime. If both buildings are incorporated in one corporation, it may be difficult to avoid the potential of an IRS challenge regarding compliance with the requirements of Sec. 355 (and the regulations thereunder) in achieving a tax-free separation of this solitary corporation after the client's death. Accordingly, in this type of a situation, the merits of a multiple incorporation should be carefully considered.[42] However, it should be kept in mind that tax advantages for multiple corporations have been reduced by the Tax Reform Act of 1969.

Phase-Out of $25,000 Multiple Surtax Exemption. For years beginning after 1969, certain tax advantages of operating a business through multiple corporations will be phased out by the 1969 Tax Reform Act. Prior to "the Act" each corporation in a controlled group was allowed a $25,000 surtax exemption. All that was required was that each corporation in the group elect to pay an additional 6 percent penalty tax on the first $25,000 of taxable income.

The 1969 Tax Reform Act withdraws the benefit of the multiple surtax

[41] *Obermer* (DC, Hawaii), 238 F. Supp. 29, which distinguished the contrary *Cruikshank* case (9 TC 162 (1947)) on the grounds that expert testimony as to the adverse effect of such factors was not offered.

For further information on this subject, the reader is directed to such articles as "How to Sustain a Lower Valuation for Stock of a Closely Held Investment Company," *The Journal of Taxation* (July 1966), p. 40; "Reduction in Value of Closely Held Stocks Due to Income Tax Liabilities," *Taxes Magazine* (July 1966), p. 487; "Valuation of Closely Held Securities: Accounting Know-How Is the Key," *The Journal of Accountancy* (March 1966), p. 47.

[42] *Est. of Moses L. Parshelsky*, CA-2, 303 F2d 14 (rev'g and rem'g TC), and *M. Wilson, et al.*, CA-9, 353 F2d 184 (rev'g and rem'g TC).

exemption gradually over a six-year period. Under the withdrawal schedule, only one $25,000 surtax exemption will be available for division among the members of a controlled group for taxable years beginning after December 31, 1974.

On the other hand, the 100 percent dividends received deduction has been commensurately phased in during this transition period for parent-subsidiary controlled corporations, *even though* multiple surtax exemptions (albeit on a reduced scale) are claimed. However, the following conditions must be met:

1. Multiple surtax exemptions must have been elected before April 23, 1969, and be effective for each corporation's taxable year which includes December 31, 1969.
2. Dividends must be distributed before 1978 out of earnings and profits of a taxable year which includes a December 31, 1970 through 1974.
3. The 100 percent dividends received deduction must be elected timely.

Phase-Out of $100,000 Multiple Accumulated Earnings Credit. Like the surtax exemption, the accumulated earnings credit will also be phased out by the 1969 Tax Reform Act. Prior to "the Act" each corporation in a controlled group had been generally entitled to a full $100,000 accumulated earnings credit.

The Act requires members of a controlled corporate group to share only one $100,000 accumulated earnings credit for taxable years beginning after 1974.

In considering the incorporation of income-producing properties, it becomes apparent that the use of multiple corporations will be much less advantageous for income tax purposes. However, this procedure continues to be attractive where a lower effective corporate rate (considering only a single surtax exemption and accumulated earnings credit) can shelter income from higher individual rates. Moreover, incorporation may still be desirable for various estate and gift tax, as well as economic or business, considerations.

202.2 Outright Lifetime Gifts

Planning Technique

Shift income to lower bracket family members by means of gifts which also involve such other planning considerations as outright lifetime gifts versus other donative dispositions, colla-

teral income tax effects of outright lifetime gifts of depreciable property, minimizing gift taxes, effect of gifts upon estate tax, and ineffective gifts.

The deflection of income to lower bracket taxpayers has income tax advantages that are most obvious. This form of income-shifting can be readily accomplished through gifts. However, as stated by Mr. Justice Holmes in the Supreme Court's opinion in *Lucas* v. *Earl* (2 USTC ¶496 (1930)), "no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew . . . ."[43]

Therefore, it is well settled that gifts of income, to be effective for income tax purposes, also require gifts of the underlying property which produces this income. Restated in terms of the above-quoted judicial metaphor, a gift of "fruit" alone will not be recognized unless also accompanied by a gift of the "fruit-producing tree" as well. Accordingly, the balance of this section will assume that gifts of income are desirable and, hence, will only be concerned with the attendant effects of the requisite gifts of principal.

Outright Lifetime Gifts Compared With Other Donative Dispositions

An outright lifetime gift of property will validly channel the income it produces to the income tax bracket of the donee, beginning *immediately* upon the effective date of the gift. Such gifts, in contrast to testamentary transfers, can remove income from a client's bracket during his lifetime. On the other hand, this tax benefit requires a client to forfeit his enjoyment of, and dominion over, the underlying property as well as its income for the balance of his life, which is not so in the case of a testamentary transfer. Thus, the immediate income tax benefit of an outright lifetime gift can only be gained by surrendering control over property (as well as its income).

If lifetime control over property is paramount, income deflection can still be obtained through the use of limited-term trusts that meet the statutory standards prescribed by Secs. 671-678 of the Internal Revenue Code. These trusts are further discussed in 202.3.

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[43] To the same effect, see the Supreme Court's decision in *Paul R. Horst,* 311 US 112, which taxed the donor on interest received by a donee where the interest coupons were detached from the bonds shortly before their due date and delivered to the donee as a gift.

Collateral Income Tax Effects of Outright Lifetime Gifts

Investment Credit Recapture. Regs. Sec. 1.47-2 (a) (1) states that a gift is included among those premature dispositions that can give rise to recapture of the investment credit. (On the other hand, Sec. 47 (b) (1) specifically excepts a transfer by reason of death from the recapture provision.)

Formerly (prior to April 19, 1969), recapture could be offset by new credits arising from additional purchases of qualified property. Because of the repeal of the investment credit, this procedure is no longer possible. Nevertheless, Sec. 47 (a) (5) allows such recapture to be offset if replacement property is acquired within six months after the date of the premature disposition. However, this post-April 18, 1969 replacement property must be property which would have been eligible for the credit had it not been repealed.

Carryover of Depreciation Recapture. A gift of depreciable property does not trigger the recapture of the donor's depreciation deductions as ordinary income.[44] (Similar treatment is accorded transfers at death, except as provided in Sec. 691, relating to income in respect of a decedent.)

However, the ordinary income potential of depreciation and like deductions carries over into the donee's hands. Thus, the donor's depreciation deductions are taken into account by the donee and may produce ordinary income upon his disposition of the property.

Gifts of Sec. 1250 Property. The donee receives the benefit of the donor's holding period. Thus, the donor and donee are treated as though they were one person, with the result that upon any subsequent sale by the donee, the same amount (if any) will be treated as ordinary income as if the donor held the property throughout the entire period.

Similarly, in determining the percentage decrease in total gain to be taken into account as ordinary income, the holding period of both the donor and the donee is taken into account. This, of course, means that a smaller proportion of the gain will be treated as ordinary income than would be true if only the donee's holding period were used for this purpose.[45]

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[44] Secs. 1245 (b) (1) and 1250 (d) (1).

[45] Based upon S. Rep. No. 830 (88th Cong., 2nd sess.), p. 135, and pre-1969 Proposed Regs. Sec. 1.1250-2 (d) (3).

However, the Tax Reform Act of 1969 has largely eliminated this sliding scale of percentage decrease in determining ordinary income resulting from post-1969 depreciation. As of January 1, 1970, *all* depreciation in excess of straight line that is claimed on Sec. 1250 property is subject to recapture upon disposition, except depreciation claimed:

1. From January 1, 1964 through December 31, 1969.
2. On property disposed of pursuant to a written contract which was binding on the owner on and after July 24, 1969.
3. Regarding government assisted projects, such as FHA programs, constructed or acquired before 1975.
4. On residential rental property (as defined in Sec. 167(j) (2) (B)).
5. For rehabilitation expenditures allowed in connection with low-income rental housing (under Sec. 167 (k)).

Recapture of excess depreciation on property in these five categories is decreased by the following percentages:

Category	*Percentage Decrease*	*Holding Period Required For No Recapture*
1, 2 and 3	100% less 1% for each full month after 20 months	120 months or 10 years
4 and 5	100% less 1% for each full month after 100 months	200 months or 16 years and 8 months

Thus, the combined holding period (of both donor and donee) will still be advantageous where gifts are made of those properties not subject to full recapture, such as those in category (1) above. (A gift of property previously sold under a binding contract (category (2)) will obviously be an ineffective means of deflecting the gain to the donee.)

In addition, the holding period of both the donor and the donee would be combined when determining the amount by which depreciation claimed exceeded straight-line depreciation. Naturally, as the holding period is increased the relative gap between straight-line and declining-balance depreciation is reduced. Given a long enough holding period, the depreciation claimed will be equalized with no resultant recapture upon disposition.

PLANNING SUGGESTION. Before making gifts of depreciable property, the following points should be considered:

1. Give appreciated property to shift ordinary income potential to lower bracket donee.

2. Bargain sales. Consider merits of a bargain sale which would still transfer appreciation to the donee but allow donor to recover his adjusted basis. As an alternative, the donor can mortgage the property for the same amount before making the gift.

   If multiple assets are involved (e.g., land, building, and equipment), proceeds should be allocated according to fair market values. Otherwise, unnecessary gain can be created for a particular asset even though there is no overall gain.
3. Weigh effect of valuation upon present gift tax vs. possible future income taxes. It was suggested in 201.6 that the interrelationship between estate and income taxes be weighed where valuation of property is not completely susceptible to objective determination.

   Similar considerations should prevail here, with comparative projections also reflecting the donee's increased basis for the donor's gift tax. (See Sec. 1015 (d) which, in addition, limits this increased basis to the property's fair market value at the time of the gift.)
4. Do not give declined-in-value property. The depreciation taint carries over to the donee who could subsequently recognize this ordinary income potential upon a taxable disposition.

   Instead, the would-be donor should sell such property in order to claim his Sec. 1231 loss. Of course, depreciation recapture is inapplicable to dispositions in which losses are realized.

   It should be cautioned that the loss on a sale to a would-be donee would usually be disallowed by Sec. 267 and that loss cannot be shifted to a donee in a higher bracket than the donor since the donee's basis for the property will be its fair market value at the time of the gift. (Sec. 1015 (a).)

Minimizing Gift Taxes

Planning Technique

Taxable gifts can still be avoided, even after the specific exemption has been exhausted, by not making gifts to any one donee which will exceed the available exclusion of $3,000 (or $6,000 if marital gift-splitting applies). In cases where the property desired to be given is not susceptible to such precise molding, the amount of reportable (i.e., gross) gifts can still be kept within the exclusion limit by staggered or partial gifts.

Staggered and Partial Gifts. The gift tax provisions of the Internal Revenue Code permit gifts made during a year to be reduced by the following items in arriving at taxable gifts:

1. Fifty percent of gifts to third parties which are deemed to be made by the donor's spouse (in accordance with the consent of both spouses pursuant to Sec. 2513).
2. $3,000 annual exclusion per donee for gifts of "present interests" (which can also be applied by a donor's spouse against Sec. 2513 "consent gifts"). "Present interests" are further discussed below.
3. Specific exemption in any amount, but which cannot exceed $30,000 during a donor's lifetime. (This same exemption is also available to a donor's spouse as an offset against Sec. 2513 "consent gifts".)
4. Marital deduction (generally, 50 percent of qualifying gifts to spouse).
5. Deduction for charitable gifts.

A married client can transfer $72,000 outright to his son over a two-year period free of gift tax, as shown in Illustration 9, below.

Illustration 9

	1970	*1971*
Client		
Total gifts	$ 66,000	$ 6,000
Less — attributable to spouse under Sec. 2513	33,000	3,000
Balance	$ 33,000	$ 3,000
Less — annual exclusion	3,000	3,000
Balance	$ 30,000	$ -
Less — specific exemption	30,000	-
Taxable gifts	$ None	$ None
Client's Spouse		
Gifts attributed from spouse (above)	$ 33,000	$ 3,000
Less — annual exclusion	3,000	3,000
Balance	$ 30,000	$ -
Less — specific exemption	30,000	-
	$ None	$ None

EXAMPLE: *Staggered gifts.* Client (a widower) owns 600 shares of Rock Oil Company, whose current fair market value is $10 per share. He desires to give this stock to his daughter at the end of 1970. CPA suggests

that he transfer 300 shares in December 1970 and the balance in early January 1971, instead of transferring all 600 shares in 1970.

Also see *Haygood*[46] in which a mother transferred property in 1961 to her sons in return for vendor's lien notes secured by trust deeds for the value, payable at $3,000 per year; and then canceled the payments as due. The Tax Court rejected the Commissioner's contention that the notes were without substance and that the mother had made a gift of the entire property in 1961. The mother made gifts in 1961 only to the extent of $3,000 to each son, since she originally received valuable consideration in the form of enforceable vendor's lien notes and trust deeds.

The *Haygood* approach may cause the initial transfer of property to be viewed as a taxable event to the donor for income tax purposes since it may be tantamount to a sale. This issue was raised by the Service and considered by the Tax Court, as follows:

> . . . Respondent makes some point of the fact that petitioner did not report any gain or loss from sales of the properties transferred to her sons in either her 1961 or 1962 income tax return. Petitioner's income tax for neither of these years is before us, and therefore we express no opinion as to the correctness of petitioner's action in this regard. . . . [Haygood, supra, p. 947]

EXAMPLE: *Partial gifts.* Client (a widower) owns a lot worth $12,000 which he desires to give his son. CPA points out that, from a gift tax standpoint, Client should not make a gift of this lot entirely in 1970. Instead, the following procedure would be preferable:

Year	*Total Value of Lot*	*Value of Client's Remaining Interest*	*% of Undivided Interest Given*	*Value of Gift*
1970	$12,000	$12,000	25	$3,000
1971	12,000	9,000	33-1/3	3,000
1972	12,000	6,000	50	3,000
1973	12,000	3,000	100	3,000

Partial gifts, which will also qualify for the exclusion, can consist of "an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain) . . ." (Gift Tax Regs. Sec. 25.2503-3 (b)).

[46] 42 TC 936, acq. in result only, 1965-1 CB 4. (Acquiescence in result only means acceptance of the decision of the Court but disagreement with some or all of the reasons assigned for the decision.)

Also see Regs. Sec. 25.2511-1(e) which provides as follows:

> If a donor transfers by gift less than his entire interest in property, the gift tax is applicable to the interest transferred. The tax is applicable, for example, to the transfer of an undivided half interest in property, or to the transfer of a life estate when the grantor retains the remainder interest, or vice versa. *However, if the donor's retained interest is not susceptible of measurement on the basis of generally accepted valuation principles, the gift tax is applicable to the entire value of the property subject to the gift.* Thus, if a donor, aged 65 years, transfers a life estate in property to A, aged 25 years, with remainder to A's issue, or in default of issue, with reversion to the donor, the gift tax will normally be applicable to the entire value of the property. [Emphasis supplied.]

Regs. Sec. 25.2503-3(a) precludes any exclusion for a "future interest" in property, as follows:

> No part of the value of a gift of a future interest may be excluded in determining the total amount of gifts made during the calendar year. "*Future interests*" *is a legal term and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession or enjoyment at some future date or time.* The term has no reference to such contractual rights as exist in a bond, note (though bearing no interest until maturity), or in a policy of life insurance, the obligations of which are to be discharged by payments in the future. But a future interest or interests in such contractual obligations may be created by the limitations contained in a trust or other instrument of transfer used in effecting a gift. [Emphasis supplied.]

Planning Technique

Plan to obtain exclusion for gifts to minors, even though constituting future interests, by meeting express statutory requirements.

Obtaining Exclusion for Gifts to Minors. Gifts to minors are usually made in trust because of the donee's inability to effectively control and manage property under his sole dominion. The minor's interest in such a gift would be "limited to commence in use, possession, or enjoyment at some future date" and thus represent a future interest which is ineligible for the $3,000 annual exclusion.

Nevertheless, Sec. 2503(c) expressly provides that:

> No part of a gift to an individual who has not attained the age of 21 years on the date of such transfer shall be considered a gift of a future interest in property . . . if the property and the income therefrom:
>
> (1) May be expended by, or for the benefit of, the donee before his attaining the age of 21 years, and
>
> (2) Will to the extent not so expended (A) pass to the donee on his attaining the age of 21 years, and (B) in the event the donee dies before attaining the age of 21 years, be payable to the estate of the donee or as he may appoint under a general power of appointment as defined in Sec. 2514 (c).

NOTE. Under Regs. Sec. 25.2503-4 (b)(3), a gift is not disqualified even though "the governing instrument contains a disposition of the property or income not expended during the donee's minority to persons other than the donee's estate in the event of the default of appointment by the donee . . . ."

In regard to discretionary vs. mandatory accumulations of income, the statutory requirements are still satisfied if:

> . . . There is left to the discretion of a trustee the determination of the amounts, if any, of the income or property to be expended for the benefit of the minor and the purpose for which the expenditure is to be made, *provided there are no substantial restrictions under the terms of the trust instrument on the exercise of such discretion* . . . . [Regs. Sec. 25.2503-4 (b)(1); emphasis supplied.]

According to Mertens, "whether a provision for mandatory accumulation of income would prevent compliance with this requirement is not clear":

> The regulations, in insisting that there be no substantial restrictions on the exercise of the trustee's discretion, *clearly* indicate that mandatory accumulation would be a substantial restriction. The question turns on whether Congress meant to permit only discretionary deferment of income or meant to permit a required deferment of income. *The odds favor the former (and the regulations)* . . . . [Mertens, *Law of Federal Gift and Estate Taxation*, Sec. 38.20; emphasis supplied.]

CAUTION. Unless one is willing to litigate the doubtful question of mandatory accumulations, *trust indentures should only permit discretionary accumulations.*

EXAMPLE. In 1970, Client (unmarried) transfers $3,000 to a trust for the benefit of his nephew, age 10. The trust indenture permits income to

be accumulated and distributed, along with the principal, to the nephew 10 years hence upon the trust's termination. The $3,000 gift in 1970 is entirely excludible.

Only Unexpended Income Distributable at Age 21: The age of 21 may not be judged by a donor as a suitable age for vesting complete control of property in a donee. Accordingly, a trust indenture may contain the following provisions:

1. Principal to be distributed at age 25.
2. Income to be expended during minority, *at trustee's unrestricted discretion.* Unexpended income to be distributed at age 21.
3. Income earned after donee attains age 21 is distributable annually.

Under these circumstances, a maximum exclusion of $3,000 would be available with respect to the actuarial present value of the minor-donee's right to such income even though (1) it may only be enjoyed in the future, and (2) the underlying income-producing property (i.e., the corpus of the trust) is not distributed to the minor until he reaches an age beyond 21 (or even if such corpus is not distributable at all to this minor-donee. For example, the corpus could revert to the donor under a "ten-year trust" arrangement as described at 202.3.)[47]

These actuarial values can be derived from tables in Gift Tax Regs. Sec. 25.2512-5. Also see supplementary tables in IRS Publication No. 11.

These tables are based upon a 3 1/2 percent interest factor. Amendments to the estate and gift tax regulations were very recently adopted which would revise these tables by using:

1. A 6 percent interest factor.
2. Updated mortality experience.
3. Separate life expectancy tables for men and women.

These changes are generally effective for post-1970 gifts.

Under the new tables, the value of an income interest would be increased while the value of a remainder interest would be decreased.

Income Tax Aspects: Observe the following pertinent provisions of Income Tax Regs. Sec. 1.662(a)-4:

1. "Any amount which, pursuant to the terms of a will or trust instrument, *is used* in full or partial discharge or satisfaction of a legal

[47] *Herr*, CA-3, 303 F2d 780, aff'g 35 TC 732, acq. IRB 1968-37, 5 (9/9/68), withdrawing nonacq. 1962-2 CB 6; *Konner*, 35 TC 727, acq. IRB 1968-37, 5, withdrawing nonacq. 1963-2 CB 2, 6; *Weller*, 38 TC 790, acq. IRB 1968-37, 5, withdrawing nonacq. 1963-2 CB 6.

obligation of. any person is included in the gross income of such person . . . . " (Emphasis supplied.)

2. " . . . In any event, the amount of trust income which is included in the gross income of a person obligated to support a dependent is limited by the extent of his legal obligation under local law . . . . "

The same limitation applies with respect to *certain* grantor trusts. See Regs. Sec. 1.677(b)-1, as recently interpreted in *Brooke.*[48]

Further Availability of Gift Tax Exclusion: Regs. Sec. 25.2503-4(c) states that:

> A gift to a minor which does not satisfy the requirements of Sec. 2503(c) may be either a present or a future interest under the general rules . . . . Thus, for example, a transfer of property in trust with income required to be paid annually to a minor beneficiary and corpus to be distributed to him upon his attaining the age of 25 is a gift of a present interest with respect to the right to income but is a gift of a future interest with respect to the right to corpus.

Effect of Gifts Upon Estate Tax

Planning Technique

Divide an estate between the gift and estate tax systems to achieve the lowest overall effective tax rate.

Equalizing Effective Estate and Gift Tax Rates. Estate and gift taxes are both imposed upon the cumulative value of property constituting their respective bases. In addition, they both have progressive rate structures, *although gift tax rates are approximately 75 percent of estate tax rates.*

Therefore, subjecting all of one's property completely to *either* tax would be much more costly (in terms of tax liabilities) than dividing an estate between these two tax systems so as to achieve a lower *overall* effective tax rate.

EXAMPLE: *No gifts.* Client's sole surviving heir is his daughter. His net worth totals $1,000,000. If he does not make any gifts, his estate tax liability will be computed as shown in the following calculation.

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[48] *Brooke* (DC, Mont.), 69-1 USTC ¶9366, amending previous decision on same point (at 68-2 USTC ¶9544). The amended decision quoted, with approval, a comparable limitation enunciated in Rev. Rul. 56-484, 1956-2 CB 23.

Adjusted gross estate	$1,000,000
Less exemption	60,000
Taxable estate	$ 940,000
Estate tax (net of maximum credit for state death taxes)	$ 270,300
(Maximum tax rate — 31.4 percent)	

EXAMPLE: *All gifts.* If, instead, Client had rashly insisted upon giving his daughter all his property four years before he died, this estate tax would have been entirely eliminated. However a gift tax of $184,045 would be payable by the donee, as follows:

Total gift		$1,000,000
Less gift tax (computed below)		184,045
Net gift		$ 815,955
Less:		
Annual exclusion	$ 3,000	
Specific exemption	30,000	33,000
Taxable gifts		$ 782,955
Gift tax (see detailed computation below)		$ 184,045
(Maximum tax rate — 27.75 percent)		

Thus, a savings of approximately $86,000 (or approximately 32 percent of the potential estate tax) would be achieved by such a gift. However, human nature, as well as sound personal financial (i.e., nontax) considerations consign such a rash gift, in actual practice, to the realm of mere theoretical possibility (which has been presented here only as an example). (See Illustration 10, below.)

Illustration 10

Computation of Gift Tax on Net Gift

Line

1. Taxable gifts = $1,000,000 less $33,000 or $967,000 less tax.
2. Partial tax on first $750,000 of taxable gifts = $174,900.
3. Remaining tax = .2775 (967,000 − 750,000 − 174,900 − tax.)
4. T = .2775 (42,100 − T)
5. T = 11,682.75 − .2775 T
6. 1.2775 T = 11,682.75
7. T = $ 9,145
8. Partial tax (line 2) 174,900
9. Gift tax $184,045

Consider Advisability of Net Gifts. The Tax Court has held "*that in determining the value of the gifts subject to tax the gross value of the gifts should be reduced by the amount of the gift tax.* The rationale of the reduction was that because the obligation to pay the tax was incurred by the donee as a condition of the gift, the donor did not have the intent to make other than a net gift . . . . "[49]

A net gift allows taxable gifts to be reduced by the amount of the gift tax thereon. In effect, this permits a deduction for gift tax in computing such a tax which, of course, is not otherwise possible. As illustrated above, the gift tax payable of $184,045 was used to reduce the gross gift of $1 million. This, in turn, reduced the tax otherwise payable by approximately $51,000 (maximum rate of 27.75 percent multiplied by the $184,045 reduction of taxable gifts) in arriving at the actual liability of $184,045.

A net gift obviously reduces the amount transferred to the donee during the donor's lifetime, resulting in additional estate tax which can exceed the gift tax savings. (See comparative summary of balanced gifts in Illustration 11, page 90.)

NOTE. A donor should weigh the following factors in deciding whether gift taxes should be borne by the donee (net gift) or the donor (gross gift): a net gift would result in (1) less depletion of donor's estate during his lifetime and (2) gift tax savings increasing donee's retainable gift.

A gross gift would result in (1) greater depletion of donor's lifetime estate, (2) the donee's obtaining a greater gift, and (3) combined gift and estate taxes decreased, providing increased inheritance for heirs.

In regard to the income tax consequences of a net gift in trust, it should be noted that trust income was not taxed to the donor under the following circumstances:

1. Trustees had discretion to borrow funds to pay tax (using corpus as security).
2. Trustees repaid loan from trust income of future years.[50]

In contrast, trust income was taxed to the donor where *his* gift tax liability was not satisfied with borrowed funds but was, instead, directly extinguished with trust income. The courts held that the donor constructively received the income applied in payment of the tax since such income was, in effect, reserved for his benefit.[51]

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[49] *Turner,* 49 TC 356 (1968), citing with approval, *Harrison,* 17 TC 1350, acq. 1952-2 CB 2.

[50] *Morgan,* 37 TC 981 (1962), aff'd CA-6, 316 F2d 238, cert. denied.

[51] *Sheaffer,* 37 TC 99 (1961), aff'd CA-8, 313 F2d 738, cert. denied.

EXAMPLE. *Balanced gifts.* Since neither extreme (no gifts or all gifts) is desirable, CPA suggests to Client that he embark upon a balanced gift program, which would also be consistent with his emotional and financial well-being. Such a program would strive to avail itself of the following tax benefits:

1. The annual gift tax exclusion.
2. Separate estate and gift tax exemptions ($60,000 and $30,000, respectively).
3. Transferring property from higher estate tax rates to lesser gift tax rates (approximately 25 percent lower). In addition, a gift removes property from taxation at the highest estate tax brackets (to which an estate is subject) and subjects it to gift tax beginning with the lowest gift tax brackets. Thus, Client's property would be exposed to the lower brackets of each tax system.

   On the other hand, gifts should not be so large as to precipitate more tax than necessary. This can occur, for example, when the size of the donor's cumulative gifts causes his maximum gift tax bracket to exceed the maximum estate tax bracket (that may confront his estate) by increasingly wider margins, thus invoking the law of diminishing returns.
4. The gift tax paid would further reduce Client's estate for estate tax purposes. However, this produces an adverse monetary factor as such payment would usually be made before the estate tax due date.

   Another negative factor in transferring property by gift rather than by reason of death relates to the *transferee's* estate tax. Under Sec. 2013, a credit is allowable against the transferee's estate tax for the estate tax attributable to the transferred property in the transferor's estate (or the estate tax attributable to the transferred property in the transferee's estate, if less). In contrast, no credit is allowed for any gift tax paid in connection with a prior transfer of property which is subsequently included in the donee's estate.

   On the other hand, these credits are subject to erosion through the passage of time between the deaths of the transferor and transferee under a sliding scale contained in Sec. 2013(a).

Client decides that he can comfortably give his daughter $300,000, on the condition that she pay the gift tax. This arrangement would have the results shown in Illustration 11, page 90.

Conclusions Regarding Effect of Gifts Upon Estate Tax. Summarizing the computations in Illustration 11 reveals the following effects of gifts

Gift Tax

Line		
1.	Total amount transferred	$ 300,000
2.	Less – gift tax	43,347
3.	Net gift	$ 256,653
4.	Less – exclusion and exemption	33,000
5.	Taxable gifts	$ 223,653
6.	Tax	$ 43,347
	(Maximum rate – 22 1/2%)	

Estate Tax

7.	Total property	$1,000,000
8.	Less – total prior transfer (line 1)	300,000
9.	Gross estate	$ 700,000
10.	Less – exemptions	60,000
11.	Taxable estate	$ 640,000
12.	Tax	$ 176,700

Comparative Summary

		Net Gift (As above)	*Donor Pays Gift Tax (300,000 gift)*	*Increase Decrease*
13.	Gift tax	$ 43,347	$ 53,355	$(10,008)
14.	Estate tax	176,700	160,160	16,540
15.	Combined taxes	$220,047	$213,515	$ 6,532

For simplicity, additional annual gift tax exclusions, obtainable through staggered or partial gifts, have not been considered.

upon the *total* incidence of estate and gift taxation (exclusive of multiple annual exclusions, monetary factors, and possible Sec. 2013 credit):

		(Rounded)
1.	No gifts	$ 270,000
2.	Balanced gifts	220,000
3.	All gifts	184,000

Similar computations and considerations to determine optimum gifts which will produce the lowest estate and gift tax cost for a particular client must, of course, always be tempered by his nontax dictates. Furthermore, there are unknown variables surrounding the possible application of Sec. 2013, which are beyond the province of mortal

planners. Therefore, the custom design of a gift program requires the exercise of sound judgment in addition to knowledgeable calculations. In the final analysis, the quality of such judgment may often prove to be more indispensable to the fruition of a client's objectives than the precision of these calculations; particularly when the effect of certain unplannable subsequent events, such as untimely deaths, are reviewed with hindsight.

Ineffective Gifts

Planning Technique

Plan gifts without any *prohibited "strings" attached in order to accomplish estate and/or income tax goals.*

Certain gifts of property are, nevertheless, not removed from the estate tax base because the donor's interest in such property has not been severed sufficiently to satisfy various statutory criteria. Similar, but *not* identical standards, prevent income from such incomplete gifts from being eliminated from the donor's income tax bracket.

The estate tax aspects of these defective gifts are summarized below, while their income tax implications will be reviewed in 202.3.

Retained Life Estates. Sec. 2036 (a) requires the inclusion of property for estate tax purposes, even though it was previously transferred as a lifetime gift, if the transferor retained for his life either "(1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."

See Rev. Rul. 67-54 (1967-1 CB 269) for an application of Sec. 2036 in connection with nonvoting common stock, transferred in trust, where the grantor retains voting control under specified conditions.

Revocable Transfers. Sec. 2038 likewise requires the inclusion in a donor's gross estate of any gifts (by trust or otherwise) whose enjoyment could be changed, at his death, "through the exercise of a power *(in whatever capacity exercisable)* by the decedent alone *or* by the decedent in conjunction with *any other person* . . . , to alter, amend, revoke, or terminate . . ." (or where any such power is relinquished in contemplation of the decedent's death). (Emphasis supplied.)

Also, Rev. Rul. 59-357 (1959-2 CB 212) holds as follows in regard to custodianships:

> A transfer of property to a minor pursuant to either the Uniform Gifts to Minors Act or the Model Gifts of Securities to Minors Act is considered to be a completed gift for Federal gift tax purposes. The income from such property, to the extent it is used for the support of the minor-donee, is includible in the gross income of any person who is legally obligated to support the minor-donee. *The value of the property so transferred is includible in the gross estate of the donor if he appoints himself custodian and dies while serving in that capacity and before the donee attains the age of 21 years*. [Emphasis supplied.]

This Ruling was cited favorably by the Tax Court in *Chrysler* (44 TC 55). However, the Second Circuit Court of Appeals (361 F2d 508) found it unnecessary to resolve the issue as to whether Sec. 2038, or Sec. 2036, required inclusion of custodial property in the custodian's estate and reversed the Tax Court on the ground that the decedent had previously relinquished all beneficial interest in the funds used to establish the custodianship.

"In all other circumstances, custodial property is includible only in the gross estate of the donee . . . ." [52]

In addition to custodianships, a power held by the grantor as a trustee of the transferred property comes within the revocable transfer section, if it otherwise qualifies. Administrative and management powers may make a transfer includible even though they are held by the decedent-donor as a trustee, or in some other fiduciary capacity.

To be distinguished are normal but broad management powers over reinvestment of trust properties in securities or properties not of a character prescribed by law.

It is not necessary for the person who acts in conjunction with the settlor to be a person *other than* a beneficiary, *and it is unimportant whether such person has or has not an adverse interest.* Thus, retention of a prohibited power exercisable jointly with a beneficiary would be within Sec. 2038's purview. See *Graham* (46 TC 415 (1966)) where a right to be consulted was not a power to alter, amend, or revoke.

A power exercisable as a participant employee under an employer-employee annuity contract renders death payments under the plan includible, but only to the proportionate extent of premiums paid by the employee. [53]

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[52] Mertens, *Law of Federal Gift and Estate Taxation*, Sec. 25.17 (1967 supp.).
[53] See Merten's *Law of Federal Gift and Estate Taxation*, Secs. 25.17 and 25.22.

Gifts Taking Effect at Death. A gift effective at death can result from conditions attached by the donor so that its possession or enjoyment by the donee is held in abeyance until the donor dies. Sec. 2037 requires such gifts to be added back to the donor's estate only if the donor had a more than 5 percent reversionary interest immediately before his death.

Gifts in Contemplation of Death. The immediately preceding discussion has been centered on the prevention of estate tax evasion through "qualitative" determinations as to *whether* property rights (i.e., incidents of ownership or enjoyment) have been sufficiently relinquished so as to permit their exclusion from a deceased donor's estate. Since the inducements offered by the gift tax provisions of the Code, as previously described, become increasingly attractive with the imminence of death, congressional concern with estate tax evasion has also been focused on "quantitative" considerations regarding *when* property has been completely severed from its owner.

Accordingly, Sec. 2035(a) requires gifts made in contemplation of death to be included in the donor's gross estate even though such gifts represent bona fide, fully complete transfers subject to gift tax. However, credit against the estate tax is allowable under Sec. 2012 for the gift tax paid (or payable) which is attributable to these tainted gifts (but not in excess of the estate tax attributable to their inclusion in the gross estate, if less).

Sec. 2035(b) enunciates the following ground rules for determining whether gifts were made in contemplation of death:

1. Gifts made within a three-year period ending with the date of death are deemed to have been made in contemplation of death (for purposes of Secs. 2035(a), 2038 (supra), and 2041 (relating to powers of appointment)), *unless shown to the contrary.*
2. Gifts made *before* this three-year period are *not* treated as having been made in contemplation of death.

Taxpayers have had some success in overcoming the statutory presumption (briefly described above) regarding gifts made within three years of the donor's death. Generally, these cases turn on the particular facts involved, especially those pertaining to whether or not the gift was induced by motives associated with death. (See Regs. Sec. 20.2035-1 (c).)

However, there may be many situations where this presumption may actually operate to a client's advantage. (See 405.) As suggested in 405.2, deathbed gifts may be particularly advantageous (from a tax standpoint).

NOTE. Sec. 2012 credit is available not only for gift tax paid (or payable) on gifts made in contemplation of death but also for gift taxes attributable to *any* gift that is subjected to estate taxation (limited to the estate tax allocable thereto). Thus, transfers included in a transferor's gross estate under Secs. 2036-2038, which may also have created gift tax liabilities, are nevertheless spared the onus of double transfer taxation.

202.3 Effective Use of Trusts

Planning Technique

The establishment of a trust enables a client to "give birth" to a new tax person whose favorable features include:

1. *Another income tax bracket (although at separate return rates) to which higher bracket income may be channeled.*
2. *A postponement of estate tax (subject to local rules against perpetuities which prevent indefinite estate tax deferral).*

The price exacted for these tax advantages is the client's forfeiture of all beneficial interest in property given in trust. This permanent relinquishment of control over one's property may be too steep a price for high-income clients with only moderate estates.

However, income diversion can be practiced on a temporary basis by limiting the duration of the trust to a specified term. The minimum term permitted for this purpose must exceed ten years (Sec. 673(a)).

On the other hand, a trust cannot be used (for gifts after October 9, 1969) to divert taxable income to a donor's spouse. This practice is prevented by Sec. 677, unless such income is taxed to the spouse under some other Code section.

Moreover, a trust can no longer be used to accumulate income, taxable to the trust, which could eventually be distributed to a higher-bracket beneficiary free of further tax. Distributions in years beginning after 1968 are subject to the unlimited throwback rule imposed by the Tax Reform Act of 1969. However, distributions made in years beginning in 1969 through 1973 are covered by the previous, more liberal five-year throwback rule to the extent the distributed income was accumulated by the trust in taxable years beginning before 1969 (although the prior $2,000 de minimis exception is inapplicable).

Planning Considerations

1. Accumulation trusts can still defer taxes since the accumulated income of the trust is not taxed to the beneficiary until an actual

distribution is made. In most instances the trust will be in a lower bracket than its grantor or beneficiary. Therefore, the trust will be able to invest money otherwise used to pay taxes.

2. Low income beneficiaries can receive tax-free income from trusts making current distributions, as follows:

Year (Beginning in)	*Amount of Tax-Free Income*
1970	$1,725
1971	1,700
1972	1,700
1973 and thereafter	1,750

An additional $100 of tax-free income is available to the extent the distribution includes qualifying dividends.

3. Refunds of tax are a possibility where the beneficiary has little or no income from other sources (besides the trust). This situation can arise if the beneficiary's tax liability on an accumulation distribution is less than the taxes paid by the trust. (Secs. 667 (b) and 6401 (b).)

Triple Statutory Standards for Recognizing Validity of Gifts

The Internal Revenue Code (Secs. 671-678) also sets forth additional tests for determining whether a transfer in trust shall be recognized as a valid gift, *for income tax purposes,* and thus countenance an effective shift of income. Accordingly, revocable trusts are disregarded by Sec. 676 as an income deflecting mechanism.

However, it must be strongly emphasized that these income tax criteria are not correlated with their estate and gift tax counterparts. Consequently, independent determinations are required to ascertain whether a gift (1) is taxable for gift tax purposes, (2) allows the income therefrom to be taxed to the donee, and (3) removes property from the donor's estate.

In view of the asymmetrical statutory standards, inconsistent results can frequently emerge. For example, Rev. Rul. 57-315 (1957-2 CB 624) states that:

> ... It is well established that a gift is not considered as being incomplete for gift tax purposes merely because the income from the property continues to remain taxable to the donor. *Although the income from a trust of the Clifford type is taxable to the donor, he is liable for gift tax on the present worth of the future income from the property ....* [Emphasis supplied.]

As a further example, a revocable trust exists for *income* tax purposes if the power to revoke is exercisable by the donor *or* a *nonadverse* party, or both (Sec. 676 (a)). In contrast, a revocable transfer exists for *estate* tax purposes, under Sec. 2038 (a) (1), if such power was exercisable by the decedent alone or by the decedent *in conjunction with any* other person.

CAUTION. An income distribution to a beneficiary (other than the donor) will, nevertheless, subject the donor to both income and gift taxes where a gift of the underlying income-producing property is incomplete for income and gift tax purposes.[54]

202.4 Joint Savings Accounts

Planning Technique

A client can deflect half of his joint savings bank account interest to a lower-bracket recipient without the necessity of making a taxable gift of a 50 percent interest in the savings account itself.

Transfers of this nature can be effected as shown in the following gift tax regulation:

> If A creates a joint bank account for himself and B (or a similar type of ownership by which A can regain the entire fund without B's consent), there is a gift to B when B draws upon the account for his own benefit, to the extent of the amount drawn without any obligation to account for a part of the proceeds to A.[55]

Thus, there would not be a taxable gift upon the creation of such a joint bank account. However, any income therefrom would generally be taxable to each co-owner in proportion to the income that each is entitled to receive under applicable local law.[56]

Of course, receipt of 50 percent of the interest income may represent a gift under the rationale of Regs. Sec. 25.2511-2 (f) (see conclusion of 202.3).

There is no need to split income in this fashion with a spouse where joint income tax returns are available. (However, this technique may be appropriate for state and local income taxation, assuming that state gift

[54] See Sec. 671 and Gift Tax Regs. Sec. 25.2511-2 (f).

[55] Gift Tax Regs. Sec. 25.2511-1 (h) (4).

[56] See income tax effect on inter-spousal joint tenancies in real property, 409, this study.

taxation, if any, follows the approach taken in Regs. Sec. 25.2511-1 (h) (4).)

Furthermore, the "donee" obtains withdrawal rights over the *entire* savings account. Therefore, this income *and* gift tax planning technique requires judicious application.

202.5 Interest-Free Loans

Planning Technique

Interest-free loans to family members have the following advantages: (1) earnings on the principal sum can be shifted to lower-bracket relatives, and (2) the value of the use of this money does not (a) constitute a gift for gift tax purposes or (b) create taxable income for the borrower.

Similarly, interest-free loans to employees may *represent a nontaxable fringe benefit.*

Loans to Family Members

Gift Tax Aspects. In a case of first impression, a Texas District Court held that interest-free loans to the lender's children did not result in taxable gifts with respect to the value of the use of such funds. The loans were made with the understanding that repayment would be on demand and without interest.

The Court noted the absence of any legal requirement, express or implied, for interest to be charged on the funds advanced. (Neither was there any corresponding duty for interest payments by the children.)[57]

Income Tax Aspects. In originally holding split-dollar life insurance to be tax free, Rev. Rul. 55-713 (1955-2 CB 23) concluded that "*the mere making available of money does not result in realized income to the payee or a deduction to the payor . . . .*"

This ruling was revoked by Rev. Rul. 64-328 (see 201.2) on the grounds that it "incorrectly analyzed the substance of the 'split-dollar' arrangement in stating that the substance of the arrangement is in all essential respects the same as if the employer corporation makes annual loans without interest to the employee . . . ."

NOTE. Presumably, the above-quoted conclusion of Rev. Rul. 55-713 remains untarnished. Also see the *Dean* decision discussed on page 98.

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[57] *E. M. Johnson,* 254 F. Supp. 73.

Loans to Employees

Gift Tax Aspects. In view of the *Johnson* decision which precluded taxable gifts where interest-free loans were made to family members, it would seem that employee loans would be at least equally immune to gift tax.

Income Tax Aspects. The conclusion reached in Rev. Rul. 55-713 (above) was cited, with approval, in *J. S. Dean* (35 TC 1083 (1961); Government's appeal dismissed pursuant to agreement) where the Tax Court, in a reviewed decision, distinguished the line of cases taxing rent-free use of corporate property, as follows:

> . . . In each of them a benefit was conferred upon the stockholder or officer in circumstances such that had the stockholder or officer undertaken to procure the same benefit by an expenditure of money such expenditure would not have been deductible by him. Here, on the other hand, had petitioners borrowed the funds in question on interest-bearing notes, their payment of interest would have been fully deductible . . . .

The *Dean* case involved an interest-free loan of over $2 million to controlling stockholders.

CAUTION. This reasoning was not accepted by all Tax Court judges. See the concurring and dissenting opinions.

Imputed Interest

Certain interest-free transactions are barred for tax purposes by Sec. 483.[58] However, Sec. 483 *only* applies to sales or exchanges of property and thus does *not* reach interest-free loans.

203 Treatment Qualifying for Long-Term Capital Gains

Since long-term capital gains are generally subject to tax at reduced rates, the quest to obtain such treatment for the greatest variety of income is quite imaginable. Therefore, 203 will be devoted to a review of various kinds of income that may be so favorably endowed.

It should be noted that the Tax Reform Act of 1969 has introduced several measures designed to narrow the "tax gap" between ordinary income and long-term capital gains. The measures of particular concern

[58] See discussion in connection with installment sales, at 204.6.

Illustration 12

Increase in Capital Gains Tax Rates	1970	1971	1972
1. Maximum tax rate on net long-term capital gains:			
First $50,000 of gains ($25,000 for married individuals filing separately)	25% (same as 1969)		
Additional gains	29.5%	32.5%	35%
2. New minimum tax on prescribed "preferences" which include the capital gain deduction for 50% of net long-term gains (105.1)	10% rate on preferences exceeding $30,000 and tax otherwise due beginning in 1970 (including 69-70 fiscal years)*		
Decrease in Ordinary Income Tax Rates			
3. Maximum tax rate on earned income (105.2)	70%	60%	50%
4. Reduction of regular tax rates through income averaging (104.1)	Liberalized averaging available, beginning in 1970		
5. Regular tax rates for unmarried individuals	Same as 1969	Reduced so as not to exceed 20% of joint return tax liability on same income	

* Unused tax carryovers also available as offsets.

to individuals and the years they become effective are as shown in Illustration 12, above.

Moreover, as more fully explained in 306.1, Chapter 3, net long-term capital gains will be converted into ordinary income to the extent they are used to increase the ordinary deduction for "investment interest." This conversion will be in effect for taxable years beginning after 1971 and will apply for purposes of computing the maximum capital gains tax rate and the 50 percent deduction for net long-term gains. On the other hand, such converted gains will not constitute tax preferences.

203.1 Lump Sum Distributions From Qualified Employees' Trusts

Planning Technique

Where advantageous, plan distributions to qualify as long-term capital gain or be eligible for rather favorable seven-year

"forward" averaging computation which may approximate capital gains tax for many lower bracket employees or even produce a lower tax.

Also consider possibility of lower ordinary income taxes if, instead, an annuity or other periodic payment is selected as well as varying estate tax consequences of each alternative.

Capital Gain Requirements

Distributions from pension, profit-sharing, or stock bonus plans are eligible for capital gains taxation to the extent that they do not exceed the sum of:

1. The benefits accrued by the employee during plan years beginning before January 1, 1970.
2. The benefits accrued during subsequent plan years exclusive of the employee's share of the employer contributions (Sec. 402(a) (5)).

In other words, ordinary income treatment applies to that part of a distribution which consists of employer contributions for plan years beginning after December 31, 1969. Employer contributions for prior plan years as well as earnings and appreciation on both employer and employee contributions for all plan years are treated as long-term capital gains. Employee contributions for all plan years are recovered tax free. House Report No. 91-413 (8/2/69, Part I, p. 155) states that "amounts contributed by the employer with respect to employees which are forfeited and . . . allocated among other employees are to be considered contributions made by the employer . . . ." Presumably, this means that such contributions will be deemed to have been made in the year in which the forfeiture occurs. The income tax treatment of lump sum distributions is exemplified in Illustration 13, page 101.

In addition, the following four conditions of Sec. 402(a) (2) must be met:

1. They are made from a trust that is qualified under Sec. 401 (a) (and exempt from tax under Sec. 501 (a)).
2. A distribution must be on account of (a) the employee's death or other separation from the employer's service or (b) the employee's death after such separation from service (Regs. Sec. 1.402(a)-1(a) (6) (i)).
3. The distribution must be paid to, or includible in the gross income of, the distributee within one taxable year of the distribution (Regs. Sec. 1.402(a)-1(a) (6) (i)).

Illustration 13

Treatment of Lump Sum Distributions

Line		(a) Benefits Accrued for Plan Years Beginning Before 1/1/70	(b) Benefits Accrued for Plan Years Beginning After 12/31/69	(c) Total
1.	Employee contributions	$1,000	$2,000	$3,000
2.	Employer contributions	3,000	3,000	6,000
3.	Earnings and appreciation on all contributions	1,000	1,000	2,000
4.	Total distribution	$5,000	$6,000	$11,000

Tax Treatment

Total distribution (line 4, col. (c))	$11,000
Less – employee contributions (line 1, col. (c))	3,000
Total taxable income	8,000
Less – ordinary income (line 2, col. (b))	3,000*
Long-term capital gain (line 2, col. (a) plus line 3, col. (c))	$ 5,000

* May be eligible for special seven-year averaging computation.

4. It must represent the "total distributions payable" which is defined as the balance to the credit of an employee which becomes payable on account of (a) the employee's death or other separation from service or (b) the employee's death after such separation (Regs. Sec. 1.402(a)-1 (a) (6) (ii)).

Seven-Year Averaging for Ordinary Income Portion of Lump Sum Distribution

Although the portion of a lump sum distribution consisting of post-69 employer contributions is no longer eligible for capital gain treatment, a special seven-year "forward" averaging computation has been substituted. This averaging formula operates similarly to the five-year averaging device available for lump sum distributions to self-employed persons under H. R. 10 plans. (See collateral comments later in 203.1.)

In addition to the obvious advantages of spreading only 1/7th of this income across the recipient's tax bracket (as opposed to 1/5th for the self-employed), the new computation is also more beneficial than the

H. R. 10 mechanism because current compensation "other than deferred compensation within the meaning of Sec. 404" and the capital gains portion of the lump sum distribution are not taken into account in calculating the ordinary income tax attributable to such post-69 employer contributions (Sec. 72 (n) (4)).

QUERY. Is restricted property current or deferred compensation, for seven-year averaging purposes, where it is taxed in the same year as the lump sum distribution? [59]

These computational exclusions prevent higher brackets from applying merely because the lump sum is received in the final year of employment instead of during a lower bracket retirement year. Moreover, the exclusion of the capital gains portion from the averaging base will also preclude a higher bracket even during retirement (which might otherwise result from the nonrecurring distribution).

Examples of this seven-year averaging procedure can be found at the conclusion of 203.1.

Current compensation cannot be excluded under this new averaging procedure if the employee has not attained age 59 1/2 — unless he has died or become disabled (as defined by Sec. 72(m)(7)). This age requirement does not apply to the exclusion for the capital gains portion of the lump sum distribution.

Eligibility for Special Averaging. Employees or their beneficiaries are eligible for this special seven-year averaging only if the distribution is made on account of separation from service or death. In contrast, self-employed individuals can use their five-year averaging computation only for distributions received after age 59 1/2 or because of death or disability.

In addition, Sec. 72 (n)(1)(C) denies averaging to an employee or self-employed person unless he has been a participant in the plan for at least five taxable years prior to the year in which the distribution is made.

Planning Considerations Regarding Lump Sum Distributions

Substantiating Records. Sec. 402 (a) (5) permits capital gain treatment for post-69 benefits only to the extent the distributee establishes that such benefits do not consist of the employee's allocable share of

[59] See discussion of restricted property's eligibility for 50 percent maximum tax rate on earned income in 204.3, this study.

employer contributions. This poses a monumental accounting problem for such distributees who must invariably rely on either the employer or the trustee of the retirement trust for its resolution. These third parties will then be plagued with additional record-keeping costs which may be particularly severe, for example, in the case of large private and public pension plans where employer contributions are not usually allocated among specific employees.

These practical difficulties, and others such as the related problem of obtaining exact determinations of employer contributions, will be inherent in calculating the capital gains portion of a lump sum distribution and may serve as another factor in selecting the alternative periodic pay-out (discussed later herein). In any event, these mechanical pitfalls should be recognized in setting up new plans.

Seven-Year Averaging. The seven-year averaging provision is inoperative if general income averaging is elected (Sec. 1304 (b) (2)). This option necessitates dual computations to determine which averaging method yields the greatest tax savings. On the other hand, the 50 percent maximum tax rate on earned income is automatically inapplicable to lump sum distributions (Sec. 1348 (b) (1)).

Effect of Prior Distributions. Prior distributions (pursuant to a trust's plan), such as installment payments to a retiree which are taxable as ordinary income, do *not* prevent capital gain treatment with respect to distribution of the remaining balance (if otherwise qualified) as, for example, a lump sum to his beneficiary (Rev. Rul. 69-495, 1969-38 IRB 11).

Additional Distribution. In contrast, a subsequent year's distribution of a retiree's share of profits for the year of retirement will be taxed as ordinary income. However, in such case, capital gain treatment accorded an earlier lump sum distribution is not adversely affected (Rev. Rul. 56-558, 1956-2 CB 290).

Delayed Distribution. A payment (pursuant to plan) of the total amount due an employee in the year following his retirement can qualify for capital gain treatment to the extent otherwise eligible, even though it includes his share of the employer's contribution for the terminal year (which was in addition to the balance due upon retirement).

NOTE: Any other post-retirement credits to the employee's account would be taxable as ordinary income.[60]

Administrative Delays. Maximum capital gains treatment is available where the delay in distribution is occasioned by administrative problems of the plan and the total amount, including *any* post-retirement increment, is distributed during one taxable year (of the employee) as soon as administratively feasible.

CAUTION. "Whether any delay in distribution is occasioned by administrative problems of the plan and whether the distribution is made 'as soon as administratively feasible' are to be determined on the basis of the facts and circumstances in each particular case." (Rev. Rul. 60-292, 1960-2 CB 153.)

Lump Sum Distributions Not Always Advisable

Income Tax Aspects. Employees should consider the tax consequences of both lump sum distributions and annuity payments.

> In some cases a lump sum distribution to an employee, even though taxed at capital gain rates, may be less desirable. The after-tax amount retained by the employee after having received a lump sum in the year of retirement may be considerably less than the amount he would have received had he taken an annuity over his lifetime or lesser period.
>
> This might be caused by the employee's high tax bracket in the year of retirement which may impose a greater tax burden on the amount received than the amount of tax that would have been imposed in later years on annuity payments when his tax brackets are lower because of reduced income and increased exemptions for age over 65 for himself and his wife.
>
> Thus, a tax computation made both ways is advisable in every case to determine whether the lump sum or annuity payments result in less tax cost.[61]

Although this quotation was written before the enactment of the 1969 Tax Reform Act, the double tax computation which it advocates remains valid. Of course, the lump sum computation must now reflect both capital gains and seven-year averaging treatment (as previously discussed).

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[60] Rev. Rul. 62-190, 1962-2 CB 130, and Isidore Goodman, "How to Obtain Capital Gain Treatment on Distributions from Qualified Plans," *Journal of Taxation* (Feb. 1966), p. 76.

[61] E. O. Wood and J. F. Cerny, *Tax Aspects of Deferred Compensation*, 1969 ed. (Prentice-Hall, Inc.), p. 51.

In addition, the 10 percent minimum tax on tax preferences should also be considered in connection with the capital gain portion of a lump sum distribution since the capital gain deduction, equal to 50 percent of the net long-term gains, is a tax preference. The effective minimum tax rate on this particular preference could be as high as 5 percent (50 percent of 10 percent). However, taxable preferences can be reduced by a $30,000 exemption ($15,000 for married person filing separate return), the income tax otherwise imposed (less certain credits), and carryovers (for seven years) of previously unused taxes.

The operation and effect of the minimum tax was more extensively considered in 105.1.

Estate Tax Considerations. The computations to determine whether a lump sum distribution or periodic payments are desirable should also consider the estate tax exemption for distributions *payable* (attributable to employer contributions) which is granted by Sec. 2039(c). Thus, undissipated assets obtained through a lump sum distribution during an employee's lifetime will be includible in his gross estate at death.

On the other hand, the remaining annuity or other payments due a deceased employee's beneficiaries, *other than* his own estate, will not be subject to estate tax. Of course, *both* capital gain and/or seven-year averaging treatment as well as estate tax exemptions are available if the lump sum distribution is made after the employee's death.

Earlier, the problem of obtaining exact determinations of employer contributions was mentioned in connection with ascertaining the capital gains and ordinary income portions of a lump sum distribution. (See discussion under Substantiating Records.)

A similar determination of employer contributions is required for the estate tax exemption under Sec. 2039 (c). However, Regs. Sec. 20.2039-2 (c) (2) acknowledges that, in certain cases, such contributions cannot be readily ascertained and, accordingly, allows the *employee's* contributions to be subtracted from the value of the matured benefits in order to arrive at the employer's contributions. Under this formula, earnings and appreciation are weighted in favor of employer contributions (which is not undesirable in ascertaining the estate tax exclusion attributable to these contributions).

Of course, this result would be inappropriate in determining the ordinary income arising from employer contributions. Hence, some modification of this method would be necessary such as imputing a realistic earnings rate to the employee's contributions with a matching or

proportionate (as appropriate) designation of earnings and appreciation with respect to the employer's contributions.[62]

Actual Selection of Annuity or Lump Sum Distribution. A plan can provide that its covered employees may elect an annuity in lieu of a lump sum distribution. If such an election is exercised *within 60 days* after the lump sum becomes payable, the employee will only be taxed on his actual cash receipts.[63]

Selecting the Most Advantageous Year

Control Over Timing Somewhat Limited. Distributions must commence when an employee attains normal retirement age, or a stated age, and the required years of service as well as other reasonable requirements set forth in the plan are satisfied. However, if later, distributions can begin upon actual retirement (except that distributions to self-employed owner-employees must start no later than age 70 1/2) (Rev. Rul. 66-11, 1966-1 CB 71).

Collateral Comments

Self-Employed Individuals. Long-term capital gain treatment is *denied* for *any* distributions attributable to "employer" contributions made on behalf of a self-employed individual (Sec. 402 (a) (2)). These distributions are also ineligible for the $5,000 exclusion (Sec. 101 (b) (3)).

However, Sec. 72 (n) (2) provides a special averaging device, as a substitute for long-term capital gains treatment, which limits the tax on such distributions to "five times the increase in tax resulting from adding 20 percent of such distribution to other taxable income, or by treating 20 percent of the distribution (reduced only by personal exemptions for the year) as taxable income. In this way some protection from the graduated rates of the individual income tax is given to those individuals who receive such a lump sum distribution."[64] (Self-employed plans are further discussed in 305.1.)

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[62] For precedent, see Sec. 170(f)(4) which prescribes a 6 percent discount rate in valuing real property remainder interests for charitable contribution purposes and permits the IRS to assign a different rate if economic circumstances change. Also see Regs. Sec. 1.403(b)-1 (d)(4) where a formula is provided for determining employer contributions in connection with tax-deferred annuities for employees of certain tax-exempt organizations.

[63] Rev. Rul. 59-94, 1959-1 CB 25 which applies Sec. 72 (h) dealing with annuity options, in general, to qualified employees' profit-sharing trusts.

[64] S. Rep. No. 2411 (87th Cong., 2nd sess.), p. 28.

Limited Income Tax Exclusion. Code Sec. 101 (b) permits a maximum income tax exclusion of $5,000 for certain employee death benefits (see 201.2). Generally, this exclusion applies *only* if the employee had a *forfeitable* right, immediately before his death, to receive these benefits while alive.

However, lump sum distributions from qualified employee's trusts that are entitled to long-term capital gains treatment under the conditions set forth above are also eligible for this $5,000 exclusion *even though* the employee had a *nonforfeitable* right thereto. (Of course, only *one* $5,000 exclusion is available for all such benefits paid by reason of an employee's death.) This exclusion is considered at greater length in 201.2.

Problem Areas

Unplanned Loss of Trust's Exemption. It was said at the outset that distributions from exempt trusts are a prerequisite for capital gains or special averaging eligibility. However, if a trust should inadvertently (and unfortunately) lose its exemption, it might be worthwhile to contend that a lump sum distribution (in excess of employee contributions), in effect, consists of the following segments:

1. Amount standing to employee's credit at the time exemption is lost.
2. Balance of distribution.

This approach *may* salvage capital gain or special averaging treatment for category (1) since such favorable treatment was approved by the Second Circuit Court of Appeals in *Greenwald* (66-2 USTC ¶9652).

CAUTION. The Tax Court, which was reversed in *Greenwald*, and, of course, the IRS disagree with this theory.

Determination of Benefits Accrued During Pre-1970 Plan Years. As previously stated, benefits accrued by the employee during plan years beginning before January 1, 1970 continue to be eligible for capital gain treatment (Sec. 402 (a) (5) (A)). The House Report[65] states that the limitation on capital gain treatment "will not apply to employer contributions *made* on behalf of the employee during plan years beginning before January 1, 1970. Thus, the bill will have no effect on benefits *previously accrued* by employees. . . ." (Emphasis supplied.) Thus, ambiguity exists as to the treatment of contributions made during

[65] H. Rep. No. 91-413, Part 1, 8/2/69, p. 155.

the post-1969 plan years which are required to fund previously accrued benefits. This question of whether "benefits accrued" is to be based upon actuarial valuations or actual employer contributions will be of particular significance to pension plans with a past service liability.

A similar problem may arise where contributions for 1969 plan years are actually made in 1970 pursuant to Sec. 404 (a) (6).

The Senate Finance Committee's Report (p. 202) flatly stated that ordinary income treatment "is not to apply to benefits accrued on behalf of the employee *attributable* to plan years beginning before January 1, 1970. . . . " (Emphasis supplied.) However, the full Senate rejected this provision and the Conference Committee followed the House version.

In any event, post-1969 employer contributions for pre-1970 service appear precluded from capital gain treatment where a plan is established after 1969 since benefits cannot be accrued during *plan years* beginning before 1970.

Post-1969 Losses. A related problem pertains to the allocation of any post-1969 net investment losses to the various lump sum components. In this regard, on April 8, 1970, the AICPA's federal taxation division

Illustration 14

*Suggested Allocation of Post-69 Losses**

	Total	*Employee Contributions*	*Ordinary Income*	*Capital Gain*
Initial year capital gain base	$12,000	$3,000		$9,000
Post-69 contributions:				
Employee	2,000	2,000		
Employer	8,000		$8,000	
Post-69 gain or (loss):				
Income	1,000			
Investment appreciation or (loss)	(6,000)			
Net (loss)	(5,000)		(5,000)	
Total distribution	$17,000	$5,000	$3,000	$9,000

* AICPA's federal taxation division's Recommendations on Content of Regulations under the Tax Reform Act of 1969 (April 8, 1970), p. 107.

submitted the following specific recommendations regarding the content of future regulations to the Treasury Department and the IRS:

1. Fair market value of trust assets should be determined as of the close of the last plan year beginning before January 1, 1970 and allocated to the participants as their "initial year capital gain base."
2. This capital gain base and all employee contributions should be considered frozen amounts.
3. Post-1969 gains or losses (income, sale of securities, valuations, etc.) should be aggregated upon distribution. *Any net loss should first reduce post-1969 employer contributions.* (See Illustration 14, opposite.)

Seven-Year Averaging Computation

EXAMPLE 1: *Taxable income consisting solely of lump sum distribution.* Client retired in 1974 and received a $148,000 lump sum distribution in 1975 from his former employer's qualified non-contributory profit-sharing plan, as follows:

Post-1969 employer contributions—ordinary income	$ 98,000
Remaining long-term capital gain portion	50,000
Total distribution	$148,000

Client and his spouse are both age 70 and have no other income nor any deductions. Client had participated in this plan for more than four years. The joint tax is computed as shown in Illustration 15, p. 110.

EXAMPLE 2: *Taxable income consisting of lump sum distributions as well as current and deferred compensation.* Assume the same facts as Example 1 except that the lump sum distribution was instead received in 1974 when client had the following other income:

Salary	$ 20,000
Deferred compensation	80,000
Total	$100,000

The joint tax is computed as shown in Illustration 16, pages 111-112.

Line			
	(A) Ordinary Income Tax		
1.	Gross income		$148,000
	Less:		
2.	Capital gain portion (Sec. 72 (n) (4) (C))	$50,000	
3.	6/7 of ordinary income portion ($98,000)	84,000	134,000
4.	Revised gross income		14,000
	Less:		
5.	Standard deduction	$ 2,000	
6.	Exemptions	3,000	5,000
7.	Tentative taxable income		$ 9,000
	Minimum taxable income (Sec. 72 (n) (2) (B)):		
8.	Ordinary income portion	$98,000	
9.	Less – exemptions (line 6)	3,000	
10.	Minimum taxable income	$95,000	
11.	1/7 of line 10		$ 13,600 *
12.	Taxable income for averaging purposes (greater of lines 7 or 11)		$ 13,600
13.	Tax thereon		$ 2,660
14.	Ordinary income tax under 7-year averaging method (line 13 multiplied by 7)		$ 18,620
	(B) Capital Gains Tax		
15.	Capital gain portion		$ 50,000
16.	Less – 50% capital gain deduction		25,000
17.	Adjusted gross income		$ 25,000 †
18.	Less – standard deduction and exemptions (lines 5 and 6)		5,000
19.	Taxable income		$ 20,000
20.	Tax thereon		$ 4,380
21.	Alternative tax – 25% of line 15 (Sec. 1201 (b) (2))		$ 12,500
22.	Capital gains tax (lesser of lines 20 or 21)		$ 4,380

* Rounded to nearest hundred dollar.

† It is submitted that the ordinary income portion of a lump sum distribution should be excluded in computing the tax on all other income. Otherwise, inclusion of such ordinary income portion would place the other income in a higher bracket and serve to defeat some of the savings granted by the seven-year averaging device.

Line		
	(C) Total Tax	
23.	Total tax (lines 14 and 22)	$ 23,000 ‡
24.	Total tax without 7-year averaging computation	53,480 ‡
25.	Tax savings (line 24 less line 23)	$ 30,480 §

‡ $25,000 tax preference (equal to the capital gain deduction pursuant to Sec. 57 (a) (9) (A) is offset by the $30,000 exemption allowable for purposes of the 10 percent minimum tax.

§ These computations ignore the possibility of greater savings if general income averaging is used in lieu of seven-year averaging. (See Sec. 1304 (b) (2).)

Illustration 16

	(A) Tax Attributable to Ordinary Income Portion of Lump Sum Distribution		
1.	Lump sum distribution (Illustration 15, line 1)		$148,000
2.	Additional compensation		100,000
3.	Gross income		$248,000
	Less:		
4.	Excludible portions of lump sum distribution (Illustration 15, lines 2 and 3)	$134,000	
5.	Current compensation (Sec. 72 (n) (4) (B))	20,000	$154,000
6.	Revised gross income		$ 94,000
7.	Less – standard deduction and exemptions (Illustration 15, lines 5 and 6)		5,000
8.	Taxable income		$ 89,000
9.	Tax thereon		$ 38,580
10.	Taxable income (line 8)	$ 89,000	
11.	Less – 1/7 of ordinary income portion of lump sum distribution (Illustration 15, line 4)	14,000	
12.	Revised taxable income	$ 75,000	
13.	Tax thereon		30,470
14.	Tax attributable to $14,000 amount on line 11		$ 8,110
15.	Tax attributable to entire ordinary income portion (line 14 multiplied by 7)		$ 56,770

Line			
	(B) Tax Attributable to All Other Income		
16.	Gross income (line 3)		$248,000
17.	Less – ordinary income portion of lump sum distribution		98,000†
18.	Revised gross income		$150,000
19.	Less – capital gain deduction (Illustration 15, line 16)		25,000
20.	Adjusted gross income		$125,000
21.	Less – standard deduction and exemption (line 7)		5,000
22.	Taxable income		$120,000
23.	Tax thereon		$ 57,580
	Alternative Tax		
24.	Taxable income (line 22)	$120,000	
25.	Less – 50% of capital gain (line 19)	25,000	
26.	Ordinary taxable income	$ 95,000	
27.	Tax thereon (Sec. 1201 (b)(1))	$ 42,180	
28.	25% of $50,000 capital gain (Sec. 1201 (b)(2))	12,500	
29.	Alternative tax (lines 27 and 28)		$ 54,680
	(C) Total Tax		
30.	Tax on ordinary income portion of lump sum distribution (line 15)		$ 56,770
31.	Tax on all other income (lesser of lines 23 or 29)		54,680
32.	Total tax (lines 30 and 31)		$111,450 ‡
33.	Total tax without 7-year averaging		118,650 ‡
34.	Tax savings (line 33 less line 32)		$ 7,200 §

† It is submitted that the ordinary income portion of a lump sum distribution should be excluded in computing the tax on all other income. Otherwise, inclusion of such ordinary income portion would place the other income in a higher bracket and serve to defeat some of the savings granted by the seven-year averaging device.

‡ $25,000 tax preference (equal to the capital gain deduction pursuant to Sec. 57 (a) (9) (A) is offset by the $30,000 exemption allowable for purposes of the 10 percent minimum tax.

§ These computations ignore the possibility of greater savings if general income averaging is used in lieu of seven-year averaging. (See Sec. 1304 (b) (2).)

203.2 Distribution of Employer's Securities

Planning Technique

The taxable portion of a lump sum distribution can be reduced by the amount of any net unrealized appreciation attributable to securities of the employer corporation included in such distribution. This tax reduction can be permanent if these securities are not disposed of during distributee's lifetime.

Described in 203.1 was the favorable capital gains and/or seven-year averaging treatment for lump sum distributions. However, if appreciated employer securities are included in such distributions, the following further advantages can be achieved:

1. Immediate taxation is completely avoided on that portion of the distribution representing net unrealized appreciation in employer securities.
2. Capital gain taxation can be obtained when these securities are later sold. If such sale occurs after the employee's death, no income tax at all would be incurred on this appreciation to the extent his estate obtains a stepped-up basis for the securities.

On the other hand, the portion of the distribution representing the adjusted cost basis of employer securities is taxed as follows:

- Adjusted cost basis attributable to employer contributions made in plan years beginning after 1969 — Ordinary income.
- Adjusted cost basis attributable to employer contributions made in plan years beginning before 1970 — Long-term capital gain.

However, all accumulated dividends on employer securities are eligible for capital gains treatment.

The following example illustrates the treatment of employer securities received in a lump sum distribution.

An employee receives the following lump sum distribution from his former employer's stock bonus plan trust:

Cash	$ 10,000
Employer securities (at fair market value)	90,000
Total distribution	$100,000

This distribution had been accumulated as follows:

	Total	*Pre-1970*	*Post-1969*
Employer contributions	$ 50,000	$30,000	$20,000
Unrealized appreciation	40,000	15,000	25,000
Dividends	10,000	3,000	7,000
Totals	$100,000	$48,000	$52,000

The following tax treatment applies:

Total distributions	$100,000
Less — cash (accumulated dividends taxed as capital gain)	10,000
Value of employer securities	90,000
Less — total unrealized appreciation (excluded)	40,000
Adjusted cost basis of securities	50,000
Less — pre-1970 employer contributions (capital gain)	30,000
Ordinary income (post-1969 contributions)	$ 20,000

In contrast, a non-lump-sum distribution containing employer securities can only be reduced by the net unrealized appreciation deemed acquired through *employee* contributions. (Compare Sec. 402 (a) (1) and (2)). Furthermore, in this latter case, appreciation in securities acquired with earnings on employee contributions cannot be excluded (Regs. Sec. 1.402 (a)-1 (b) (3)).

"Securities of the employer corporation" are defined in Sec. 402 (a) (3) (A) and (B) while the determination of net unrealized appreciation is set forth in Regs. Sec. 1.402 (a)-1 (b) (2).

Planning for Permanent Income Tax Exemption

Regs. Sec. 1.402 (a)-1 (b) (1) (i) provides that net unrealized appreciation in employer securities, which has been excluded from a distributee's income, shall also be excluded from the distributee's basis for these securities (for purposes of determining gain or loss upon their subsequent disposition). Consequently, this untaxed appreciation is deemed to be a long-term capital gain to the extent realized in a subsequently taxable transaction.

However, if the distributee does not dispose of these securities prior to his death, they will obtain a new basis which, under the general rules of Sec. 1014 (a), will be equal to their fair market value at death (or their alternate estate tax value, if elected under Sec. 2032 (as previously described in 201.6)). Therefore, any appreciation in these securities during the time they were held by the trustee as well as during the time

they were held by the distributee will be eliminated and *never* subjected to income tax.

Consequently, it would be *desirable* (from a sheer tax standpoint) for a *distributee, during his lifetime, to avoid a taxable disposition of such employer securities* unless financially mandatory. For example, if need arises, consideration should be given to the feasibility of borrowing required funds against such securities *(e.g., using vested interest in securities as collateral).*

NOTE: The "benefits" of qualified retirement plan benefits are further discussed in Tax Study No. 1 (at 208.2) and in this study at 204.2.

203.3 Qualified Stock Options

Planning Technique

The advantages and disadvantages of qualified stock options should be compared with other forms of compensation, such as qualified deferred compensations plans (203.1 and 203.2), nonqualified deferred compensation (204.2), restricted property and phantom stock (204.3), nonqualified stock options (204.4), cash bonuses, and stock bonuses.

Criteria to consider in this comparative evaluation include:

1. *The gross amount obtainable by the employee which, in turn, depends upon such matters as:*
    - *Employer's after-tax cost.*
    - *Degree of selectivity available to the employer and extent to which stock dilution is desired.*
2. *Capital gain opportunities for the employee.*
3. *Employee economics, including:*
    - *Market performance of stock after option is exercised.*
    - *Monetary factors (e.g., time lapse until compensation can be financially utilized).*
    - *Investment, if any, of own after-tax funds.*

Sec. 421 of the Code recognizes the following categories of employee stock options: qualified stock options (Sec. 422), employee stock purchase plans (Sec. 423), and restricted stock options (Sec. 424).

In addition, other extra-statutory options (i.e., nonqualified options) are treated by Regs. Sec. 1.421-6. (See 204.4.)

Restricted Stock Options

Restricted stock options must generally have been granted before January 1, 1964. (For a very limited exception, see Sec. 424 (c) (3).) Accordingly, they will not be further discussed.

Employee Stock Purchase Plans

It has been indicated that employee stock purchase plans are designed primarily as a means of raising capital and, therefore, are not generally thought of in terms of providing incentives for key executives in a business. As a result, they must be available, without discrimination, to most employees of a corporation.[66]

Of course, employee stock options may be advantageous for business reasons since they may have a favorable effect upon employee motivation, morale, and so forth, especially if the employer's stock increases in value and provides the employees with greater potential for realizing capital gains.

However, the rather broad nondiscrimination requirements of these plans renders them less practical as a means of converting ordinary income into long-term capital gain. Hence, they will not be compared with other forms of compensation which might be more desirable for this purpose.

Qualified Stock Options

The grant or exercise of a qualified stock option is a nontaxable event, with the two exceptions described below. As a result, appreciation on the underlying employer stock, if held for at least three years, can be realized (generally) at favorable capital gain rates.

At the same time, though, this type of compensation does not yield any deduction for the employer.

Ordinary Income Consequences for Failure to Meet Exact Valuation Requirements. Among other requirements, the option price of a qualified stock option must at least *equal* the stock's fair market value at the time the option is granted. However, an option is not disqualified if its price is *unintentionally* below such value. Instead, ordinary income is recognized when the option is exercised, with a corresponding increase in the basis of the acquired stock. Recognizable ordinary income can be as high as *150 percent* of the prohibited bargain element at the date of

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[66] H. Rep. No. 749 (88th Cong., 1st sess.), pp. 64 and 65 (explaining the Revenue Act of 1964).

grant, but not more than the actual spread at date of exercise (Sec. 422(c)(1)).

These features, both positive (no disqualification) and negative (reconversion of capital gain into ordinary income), are of concern where there are difficulties in valuing the employer's stock, as, for example, in the case of unlisted stock. Consequently, they enable qualified stock options to be used by closely held corporations, although capital gain potential may be curtailed.

This provision does not *produce any corresponding deduction for the employer* (Regs. Sec. 1.422-1 (b) (3), Example (6)).

Ten Percent Minimum Tax Upon Exercise of Qualified Stock Options. A qualified stock option is usually exercised when the fair market value of the underlying stock exceeds the option price, enabling the employee (or his heirs) to acquire the stock at a bargain. This bargain element is classified as a tax preference at the time such an option is exercised (Sec. 57 (a) (6)). For example, an option to buy 500 shares of stock at $50 per share which is exercised when the market price of the stock is $100 per share will create a tax preference of $25,000.

Tax preferences are subject to a 10 percent minimum tax as described in Chapter 1, at 105.1.

EXAMPLE. Client is employed by The Gene Giant, Inc. In December, 1970, Giant offers Client a choice of a $3,000 cash bonus or a qualified stock option to acquire ten shares of its stock, currently worth $100 a share.

The after-tax cost of the bonus to Giant (in 48 percent bracket) would be $1,560, as opposed to no cost for granting the option except for the potential dilution of its stock.

Client (in 50 percent bracket) would retain $1,500 of the cash bonus which he could *immediately* enjoy in *any* fashion, without risking any of his own funds.

On the other hand, the stock option could be more attractive *if* Client is:

1. Confident that Gene Giant stock will rise.
2. Willing to forego immediate, unrestricted use of these earnings.
3. Able, and also willing, to invest his own money in Gene Giant for the minimum three-year holding period (required by Sec. 422 (a) (1) in order to achieve maximum capital gain treatment).

NOTE. If held less than three years, an option can still be a qualified option, but the spread between the option price and the value of the

stock at the time the option is exercised will be treated as ordinary income at the time the stock is sold. However, an employee can never be taxed on more than his gain.[67]

In such cases, the employer *does* obtain a corresponding deduction (Regs. Sec. 1.421-8 (b)). Therefore, procedures should be instituted to insure knowledge of any such premature disposition. Otherwise, this deduction could be forfeited.

Assume that (a) Client, affirmatively responding to these economic considerations, selects the qualified stock option and (b) the following further facts:

Year	*Event*	*Fair Market Value of Stock (per share)*
1971	Option exercised	$300
1975	Stock sold	800

Tax Treatment — 1971

Total fair market value of stock	$3,000
Less option price	1,000
Tax preference	$2,000

If Client has no other tax preferences, the ten percent minimum tax does not apply since the $2,000 preference would be offset by the $30,000 exemption on Client's joint return.

Tax Treatment — 1975

Proceeds	$8,000
Less purchase price	1,000
Long-term capital gain	7,000
Less 25% maximum capital gains tax	1,750
Net compensation — five years afterward	$5,250

The 25 percent maximum capital gains tax applies since Client's total long-term gains for the year is less than $50,000. However, 50 percent of Client's net long-term gains constitute a tax preference, even though the alternative capital gains tax computation is used. This preference is $3,500 (50 percent of $7,000) and is absorbed by the statutory exemption, assuming no other tax preferences.

If Client could have invested his 1970 after-tax bonus of $1,500 at 6 percent (3 percent after tax) per annum (compounded annually), he would have accumulated approximately $1,740 at the end of 1975.

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[67] See Senate Finance Committee Report, explaining 1964 Revenue Act, p. 91.

Under these facts, he would be further enriched by $3,510 if he had selected the qualified stock option, as follows:

After-tax compensation provided by option	$5,250
Less accumulated, after-tax value of cash bonus	1,740
Additional compensation provided by option	$3,510

As is evident with hindsight, under the particular facts assumed in this given situation, an unrealistically high investment yield would be required for the cash bonus to be as attractive as the qualified stock option.

Other Planning Considerations

Minimum Tax on Tax Preferences. The advantages of qualified stock options can be adversely affected by the creation of tax preferences both at the time the option is exercised (Sec. 57 (a) (6)) and the time that the underlying stock is sold (Sec. 57 (a)(9)(A)). Moreover, the tax preference created upon the option's exercise (i.e., the bargain element) cannot be added to the cost or other basis of the stock. Therefore, the same bargain element is again designated as a preference when the stock is sold (although only to the extent of 50 percent of this amount). In other words, as shown in the preceding example, the $3,500 preference created upon the sale of the stock represents 50 percent of the $7,000 realized gain which already reflects the $2,000 bargain element (unrealized gain) deemed to be a tax preference at the time the option is exercised.

This double taxation is deliberate since "the committee is aware that in these instances some case could be made for providing adjustments to basis to avoid double taxation .... However, the committee concluded that, as a practical matter, it would be best not to provide for such basis adjustments ... since such adjustments would complicate the minimum tax ...."[68]

Nevertheless, the actual incurrence of minimum tax liability depends upon such other factors as:

1. The size of the preferences generated upon exercise of the option and sale of the stock.
2. The amount of other preferences, if any, in each of the years in which such exercise and sale occur.

[68] S. Rep. No. 91-552, 11/21/69, p. 117.

3. The amount of taxable income and resulting tax available as offsets against tax preferences for each of these years.
4. The tax carryovers to these years (as described in 105.1).

Thus, it can be seen that payment of the ten percent tax will hinge on the extent to which the preferences in (1) and (2) exceed the statutory exemption (e.g., $30,000) and the income taxes referred to at (3) and (4). If economic conditions permit, these situations can be controlled through the gradual exercise of options and "pinpointed" sales of stock. Employers may also consider cash bonuses interspersed with options over a period of years in order to stagger exercise dates and provide any cash needed to acquire the stock.

Maximum Tax Rate on Earned Income. Code Sec. 1348, as explained in 105.2, generally limits the tax rate on "earned income" to 60 percent in 1971 tax years and 50 percent thereafter. However, earned income is reduced for tax preferences, as described therein.

To reiterate, both the bargain element in qualified stock options and the capital gain deduction upon the subsequent sale of the underlying stock constitute tax preferences. Therefore, the interplay between the maximum tax rate on earned income and the minimum tax on tax preferences requires careful consideration and calculation by both employer and employee in selecting the role to be played by qualified stock options in the employee's overall compensation package.

Stock Bonuses. Although stock bonuses generate current ordinary income to employees, they nevertheless can be advantageous as indicated in Illustration 17, page 121.

Technical Resume

> The disposition by a corporation of shares of its own stock (including treasury stock) for money or other property does not give rise to taxable gain or deductible loss to the corporation regardless of the nature of the transaction or the facts and circumstances involved. . . . A transfer by a corporation of shares of its own stock (including treasury stock) as compensation for services is considered . . . as a disposition by the corporation of such shares for money or other property . . . [Regs. Sec. 1.1032-1 (a)].

Revenue Service Interpretation. "A corporation distributed shares of its previously *authorized, but unissued stock* to its employees as compensation for services rendered. The fair market value of the stock

Planning Factors

	Advantages		*Disadvantages*
(i)	Fair market value of stock deductible by employer.	(i)	Fair market value of stock taxable to employee as ordinary income.
(ii)	Net tax savings improves employer's cash position, possibly permitting increased bonus.	(ii)	Present stockholders' equity diluted.
(iii)	May be immediately enjoyable and no employee investment is required.	(iii)	Ultimate realization (as long-term capital gain) depends upon stock's market performance.
(iv)	No statutory restrictions (as is the case with qualified stock options).		

on the date of the distribution together with other compensation paid to the employees represented reasonable compensation for personal services rendered."

> Held, under Sec. 1032 (a) of the Internal Revenue Code of 1954, *no gain or loss is recognized to the corporation by reason of the distribution of the stock. The fair market value of the stock on the date of the distribution is deductible by the corporation as a business expense* under Sec. 162(a) of the Code. See Rev. Rul. 62-217, 1962-2 CB 59, which holds similarly with respect to *treasury stock* distributed by a corporation to its employees. [Rev. Rul. 69-75, 1969-1 CB 52; emphasis supplied.][69]

NOTE. In contrast, capital gain *was recognized* to an employer corporation which had distributed certain of its *portfolio securities* to an employee for services rendered. (See Rev. Rul. 69-181, 1969-15 CB 18.) Of course, this ruling also permitted an ordinary deduction for the fair market value of the distributed securities.

Also see Rev. Rul. 67-402 (1967-2 CB 135) where the fair market value of the employer's stock was taxable to the employees *even though* their proportionate ownership of the employer corporation was *not* affected (e.g., two 50 percent stockholder-employees).

[69] To the same effect, see *Hollywood Baseball Association*, 42 TC 234 (1964), p. 270.

Capital Gains Taxation

Qualified stock options offer opportunities to convert ordinary income compensation into long-term capital gains. This opportunity has been restricted for qualified deferred compensation plans and is nonexistent for other compensatory media.

However, the gap between ordinary income and capital gains taxation has been significantly narrowed through such new measures as:

1. Increase in maximum capital gains tax rates for gains exceeding $50,000.
2. The favorable seven-year averaging computation for the ordinary income portion of lump sum distributions from qualified deferred compensation plans (203.1).
3. The maximum rate on ordinary compensation (earned income) of 60 percent in 1971 and 50 percent thereafter (105.2).

Discrimination

In contrast to qualified deferred compensation plans, qualified stock options can be used, *discriminately*, to favor key employees with capital gain compensation (although limited to some extent by the minimum tax on tax preferences). In this respect, they are comparable to restricted property and nonqualified stock options. However, unlike these latter two categories, qualified stock options may have a greater adverse impact on the maximum tax rate on earned income and are also subject to a host of requirements (set forth in Sec. 422) that tend to limit their application to only the larger corporate employer.

For example, Sec. 422(b)(7) denies qualified stock option benefits for substantial stockholders by establishing the following rules:

Employer's Equity Capital	*Maximum Permissible Employee Ownership**
Less than $1 million	10%
$1 million to $2 million	10-5% (proportionate sliding scale)
$2 million or more	5%

* Total combined voting power or value of all classes of stock (of employer, its parent or subsidiary) immediately *after* option is granted, *including optioned shares* (Sec. 422 (c) (3)).

Attribution rules are also prescribed by Sec. 425 (d) while "equity capital" is defined in Sec. 422 (c) (3) (A).

Employee's Investment

An employee must either borrow or expend his own (usually after-tax) funds to purchase his employer's stock in order to avail himself of the

capital gain possibilities emanating from a qualified stock option. This financial drawback is absent in a noncontributory qualified deferred compensation plan or restricted property arrangement.

Moreover, the employee investment must be "locked-in" for at least three years (as previously discussed).

Conclusion

What's best for the client? A generalized tax study of this nature can only depict the pros and cons of so esoteric a field as employee compensation methods. The final, precise picture that is required for each individual executive can only be painted by mixing these varying alternatives with the practitioner's fine brush of intimate knowledge as to what is both required and possible in a given situation.

203.4 Treatment of Net Gain or Loss Regarding Business Properties and Involuntary Conversions Under Sec. 1231

Planning Technique

If practicable, avoid matching Sec. 1231 gains and losses.

Sec. 1231 provides a "heads you win — tails you *don't* lose" approach to the taxation of gains and losses from sales or exchanges of certain Code-enumerated properties, stated in Mertens' *Code Commentary* (at Sec. 1231) as follows:

> . . . This section provides that, on the sale or exchange of either depreciable or real property used in the trade or business (which has been held for longer than six months), gains in excess of losses are considered capital gains, but losses in excess of gains are considered ordinary losses. In effect, this section authorizes a taxpayer to treat gain from the sale of practically all business property (other than inventory or stock in trade) as capital gain if held for longer than six months. Loss is treated as an ordinary loss to the extent that it exceeds such gain. *In other words, "Sec. 1231" gains and losses are* aggregated: net gains are capital gains; *net losses are ordinary* losses. [Emphasis supplied.]

Treatment of Involuntary Conversions

Casualty Losses. Casualty or theft gains and losses on enumerated properties (described below) are consolidated. If a net loss results, it is treated as an ordinary casualty or theft loss. On the other hand, if

casualty gains exceed casualty losses, the net gain is considered a Sec. 1231 gain and must be further consolidated with other Sec. 1231 gains and losses. (Casualty gains can arise, for example, if insurance proceeds exceed the basis of the casualty property.)

This rule applies to the following types of property:

1. All business properties.
2. Capital assets held more than six months, including such personal assets as a residence and nonbusiness automobile.

It is immaterial whether these properties are uninsured, partially insured, or totally insured (Sec. 1231 (a), as effective for years beginning after 1969).

Other Involuntary Conversions. Gains or losses from the compulsory or involuntary conversion of business and personal assets (as described above), resulting from seizure, requisition, or condemnation, are initially treated as Sec. 1231 gains or losses. Therefore, they are not first offset against each other but are directly consolidated with other Sec. 1231 gains and losses (such as those arising from the sale or exchange of business properties).

PLANNING SUGGESTION. Tax perfection would be achieved by annually alternating Sec. 1231 gains and losses. In this way, *all* gains would qualify for capital gain treatment in any given year while *all* losses would be fully deductible in some other year.

Of course, this theory is difficult to practice — causing its favorable implementation to be a matter of degree.

Situation	*Remedy*	*Comment*
Gains already realized	Postpone losses	Current losses treated as capital losses (rather than ordinary losses).
Losses sustained	Defer gains	Current gains treated as ordinary income (instead of capital gains).

NOTE. The benefits of Sec. 1231 have been severely curtailed and will eventually be eliminated for most depreciable personal property as a result of the recapture of depreciation prescribed by Sec. 1245.

Depreciation recapture is also required for depreciable real property under Sec. 1250. However, as more fully explained in 203.7, Sec. 1250 only recaptures the excess of accelerated over straight-line depreciation.

203.5 Stock Redemptions and Distributions in Complete or Partial Liquidation

Planning Technique

Qualified shareholder redemptions or corporate liquidations permit complete or *partial reductions of shareholder's equity to be taxed as capital gains instead of ordinary dividends.*

This objective also requires the corporation to avoid collapsible status or else consider application of relief provisions, including advisability of special election.

A shareholder's receipt of corporate property, representing accumulated earnings and profits, is not always taxable as ordinary dividend income. Certain transactions, involving either a complete or partial diminution of the shareholders' equity in the payor corporation, can qualify for capital gain treatment if stringent statutory and regulatory tests are met. These transactions can be categorized as follows:

	Governing Code Section
Redemption of shareholder's stock:	
Complete redemptions	302
Partial redemptions	302
Liquidation of corporation:	
Complete liquidations	331
Partial liquidations	346

In addition, dividend treatment can be avoided under Sec. 303 upon the redemption of certain stock included in a decedent's gross estate for federal estate tax purposes. However, the amount of the redemption cannot exceed (1) the estate, inheritance, and other death taxes resulting from the decedent's death, and (2) the funeral and administration expenses allowable as estate tax deductions.

NOTE. Administration expenses can be included in determining the amount of a Sec. 303 redemption even though they are actually deducted for income tax purposes (Rev. Rul. 56-449, 1956-2 CB 180). The treatment of administration expenses, as either estate or income tax deductions, is further discussed in Chapter 4, at 403.2.

Such redemptions must generally occur within a time period ending 90 days after the expiration of the three-year estate tax assessment period

(Sec. 303 (b) (1)). Also, the redeemed stock must be more than (a) 35 percent of the decedent's gross estate *or* (b) 50 percent of his taxable estate (Sec. 303 (b) (2)).

A comprehensive discussion of all of these quite complex and fairly detailed code sections is beyond the scope of this tax study. Therefore, the succeeding remarks will be confined to a summary of several functional highlights.

Distinction Between Redemptions and Partial Liquidations

Redemptions. " . . . Those distributions which may have capital-gain characteristics because they are *not* made pro rata among the various shareholders would be subjected, *at the shareholder level,* to the separate tests described in . . . " (Sec. 302).[70]

Partial Liquidations. " . . . On the other hand, those distributions characterized by what happens *solely at the corporate level* by reason of the assets distributed would be included as within the concept of a partial liquidation. . . . "[71]

" . . . It is intended that a genuine contraction of the business as under present law will result in partial liquidation. See, for example, *Joseph Imler* (11 TC 836). However, a distribution of a reserve for expansion is not a partial liquidation. . . . "[72]

Planning Implications

Maintaining Shareholder's Capital Gain. Redemptions may not qualify for capital gain treatment because of attribution rules (see Sec. 302 (c) which invokes the rules set forth in Sec. 318). In contrast, there is *no* such attribution in the case of partial liquidations under Sec. 346.

Similarly, unlike partial (and complete) liquidations, the redemption of Sec. 306 stock could precipitate ordinary income. (Sec. 306 stock is stock issued as a tax-free stock dividend,[73] except common stock issued with respect to common stock, at a time when the issuing corporation has earnings and profits. Sec. 306 is basically designed to prevent so-called

[70] S. Rep. No. 1622 (83rd Cong., 2nd sess.), p. 49 (emphasis supplied).

[71] *Ibid.*

[72] *Ibid,* p. 262.

[73] Also included is: (1) any stock, except common stock, received in a reorganization whose receipt has substantially the same effect as a stock dividend or received in exchange for Sec. 306 stock and (2) stock whose basis is determined by reference to Sec. 306 stock. As explained in Regs. Sec. 1.306-3 (e), this particular definition can cause common stock to be tainted as Sec. 306 stock.

preferred stock "bail-outs" by taxing the entire proceeds of certain dispositions of Sec. 306 stock as ordinary income. However, some dispositions are not subject to this stringent treatment, such as those completely terminating the shareholder's interest in the corporation and those arising through corporate liquidations (as previously mentioned herein).)[74]

On the other hand, redemptions (but not partial liquidations) are apparently able to avoid the ordinary income that may flow from a collapsible corporation (Sec. 341).[75]

Detailed discussion of the ignominious collapsible corporation provisions is beyond the scope of this study. However, in passing, cognizance should be taken of a relatively recent measure which enables shareholders, as such, to combat the effects of collapsibility.

Under Code Sec. 341 (f), selling shareholders can avoid their collapsible corporation's taint if:

1. The corporation consents to recognize gain on any future disposition of its "Subsection (f) Assets" (i.e., assets owned, or held under option, on the date its stock is sold — except for certain capital assets).
2. The stock is sold within six months after the consent is filed.

Other relief provisions are contained in Subsections (d) and (e) of Sec. 341.

Deductibility of Shareholder's Losses. Redemption losses are not deductible by a more-than-50-percent shareholder (Sec. 267 (b) (2)). However, Sec. 267 does *not* apply to "losses in case of distributions in corporate liquidations. . . " (Sec. 267 (a) (1)).

Effect Upon Corporation. If appreciated property is distributed in partial or complete redemption of stock, gain is generally recognized to the extent of the appreciation (Sec. 311 (d) (1)). However, Sec. 311 (d) (2) contains the following exceptions to this rule:

1. Redemptions in complete termination of the interest of a shareholder owning at least 10 percent of the corporation's stock during prior 12-month period.

[74] Exceptions are also permitted if the IRS can be satisfied that the distribution and disposition were not part of a plan which had federal income tax avoidance as one of its principal purposes. (Code Sec. 306(b)(4).)

[75] See Regs. Sec. 1.341-1; Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* (2nd ed.), p. 419.

2. Redemptions under Sec. 303.
3. Distributions of stock of a 50 percent or more owned subsidiary.
4. Distributions pursuant to an antitrust decree.
5. Certain redemption distributions to private foundations.
6. Distributions by regulated investment companies.
7. Distributions before December 1, 1974 of stock of a newly created subsidiary if substantially all its assets were held on November 30, 1969 by the distributing corporation (or its affiliate).

It is obvious that the first two exceptions are of greatest significance in tax planning for closely held corporations and their individual shareholders.

On the other hand, if Sec. 311 (d) does not apply, ordinary income or capital gain (as appropriate) is nevertheless recognized if, in redemption of its stock, a corporation distributes appreciated LIFO inventory or property encumbered with debt in excess of its basis (Secs. 311 (b) and (c)). However, these gains need not be recognized if the distribution can be classified as a partial liquidation (compare Secs. 311 and 336).

NOTE. Distributions in *either* redemption or partial liquidation can be included in the dividends paid deduction for accumulated earnings tax purposes. (See Secs. 346 (a) and 562 (b) (1) (A)). However, the deductible portion is limited to the amount properly chargeable to earnings and profits as set forth in Regs. Sec. 1.562-1 (b) (1) (ii). In contrast, distributions in complete liquidation can be deducted for both personal holding company and accumulated earnings tax purposes. (For examples, see Secs. 316 (b) (2) (B) and 562 (b) (1) (B), respectively.)

In addition, the accumulated earnings tax cannot be asserted merely because of (1) redemptions under Sec. 303 and (2) redemptions from private foundations to comply with the excess business holdings requirements of Sec. 4943. (See Sec. 537 as amended by the 1969 Tax Reform Act.)

203.6 Subdividing of Real Estate

Planning Technique

Capital gain on subdivided property can be attained by meeting the requirements of Sec. 1237. If such compliance is not possible or desirable, ordinary income may still be avoided in certain circumstances.

A Case Study

A client owns a fairly substantial tract of real property which he is currently using as his residence. He has been offered the following alternative inducements to vacate the premises: (a) $250,000 "as is" *or* (b) $400,000 if the property is subdivided and sold as individual parcels.

Accordingly, he consults his CPA as to whether subdividing would be worthwhile. Upon due deliberation, the following advice is submitted:

1. *Sale of Entire Property (Without Subdividing).* It has been indicated that the entire property, in its present status, can be sold for $250,000 which will result in the following gain:

Selling price	$250,000
Less cost	72,000
Gain	$178,000

For federal income tax purposes, this gain could be treated as a long-term capital gain. Such treatment might be available whether the property was a personal residence at the time of sale, or had been converted to rental property.

In the event that a new residence is acquired within one year of the sale, or construction of a new residence is started within one year of the sale and completed within 18 months of the sale, some or all of the tax on this gain may be postponed until the new residence is sold (and not replaced). The gain taxed currently will be determined by the excess of the selling price of the old residence over the cost of the new residence. This means that the entire sales proceeds of $250,000 would have to be reinvested in a new residence in order to presently postpone all federal income tax on the gain. If a new residence is purchased, for example, at a cost of $200,000, the total gain (above) of $178,000 would be taxable only to the extent of $50,000. However, in order for any tax to be postponed in this manner, both the old and the new property must qualify as the client's *principal* residence.

Whether *all* of the surrounding acreage will be considered to have been used as part of the client's residence is, of course, a *factual* question (Regs. Sec. 1.1034-1 (c) (3)).

For example, a garden, orchard, and chicken yard, which provided products for a taxpayer's *own* use, were categorized as residential property by the IRS. (See Rev. Rul. 56-420, 1956-2 CB 519.)

However, since it is understood that the client may rent an apartment,

these nonrecognition-of-gain provisions may not be available.[76] Furthermore, because of the client's age, he will be unable to exclude a portion of the gain from gross income since this privilege is reserved for taxpayers 65 or older.[77]

2. *Sale of Property After It Has Been Subdivided.* The client has stated that all of the acreage could be sold for $400,000 if it is first subdivided. The estimated cost of such subdivision is unknown, but if it is assumed to be $50,000 the following gain would be realized:

Selling price		$400,000
Less:		
Original cost	$72,000	
Cost of subdividing	50,000	
Total cost		122,000
Gain		$278,000

The gain from the sale of lots that have been subdivided by their owner is, usually, not eligible for capital gain treatment, but, instead, is subjected to tax at the rates applicable to ordinary income (except as discussed below). The cash yield in this situation is compared with the cash yield based on a sale of the property without subdividing (the first alternative, above), as shown in Illustration 18, below.

This computation assumes that all gains would be realized during one

Illustration 18

	Sale of		
	Subdivided Lots	*Entire Tract*	*Increase (Decrease)*
Total gain realized	$278,000	$178,000	$100,000
Less – federal income tax:			
Ordinary rate (70%)*	$194,600	$ –	$
Capital gain rate† (1970)	–	50,260	
Total federal income tax	$194,600	$ 50,260	144,340
Net gain (cash yield)	$ 83,400	$127,740	$ (44,340)

° Presumes joint return and other income of over $200,000.
† See subsequent discussion of tax preferences.

[76] These provisions, authorized by Sec. 1034 are discussed further in 204.1, herein.
[77] See discussion of Sec. 121 at 201.1.

year. Of course, the income tax could be decreased if the sale or sales are made on the installment basis so that income would be reportable over a period of years rather than in one year.

The above computation discloses a net cash reduction of $44,340 if the property is subdivided due to the imposition of the ordinary income tax. Therefore, subdividing would be advisable, under these circumstances, only if the resulting gain would qualify as long-term capital gain (completely, or in substantial part) by meeting either (a) requirements expressly prescribed by the Code (specifically, Sec. 1237) or (b) the general rules for differentiating capital assets.

Internal Revenue Code Provisions: Under Sec. 1237 of the Code, gain from the sale of subdivided property would be entitled to capital gain treatment if *all* of the following tests, among others, are satisfied:

1. The lot has been held for five years (unless acquired by inheritance).
2. No other real property is held primarily for sale to customers in the ordinary course of business during the same year in which the subdivided lots are sold.
3. There is no substantial improvement, that substantially enhances the value of the lots, made by the client, certain related parties, a lessee (if the improvement replaces rent payments), or a governmental unit (if the improvement increases the property's cost as, for example, in the case of a special tax assessment for paving streets), either during the time that the client owns the property or pursuant to a contract for its sale.

Whether improvements have substantially increased the value of the lots depends upon the particular circumstances. However, the income tax regulations provide that if improvements increase such values by not more than 10 percent, the increase will not be considered substantial. In addition, the improvement itself must be substantial in order to prevent capital gain treatment. The regulations provide the following illustrations of improvements which are, and are not, considered substantial:

"Among the improvements considered substantial are shopping centers, other commercial or residential buildings, and the installation of hard surface roads or utilities such as sewers, water, gas, or electric lines. On the other hand a temporary structure used as a field office, surveying, filling, draining, leveling and clearing operations, and the construction of minimum all-weather access roads, including gravel roads where required by the climate, are not substantial improvements" (Regs. Sec. 1.1237-1 (c) (4)).

Further, the benefits of Sec. 1237 can be obtained even though

substantial improvements have been made if the following conditions are met:

1. The client has held the property for ten years.
2. The improvement consists of the building or installation of water, sewer, or drainage facilities (either surface, subsurface, or both) or roads, including hard surface roads, curbs, and gutters.
3. Client shows, to the satisfaction of the IRS, that, without such improvement, the lot sold would not have brought the prevailing local price for similar building sites.
4. Client elects to forfeit the tax benefit of the improvement itself. This means that the cost of the improvement cannot be added to the cost of the property or deducted as an expense.

The advisability of such an election will depend upon the amount of improvement cost involved and the difference between the ordinary income and capital gain tax rates. However, based upon the facts previously assumed, this election could increase the client's after-tax gain on the subdivided property by $100,090 as shown in Illustration 19, below.

In comparison with the capital gain on the property, without

Illustration 19

	Sale of Subdivided Lots		
	With Election	*Without Election*	*Increase (Decrease)*
Selling price	$400,000	$400,000	
Less:			
Original cost	$ 72,000	$ 72,000	
Cost of improvements (subdividing)	–	50,000	
Total costs for tax purposes	$ 72,000	$122,000	
Taxable gain	$328,000	$278,000	
Less:			
Ordinary tax (70%)	$ –	$194,600	
Capital gain tax (1970 rate)*	94,510	–	
Total tax	$ 94,510	$194,600	$(100,090)
Gain less tax	$233,490	$ 83,400	
Cost of improvements not deducted above	50,000	–	
Net gain (cash yield)	$183,490	$ 83,400	$ 100,090

* See subsequent discussion of tax preferences.

subdividing, the election produces the following additional after-tax gain:

Net gain on subdivided property, with election in effect	$183,490
Net gain on property, without subdividing	127,740
Benefit from subdividing and election	$ 55,750

Sec. 1237 contains a special rule which is effective when more than five lots (from the same tract) are sold. This rule requires 5 percent of the selling price of *each* lot sold in the taxable year that the sixth lot is sold, and thereafter, to be considered ordinary income (to the extent that this amount represents a gain). The balance of any gain would be considered as capital gain. (However, expenses of sale are first deducted against the 5 percent ordinary income portion of the total gain. Any remaining expenses would then reduce the capital gain portion.)

However, the effect of this special rule can be mitigated if sales can be controlled as shown in Illustration 20, below.

Illustration 20

	Taxpayer	
	A	B
Lots sold:		
1970	5	6
1971	2	1
Tax treatment:		
1970	All capital gain	5% rule applies
1971	5% rule applies	5% rule applies

Further, if the client does not sell any lots for five years after the sale of at least one lot, the remainder of the tract will be deemed a new tract in determining when more than five lots have been sold (for purposes of this 5 percent rule). (Please note that this special 5 percent rule applies even though all the other requirements of Sec. 1237 are met.)

Sale of Subdivided Property Not Covered by Sec. 1237: Failure to meet the requirements of Sec. 1237 does not *automatically* disqualify a transaction from capital gain treatment since "Sec. 1237 is not exclusive in its application . . . ." [78] By the same token, Sec. 1237 does not apply,

[78] Regs. Sec. 1.1237-1(a)(4).

even though its conditions are met, if the real property sold would be entitled to capital gain treatment (or Sec. 1231 treatment)[79] without regard to Sec. 1237.

"... Thus, the district director may at all times conclude from convincing evidence that the taxpayer held the real property solely as an investment. ..." [80]

NOTE. Regardless of whether or not its conditions are met, Sec. 1237 is inapplicable to losses realized upon the sale of subdivided realty.

Qualifying Realty as Investment Property Eligible for Capital Gain Treatment

> ... In drawing a rather wavering line between the investor in real estate and the dealer in real estate, the courts have resorted to multifactoral analyses, considering relevant such factors as:
>
> 1. The frequency, number, and continuity of the sales;
> 2. Subdivision, platting, and other improvements or developments tending to make the property more marketable;
> 3. The extent to which the taxpayer engaged in sales activity;
> 4. The length of time the property has been held;
> 5. The substantiality of the income derived from the sales, and what percentage that is of the taxpayer's total income;
> 6. The nature of the taxpayer's business;
> 7. The taxpayer's purpose in acquiring and holding the property;
> 8. The extent of sales promotional activity such as advertising; and
> 9. The listing of property for sale directly or through brokers.
>
> No one of these factors is necessarily decisive, and some weigh more heavily than others. As Mertens[81] correctly observes: "It is difficult to attach an absolute or specific degree of importance to the particular factors involved, and in part the weight of any one factor has depended on the combination of others with which it occurred." ...[82]

Planning Considerations

Minimum Tax on Tax Preferences. When considering whether to qualify for capital gain treatment under Sec. 1237, the tax adviser should also take into account the minimum tax on tax preferences. Since the

[79] See 203.4, herein.
[80] Regs. Sec. 1.1237-1 (a) (4).
[81] Mertens, *Law of Federal Income Taxation*, Sec. 22.138, footnote 69, pp. 623 and 624.
[82] Excerpt from 1964 opinion in *Howard W. Gault, et al.*, CA-2, 332 F2d 94, aff'g 22 TC Memo 847.

capital gains deduction is considered an item of tax preference, it is possible that a large capital gain (such as in the preceding examples) may raise the effective capital gain rate by 5 percent (10 percent of 50 percent) of the net long-term gain less the tax otherwise imposed thereon. Consequently, reporting on the installment method, if otherwise desirable, takes on added significance. (This method is discussed in 204.6.)

Maximum Tax Rate on Earned Income. Consideration might also be given to whether a client should engage in sufficient subdividing and selling activities to be classified as a dealer and avoid Sec. 1237 treatment. (See Regs. Sec. 1.1237-1 (a) (1), (2), (3).) However, this procedure is desirable only if the increased after-tax profit resulting from the client's activities would exceed the additional taxes generated by converting capital gain into ordinary income. In making this comparison, the following factors are pertinent:

1. Thirty percent of the net profits arising from such real estate activities could be "earned income." (Sec. 911 (b).) Therefore, 30 percent of the resulting ordinary income appears eligible for the maximum tax rate on earned income (60 percent in 1971, 50 percent thereafter). (Sec. 1348 (b) (1).)

   However, the balance of such income would be subject to regular rates.
2. The maximum capital gains tax rates, listed in the introduction to 203, could be as high as 35 percent after 1971. An additional minimum tax, which could be as high as 5 percent, might also apply as previously indicated.
3. Capital gains are eligible for income averaging which could lower their effective tax rate. On the other hand, the maximum tax rate on earned income and income averaging are mutually exclusive. (See Sec. 1304 (b) (6).) This particular factor may necessitate still further computations.

NOTE. The maximum tax rate on earned income and the minimum tax were discussed in 105.

Infrequent Sales of Real Property

Sales to Related Parties. Where the benefits of Sec. 1237 are unavailable, consider the following points in any transaction between a taxpayer and his controlled corporation or members of his family.

Controlled Corporations — Thinness: A sale to a newly created

corporation cannot usually be consummated for full and immediate payment in cash. Using the *"thin corporation" doctrine,* the taxing authorities may construe the incorporator-seller's notes receivable as representing an equity interest, with the following undesirable results:

- The corporation would be denied a stepped-up basis for the property, causing it to realize greater gains (generally taxed at ordinary rates) upon ultimate disposition.
- Double ordinary income taxation would be generated since principal and interest payments on the notes would be classed as nondeductible dividends, taxable as ordinary income to the payee.

Controlled Corporations — Collapsibility: Premature sales of the corporation's stock, either to avoid the thin corporation problem or to liquify investments, could nevertheless precipitate ordinary income if the corporation is a "collapsible corporation" within the meaning of Sec. 341. (See 203.5 for discussion of Sec. 341 (f) special relief election.)

Controlled Corporations — Sham: In appropriate cases, the Revenue Service could argue *substance* over *form* and disregard the corporation's existence. This, of course, would undo the entire transaction and place a client in his original position (of, hopelessly, being unable to avoid ordinary income on the sale of his land).

Family Members: A sale to a child, or a trust for his benefit, may produce capital gain for the selling parent. The buyer, who originally is clearly not a "dealer," would also stand a better chance of avoiding ordinary income upon subsequent sales. (As one alternative, Sec. 1237 — which is unavailable to dealers — would be within easier reach.)

Furthermore, if and when ordinary income is recognized to the buyer, it may be taxed in a lower bracket than that of the selling parent.

However, the "substance over form" danger (see "Sham" above) might also be equally virulent in this situation.

Sales to Unrelated Parties. Ordinary income through dealer status, might also be avoided — at least with respect to appreciation of raw land — by selling to a developer. (The developer would, of course, be ineligible for capital gain treatment — in any event — on profits attributable to the property's development.)

"... The price paid by the developer may be made dependent in some manner on the proceeds the developer receives from the dis-

position of the property after he has improved, subdivided or otherwise acted with respect to it . . . ." [83]

Sales of Inherited Real Property

"In the absence of extensive development and sales activity, however, the liquidation of inherited property has been held to result in capital gain even though the process of liquidation involved frequent and continuous sales . . . ." [84]

203.7 Reducing Ordinary Income Resulting From Depreciation Recapture

Planning Technique

Sec. 1250 recapture can be avoided through straight-line depreciation or by meeting the holding period requirements for certain types of property. Both Secs. 1245 and 1250 recapture can be either avoided or mitigated through multiple asset accounts, installment sales, sales of stock, or statutory exceptions.

The process of distilling capital gains from ordinary income received a severe jolt in 1962 and further setbacks in 1964 and 1969 with the enactment of two Code sections and their later amendment. These relatively new statutory provisions seek to recapture gains on sales of property, to the extent of "tainted" depreciation, and imprison them in the hades of noncapital gains. These capital gain retarding mechanisms are embodied in the following sections of the Code:

1. Sec. 1250, which relates to depreciable real property (the 1964 model of the recapture vehicle remodeled in 1969).
2. Sec. 1245 dealing with all other depreciable property (including livestock).

NOTE. Certain real property described in Sec. 1245 (a)(3)(B) is subject to the jurisdiction of Sec. 1245 instead of Sec. 1250.

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[83] Mertens, *Law of Federal Income Taxation*, Sec. 22.146, footnote 71.
[84] Mertens, *op. cit.*, Sec. 22.142.

These provisions are all-pervasive in the sense that they tend to touch all Code sections concerned with depreciable property dispositions unless excepted by the express terms of either Secs. 1245 or 1250. Thus, a run-down of some of the relatively few and invaluable (and in some cases — obvious) doors still open to escape from this dire peril to capital gains taxation is in order.

Illustration 21

Permissible Depreciation Methods

Property Acquired After July 24, 1969 (Sec. 167 (j))	
New:	
Residential rental property	200% declining balance or sum of the years' digits
Other new Sec. 1250 property	150% declining balance or any other generally comparable method
Used:	
Residential rental property having a useful life of at least 20 years	125% declining balance method (generally)
Other used Sec. 1250 property	Straight line (generally)
Rehabilitation expenditures incurred before 1975 for low-income rental housing	Straight line over 60-month period
Property Acquired Before July 25, 1969 (Sec. 167 (b))	
New	200% declining balance or sum of the years' digits
Used	150% declining balance
Transitional Rules for "In-Process" Property Acquired After July 24, 1969	
New (Sec. 167 (j) (3)):	
Construction, reconstruction, or erection begun before July 25, 1969	200% declining balance or sum of the years' digits
Contract for construction, etc., or for permanent financing thereof, entered into before July 25, 1969 and binding on owner on and after such date	200% declining balance or sum of the years' digits
Used (Sec. 167 (j) (6) (C)):	
Contract for acquisition, or permanent financing thereof, binding on owner on and after July 24, 1969	150% declining balance

Avoiding Recapture on Sec. 1250 Property

Planning Techniques Peculiar to Sec. 1250 Property

1. *Confine depreciation methods on Sec. 1250 real estate to the straight line (and hold property for at least one year).*
2. *In the case of certain properties:*
   - *Select other permissible depreciation method.*
   - *Hold property for at least the period necessary to avoid recapture.*

Permissible methods and necessary holding periods for Sec. 1250 property are summarized as shown in Illustration 21, opposite.

These methods are the "fastest" ones permitted for the various categories of properties and do not preclude "slower" methods, such as the straight line, where appropriate.

Necessary Holding Periods. As of January 1, 1970, *all* depreciation in excess of straight line that is claimed on Sec. 1250 property is subject to recapture upon disposition, except depreciation claimed:

1. From January 1, 1964 through December 31, 1969 (on any Sec. 1250 property).
2. On property disposed of pursuant to a written contract which was binding on the owner on and after July 24, 1969.
3. Regarding government assisted projects, such as FHA programs, constructed or acquired before 1975.
4. On residential rental property (as defined in Sec. 167 (j) (2) (B)).
5. For rehabilitation expenditures allowed in connection with low-income rental housing (under Sec. 167 (k)).

Recapture of excess depreciation on property in these five categories is decreased by the following percentages:

Category	*Percentage Decrease*	*Holding Period Required For No Recapture*
1, 2, and 3	100% less 1% for each full month after 20 months	120 months or 10 years
4 and 5	100% less 1% for each full month after 100 months	200 months or 16 years and 8 months

Consequently, the length of the holding period is immaterial in reducing recapture of excess *post-1969* depreciation on "general" Sec. 1250 property (i.e., not described in categories 3, 4, and 5) unless within

the transitional category (2). As later illustrated, post-1969 excess depreciation is recaptured before its pre-1970 counterpart.

Changing Depreciation Methods. Projections may be advisable in appropriate situations to ascertain the desirability of changing from an accelerated method to the straight-line method in order to minimize anticipated future recapture. Another factor to consider is that the excess of accelerated depreciation over straight line is a tax preference for purposes of the 10 percent minimum tax (Sec. 57 (a) (2).[85]

A change from accelerated to straight-line depreciation can be elected for Sec. 1250 property by the due date (including extensions) of the return for the first taxable year beginning after July 24, 1969 (e.g., calendar year 1970 return) under regulations to be prescribed. This election is possible notwithstanding any contrary provision in a binding agreement consummated under Sec. 167 (d). (See Sec. 167 (e) (3).)

A change from the 200 percent declining balance method to the straight line can be made with returns for other years, unless prohibited by a Sec. 167 (d) agreement. (Regs. Sec. 1.167 (e)-1 (b).) This rule does not apply to changes from the 150 percent declining balance method (Rev. Rul. 57-510, 1957-2 CB 152).

A change from the sum-of-the-years digits or 150 percent declining balance methods to the straight line can likewise be made for other years under Rev. Proc. 67-40 (1967-2 CB 674). However, the application for change must be filed (with the appropriate district director) within ninety days of the *beginning* of the year for which the change is sought.

Conversely, Rev. Proc. 67-40 can also be used, if advisable, to change from straight-line to accelerated depreciation for otherwise eligible property (see Illustration 21, page 138).

The Moral of Sec. 1250

Sec. 1250 can be described as a somewhat milder version of Sec. 1245. Basically, this praiseworthy attribute is caused by the following two factors uniquely found in Sec. 1250:

1. Only "additional" depreciation is recapturable. (Generally, additional depreciation is defined in Sec. 1250 (b) as the actual depreciation allowed or allowable (after December 31, 1963) to the extent that it exceeds a hypothetical straight-line computation for the same period.)

[85] This tax is further discussed in 105.1, herein.

2. Only a constantly decreasing percentage of this additional depreciation is taken into account in determining the amount ultimately recaptured. (This sliding scale is known as the "applicable percentage.") However, as indicated in the above summary, this particular attribute only applies to specified property in the case of depreciation claimed after 1969.

Computation of Recapture for "General" Sec. 1250 Property (Not Subject to Special Exceptions)

Assume a commercial building is sold for $100,000 on December 31, 1970, which was acquired for $100,000 on December 31, 1967. The actual accelerated depreciation claimed and the hypothetical comparable straight-line depreciation are as shown in Illustration 22, below.

Illustration 22

	Depreciation		
Year	*Accelerated*	*Straight Line*	*Additional*
1968	$15,000	$10,000	$5,000
1969	12,750	10,000	2,750
Subtotal	$27,750	$20,000	$7,750
1970	10,850	10,000	850
Totals	$38,600	$30,000	$8,600

Recapture is computed as shown in Illustrations 23 and 24, page 142.

Avoiding or Mitigating Recapture on Property Subject to Sec. 1245 or 1250

Planning Technique

1. *Use multiple asset accounts (where possible).*
2. *Consider installment sales.*
3. *Sell stock rather than corporate assets.*
4. *Be aware of relevant statutory exceptions.*

Since Sec. 1245's impact upon capital gain taxation is so much more devastating in comparison to Sec. 1250, the primary thrust of the following defensive maneuvers is particularly attuned to the Sec. 1245 problem. However, these maneuvers would also be applicable in a Sec. 1250 situation, especially where the ordinary income potential is material.

Illustration 23

Line			
1.	Proceeds of sale		$100,000
	Less – adjusted basis:		
2.	Original cost	$100,000	
3.	Less – depreciation allowed or allowable	38,600	
4.	Adjusted basis		61,400
5.	Total gain recognized		$ 38,600
6.	Post-1969 additional depreciation		$ 850
	Recapture of Post-1969 Depreciation:		
7.	*100%* of lesser of lines 5 or 6		$ 850
	Recapture of Pre-1970 Depreciation:		
8.	Line 5	$ 38,600	
9.	Less – line 7	850	
10.	Remaining gain	$ 37,750	
11.	Pre-1970 additional depreciation	$ 7,750	
12.	Applicable percentage (see chart below)	84%	
13.	84% of lesser of lines 10 or 11		6,510
14.	Total recapture (lines 7 and 13) treated as ordinary income		7,360
15.	Sec. 1231 gain* (line 5 less line 14)		31,240
16.	Total gain recognized (per line 5)		$ 38,600

* See 203.4.

Illustration 24

*Selected Applicable Percentages for Pre-1970 Additional Depreciation**

Full Months Held	*Percentage*	*Comments*
6 or less	100	Entire gain is ordinary income
7 through 12	100	Lesser of *any* post-1963 depreciation or gain is ordinary income
13 through 20	100	
21	99	
36	84	
60	60	
84	36	
108	12	
120 or more	0	

* For property held more than 20 full months, the applicable percentage *decreases by one percent for each full month* that the property is subsequently held. Thus, at the expiration of 120 months, or ten years, the applicable percentage is zero, completely eliminating recapture of *pre-1970* depreciation. However, post-1969 depreciation is recaptured prior to pre-1970 depreciation (to the extent of the gain realized). In the case of "general" Sec. 1250 property, this prior recapture is at a constant rate of 100 percent.

Accounting for Depreciable Property Using Multiple Asset Accounts

Multiple asset accounting can be effectively utilized by individual owners of depreciable properties, such as (1) an owner of an apartment house providing furnished rooms or (2) sole proprietors of a professional practice or a commercial enterprise.

Furthermore, partners' taxable incomes derived from their partnership operations would also be affected by recapture at the company level. Consequently, the ensuing discussion is equally applicable to depreciable property owned by partnerships.

Depreciable property may be accounted for by treating each individual item as an account, or by combining two or more assets in a single account (Regs. Sec. 1.167 (a)-7 (a)).

In turn, Regs. Sec. 1.167 (a)-8(e)(2), dealing with the accounting treatment for asset retirements, permits the nonrecognition of gains therefrom under the following circumstances:

1. Multiple asset accounts are used and acquisitions and retirements are numerous;
2. To avoid unnecessarily detailed accounting for individual retirements, a taxpayer consistently follows the practice of (a) charging the reserve with the full cost or other basis of assets retired and (b) crediting the reserve with all receipts from salvage.

This practice may be continued so long as it clearly reflects income, in the Commissioner's opinion.

NOTE. By crediting salvage proceeds to the depreciation reserve in the manner indicated, gains from asset retirements (i.e., dispositions) can avoid taxation as long as the reserve account does not exceed the amount of the multiple asset account. Thus, continued acquisitions will prolong this deferment process.

On the other hand, increasing the reserve account, in effect, hastens the recovery of asset cost (or other basis) and thus reduces the amount of depreciation deductions allowable (after such retirements).

Effect Upon Recapture: What has this got to do with such broad and far-reaching provisions as Secs. 1245 (d) and 1250 (i) which thunder that "this section shall apply notwithstanding any other provision of this subtitle."

The answer, in a nutshell, is — everything — since Regs. Sec. 1.1245-

6 (c) grants the following dispensation from the awesome grip of Sec. 1245:

> *Normal retirement of asset in multiple asset account.* Sec. 1245 (a) (1) does *not* require recognition of gain upon normal retirements of Sec. 1245 property in a multiple asset account *as long as the taxpayer's method of accounting*, as described in paragraph (e) (2) of Sec. 1.167 (a)-8 (relating to accounting treatment of asset retirements), *does not require recognition of such gain.* [Emphasis supplied.]

A similar provision is contained in pre-1969 Proposed Regs. Sec. 1.1250-1 (b) (5).

Disposing of Recapturable Property Through Installment Sales

Sec. 1245 treats gains attributable to depreciation as ordinary income since such depreciation is deductible from ordinary income. However, in view of changing tax rates as well as the *total* inclusion in income, in *one* taxable year, of depreciation that had been deducted in *several* years, recapture may not be accomplished at the same tax rates applicable to the original deductions. This probability continues to increase the longer Sec. 1245 remains in effect.

Some tax *rate* relief for this pile-up of ordinary income may be grasped through income averaging. (See 104.1, Chapter 1.) However, another and, perhaps, more positive means of regulating a client's ordinary income bracket can be reached through the medium of installment sales. Naturally, installment sales must also give due heed to the interest requirements of Sec. 483. (See 204.6.)

In this regard, Regs. Sec. 1.1245-6 (d) provides that if the installment method of reporting gain applies to a sale or other disposition of Sec. 1245 property, any recapturable depreciation gain recognized also may be reported on the installment method. *The income (other than interest) on each installment payment is deemed to consist of recapturable depreciation gain until all such gain recognized has been reported.*

EXAMPLE. Client sells an item of Sec. 1245 property for $10,000 payable in ten $1,000 installments plus interest at 4 percent simple interest per annum on the unpaid balance *(payable with each installment of principal).* Assuming that his total gain is $3,000, that recapturable depreciation is $2,000, and that the Sec. 1231 capital gain-ordinary loss provision applies, he would report $300 of each $1,000 installment (in addition to interest) as shown in Illustration 25, page 145.

Illustration 25

Installments	*Recapturable Depreciation Taxable as Ordinary Income*	*Sec. 1231 Gain*
1st	$ 300	$ –
2nd	300	–
3rd	300	–
4th	300	–
5th	300	–
6th	300	–
7th	200	100
8th	–	300
9th	–	300
10th	–	300
Totals	$2,000	$1,000

The same treatment would apply to recapture of depreciation under Sec. 1250, in the case of a building sold on the installment method (Pre-1969 Proposed Regs. Sec. 1.1250-1 (b) (6).

Sales of Stock vs. Sales of Corporate Property

Sales of stock instead of corporate property will solve a seller's recapture problems but may create them for the buyer. Negotiations should not overlook any adverse effects of this dilemma on your client. Where recapturable properties are owned in corporate form, a sale of the corporate owner's stock, instead of the properties themselves, will bypass the depreciation recapture provisions as far as the seller is concerned. A sale of stock, rather than corporate assets, will also obviate investment credit recapture.

However, the buyer will find himself in the unenviable position of having acquired these potential tax headaches if stock is purchased in lieu of property. Of course, the longer these assets are held by the original corporate owner (even though itself under new ownership), the greater the likelihood that recapture of pre-1970 depreciation under Sec. 1250, if any, as well as investment credit recapture, can be permanently forestalled. The minimum holding period required for completely obliterating these particular types of recapture are:

1. Sec. 1250 — 10 years (see table, page 139).
2. Investment credit (Sec. 47) — eight years.

(It might also be noted that the investment credit will not be recaptured if replacement property is acquired within six months after

disposition of the original assets. This rule applies where the replacement property is acquired after April 18, 1969 and would, itself, be eligible for the investment credit in the absence of its repeal (Sec. 47 (a) (5)).

On the other hand, a buyer may want to liquidate the corporation whose stock has been acquired (who would still be the actual owner of the property) in order to obtain a stepped-up basis for its assets. Where the buyer is itself a corporation, a stepped-up basis for the assets of the seller's corporation can be achieved by liquidating the acquired corporation in accordance with Code Sec. 334 (b) (2). [86] (Briefly, this section applies if (1) at least 80 percent of the stock (except nonvoting preferred) is purchased during a period of not more than 12 months and (2) a plan of liquidation is adopted within two years thereafter.)

Such early liquidations would, of course, precipitate almost all of the depreciation and investment credit recapture avoided by the seller.

Thus, a recapture conflict may often exist between buyer and seller. It is imperative that your client, regardless of which role he plays, be armed with this knowledge and negotiate accordingly. A major decision, naturally, will be the sales medium (stock or assets). However, if the asset vehicle is chosen, much dealing can be done in connection with the arm's-length bargaining necessary for allocating the total selling price among the properties to be sold. Here again, though, the parties' interests are diametrically opposed.

EXAMPLE: *Tax savings possible through arm's-length negotiation.* Client is on the verge of selling the properties shown in Illustration 26, page 147, on December 31, 1969.

However, before the sale is consummated, Client (fortunately) consults with CPA who advises him of the potential tax consequences shown opposite. Thereupon, in conjunction with Client's attorney, hard bargaining occurs with the buyer's negotiating team and the following results emerge:

1. Sale is to be transacted on January 2, 1970 in order to provide additional time for seller to pay tax.
2. Selling price will be reduced by $5,000 and re-allocated as shown in Illustration 27, page 148.

Client was able to clear an additional $3,000 on this transaction as a result of arm's-length determinations of fair market values, arrived at

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[86] Sec. 334 (b)(2) may not be the sole authority permitting such stepped-up basis by a corporate vendee. See Court of Claims opinions in *American Potash & Chemical Corp.*, 68-2 USTC ¶9472 and ¶9650.

Illustration 26

Asset	Adjusted Basis	Tentative Selling Price	Potential Gain Capital*	Potential Gain Ordinary†
Land	$ 15,000	$ 17,000	$ 2,000	$
Building	20,000	32,000	10,000	2,000
Machinery	5,000	30,000		25,000
Furniture	1,000	19,000		18,000
Goodwill	–	2,000	2,000	
Totals	$ 41,000	$100,000	$ 14,000	$ 45,000
		(41,000)		14,000
		$ 59,000		$ 59,000

After-Tax Proceeds

Line			
1.	Gross proceeds		$100,000
	Less – income tax:		
2.	Gain – above	$ 59,000	
3.	Less – capital gain deduction (at 50%)	7,000	
4.	Taxable income (it is assumed that other income is exactly offset by deductions and exemptions)	$ 52,000	
5.	Tax on line 4 (joint rates to nearest thousand) and assuming no investment credit recapture		18,000
6.	After-tax proceeds		$ 82,000

* Including net Sec. 1231 gain.
† Resulting from depreciation recapture.

through negotiations with an adverse, nonrelated party. The effect of Client's actions can be summarized as follows:

Tax savings attributable to reallocation of values	$8,000
Less concession to buyer (reduction of selling price)	5,000
Net savings (as above)	$3,000

When Are Contractual Allocations Conclusive for Federal Income Tax Purposes? In instances where contractual allocations are later disputed,

Asset	*Adjusted Basis*	*Final Selling Price*	*Actual Gain*	
			Capital	*Ordinary*
Land	$ 15,000	$ 30,000	$ 15,000	$
Building	20,000	40,000	18,000	2,000
Machinery	5,000	8,000		3,000
Furniture	1,000	12,000		11,000
Goodwill	–	5,000	5,000	
Totals	$ 41,000	$ 95,000	$ 38,000	$ 16,000
		(41,000)		38,000
		$ 54,000		$ 54,000

After-Tax Proceeds

Line			
1.	Gross proceeds		$ 95,000
	Less – income tax:		
2.	Gain above	$ 54,000	
3.	Less – capital gain deduction (at 50%)	19,000	
4.	Taxable income	$ 35,000	
5.	Tax on line 4 (nearest thousand)		10,000
6.	After-tax proceeds		$ 85,000
7.	After-tax proceeds (per Illustration 26)		82,000
8.	Increase in retained proceeds		$ 3,000

the "strong proof" rule and "substance over form" will usually be given precedence in determining the outcome.

> . . . We do not mean to imply that the form which the parties use to effectuate their transaction should be given no consideration. Rather, we concur with the Tax Court's quotation from *Ullman* v. *Commissioner*, 2 Cir., 1959, (59-1 USTC ¶ 9314) 264 F2d 305, 307 that "when the parties to a transaction such as this one have specifically set out the covenants in the contract and have there given them an assigned value, *strong proof* must be adduced by them in order to overcome that declaration." However, we think that the convenant must have some independent basis in fact or some arguable relationship with business reality such that reasonable men, genuinely concerned with their economic future, might bargain for such an agreement.

Generally speaking, the countervailing tax considerations upon each taxpayer should tend to limit schemes or forms which have no basis in economic fact. The Commissioner should be slow in going beyond the values which the taxpayers state when such countervailing factors are present. Such a result gives certainty to the reasonable expectations of the parties and relieves the Commissioner of the impossible task of assigning fair values to good will and to covenants. Since amounts saved by one taxpayer are generally made up by the other, there is no appreciable loss of revenue. See 67 *Yale Law Journal* 1261. . . . [87]

This requirement of substance over form has governed when a contract was challenged by the IRS as in the *Danielson* case.[88] However, in a subsequent consolidated case, involving buyer and seller (with IRS as a stakeholder), the Tax Court, in a reviewed decision (three dissents), declined to follow the *Danielson* doctrine. Instead, it reiterated the previously quoted "strong proof rule" of *Ullman (J. L. Schmitz,* 51 TC 306 (1968), on appeal to CA-9).

PLANNING SUGGESTION. It might be advisable to suggest that buy-sell agreements specifically provide for damages resulting from failure of a party to adhere to the valuations therein for tax purposes.

Statutory Exceptions

Secs. 1245 (b) and 1250 (d) bestow various degrees of relief from recapture in the following situations:

Gifts. However, the deduction for charitable gifts is reduced by the depreciation that would have been recaptured had the property been sold at its fair market value (at the time of the gift). (See Sec. 170 (e).) Also, see 202.2 and 401.2 for related planning techniques.

Death. This event completely eradicates all traces of depreciation recapture (except for income in respect of a decedent attributable to a

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[87] *Schulz, et al.*, CA-9, 294 F2d 52 (emphasis supplied). Also see *Hamlin Trust, et al.*, CA-10, 209 F2d 761.

[88] *Danielson, et al.*, CA-3, 378 F2d 771, rev'g and rem'g 44 TC 549; cert. denied 389 US 858. However, in this decision, a divided Appeals Court refused to permit a *taxpayer* to upset the form of his agreement by applying similar standards. The court enunciated the following rule: "A party can challenge the tax consequences of his agreement as construed by the Commissioner *only* by adducing proof which in an action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc. . . ." (Emphasis supplied.)

pre-death sale). However, it does not lend itself, naturally, to positive thinking on the part of a tax adviser.

Certain Tax-Free Transactions (Where the Transferred Property's Basis Is Carried Over). Ordinary income is, nevertheless, precipitated to the extent of any gain recognized due to the receipt of boot (money or its equivalent), limited, of course, to recapturable depreciation (post-1961 depreciation for Sec. 1245 property and post-1963 depreciation in the case of Sec. 1250 property).

Seven kinds of tax-free transactions are spelled out in Secs. 1245 (b) (3) and 1250 (d) (3). However, the following two are particularly apropos to taxpayers in their capacity as individuals:

1. Incorporation of, or additional investment in, a corporation, generally owned at least 80 percent by such incorporators or investors.
2. Contribution of property to a partnership in exchange for a partnership interest. (In addition, a partnership, unlike a corporation, can distribute property to its owners without precipitating recapture in specified circumstances. See Sec. 751.)

Of course, in these tax-free (and basis carryover) situations, the new owner generally steps into the transferor's tainted shoes.

EXAMPLE. Jones (a non-client, who manufactures shoes and boots) transfers depreciable property, with $3,000 of potential depreciation recapture, to his wholly owned corporation (Sandals, Inc.) in exchange for stock and $1,000 cash. Under Sec. 351, Jones' taxable gain is limited to the $1,000 cash receipt (i.e., the "boot") which is taxed as ordinary income due to the intervention of Sec. 1245 (a) (1).

Accordingly, the property's potential depreciation recapture in the hands of the corporation, immediately after the exchange, is $2,000 (that is, $3,000 less $1,000). (Based upon Regs. Sec. 1.1245-2(c)(2)(iii).)

NOTE. See 402.7, Chapter 4, Tax Study No. 1, for situations where Sec. 351 would be inapplicable in the case of transfers to an investment company (after June 30, 1967).

Special relief rule regarding distributions of partnership property: In the case of partnership distributions to partners, the transfer of potential depreciation recapture is limited to the *lesser* of the following amounts:

1. The partnership's total recapturable depreciation with respect to the distributed property.
2. The Sec. 1245 *gain* which would have been recognized by the

partnership if the property, instead, had been sold (at fair market value) immediately before the distribution.

(Either amount is further reduced by any ordinary gain recognized to the partnership under Sec. 751 (b), dealing with a disproportionate distribution to a partner.)[89]

EXAMPLE.[90] A, B, and C are equal partners in a partnership whose assets consist of the following three pieces of Sec. 1245 property:

Line		*Asset* X	Y	Z
1.	Fair market value	$100,000	$100,000	$100,000
2.	Adjusted basis	60,000	85,000	95,000
3.	Hypothetical gain	$ 40,000	$ 15,000	$ 5,000
4.	Recapturable depreciation reflected in adjusted basis (line 2)	$ 25,000	$ 25,000	$ 5,000

Asset Y is distributed to B in complete liquidation of his partnership interest. The asset's potential depreciation recapture carried over to B is only $15,000.

Like Kind Exchanges (i.e., Trade-Ins) and Involuntary Conversions. Like kind exchanges (Sec. 1031) and involuntary conversions (Sec. 1033) result in ordinary income to the extent of gain recognized *plus* the *fair market value of nondepreciable or non-Sec. 1245 property received* which was not considered in computing the gain. This is intended to prevent future loss of depreciation recapture because the receipt of certain property is not taxed under Secs. 1031 or 1033 and is also outside of Sec. 1245. An example of such non-Sec. 1245 property is stock of a controlled corporation owning property similar to that converted under Sec. 1033.

Similar provisions are contained in Sec. 1250(d)(4). However, note the following twist regarding the holding period for Sec. 1250 property acquired in like kind exchanges or involuntary conversions.

Sec. 1250 (e)(2) provides that the holding period of Sec. 1250 property includes the holding period of the property in the hands of the previous owner *if* such property is acquired in transactions which are specified

[89] Secs. 1245 (b) (6) and 1250(d)(6).

[90] Based upon illustration contained in S. Rep. No. 1881 (87th Cong., 2nd sess.), pp. 284-285, accompanying the Revenue Act of 1962.

in Sec. 1250 (e) (2). Since like kind exchanges under Sec. 1031 and involuntary conversions pursuant to Sec. 1033 are *not* referred to in Sec. 1250 (e) (2), pre-1969 Proposed Regs. Sec. 1.1250-3(d)(1)(i), relating to the limitation on Sec. 1250 gain in cases of like kind exchanges and involuntary conversions, reads in pertinent part, as follows:

> . . . The holding period of the acquired property for purposes of computing applicable percentage . . . . *does* not *include the holding period of the property disposed of* . . . . [Emphasis supplied.]

Disposition of Principal Residence. Recapture exceptions also exist for dispositions of certain principal residences (upon which depreciation has been claimed for partial business use). See Sec. 1250 (d) (7) and the pre-1969 proposed regulations thereunder.

203.8 Natural Resources

Planning Technique

Capital gain opportunities are available for dispositions of oil and gas property interests; cut timber; and timber, coal, and domestic iron ore royalties.

Disposition of Oil and Gas Property Interests

> Even to the tax specialist, the taxation of oil and gas interests is an esoteric subject. The industry rests on a tripod of tax supports — the drilling deduction, the percentage depletion deduction, and capital gain. Each of these has some counterpart in other fields, but the problems which arise are essentially unique to the industry. A complex body of tax law has grown around these three elements, partly due to the bewildering variety of economic relationships which the industry has created. These relationships, in turn, are partly inherent in the intensely speculative nature of the industry, and are partly the result of the tax rules which make the form of the relationship so important . . . . [*Federal Income, Gift and Estate Taxation,* Rabkin and Johnson, Vol. 3, Sec. 47.01.] [91]

In view of these formidable obstacles to a comprehensive review of this vast oil and gas "reservoir," only the following brief summary can be

[91] For further income tax aspects of this subject, see K. G. Miller, *Oil and Gas — Federal Income Taxation* (1970 ed.) (CCH). Estate planning in this specialized area is discussed in J. W. Storms, "Estate Tax Considerations as to Oil and Gas Property," *New York CPA,* (April 1968), pp. 277-284.

presented within the limitations of this tax study:

> . . . There can be no capital gain or loss unless the property involved is a capital asset and unless there is a sale or an exchange. Whether a particular transaction involving oil and gas properties involves a sale has been the subject of considerable litigation. A number of transactions that would appear to be sales have for tax purposes been deemed to be subleases or leases. . . .
>
> It is always advantageous to the vendor for a transaction to be regarded as a sale subject to long-term capital gain treatment rather than as a lease or sublease. . . . [92]

EXAMPLE.[93] Adams owns a producing oil and gas lease and is offered $20,000 for an assignment of the lease by the ABC Oil Co. with the right to reserve either a 2 percent overriding royalty or an oil payment of $150,000 payable out of 4 percent of the oil produced. If Adams elects to reserve an override, the transaction will be regarded as a sublease; if he elects to reserve an oil payment, it will be regarded as a sale. Adams is married, files a joint return and has no other income. His exemptions are $1,250 and his deductions (other than for depletion) total $2,250. The oil and gas lease was acquired several years previously by Adams, qualifies as a Sec. 1231 asset, and has an adjusted basis of zero (through prior reductions for the greater of cost or percentage depletion allowed or allowable). The consequences of his selection are shown in Illustration 28, page 154.

Tax Limitation for Certain Sales of Oil or Gas Properties. "In the case of a bona fide sale of any oil or gas property, or any interest therein, where the principal value of the property has been demonstrated *by prospecting or exploration or discovery work done by the taxpayer*, the portion of the tax imposed by Sec. 1 attributable to such sale shall not exceed 33 percent of the selling price of such property or interest." (Sec. 632; emphasis supplied.) For pre-1971 years, a 30 percent surtax limitation applies.

NOTE. In view of the maximum long-term capital gain tax rates listed in the introduction to 203, Code Sec. 632 affects only short-term capital gains and noncapital gains of higher bracket individuals (and fiduciaries) — and long-term capital gains exceeding $50,000 realized by such taxpayers in taxable years beginning after 1971.

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[92] H. S. Bloomenthal, "Tax Advantages of Oil and Gas Operations," *Tax Ideas* (Prentice-Hall), ¶17,011.7.

[93] *Ibid.* Updated to reflect 1969 TRA.

Illustration 28

Consequences of Override vs. Oil Payment

	(A) Reserves Overriding Royalty	(B) Reserves Oil Payment*
Gross income	$20,000	$20,000
Less long-term capital gain deduction	—	10,000
Adjusted gross income	$20,000	$10,000
Less exemptions and deductions (other than depletion)	3,500	3,500
	$16,500	$ 6,500
Less statutory depletion (22% x $20,000)	4,400	—
Taxable income	$12,100	$ 6,500

*Under Sec. 636(b), the retained oil payment is treated as a purchase money mortgage loan fromAdams to theABC Oil Co. Thus, its fair market value is part of the sales price. However, the above computation is based upon the assumption that the installment method (204.6) can be elected to defer taxation of the oil payment until it is received byAdams in future years. See Rev. Rul. 68-226 (68-1 CB 362).

Illustration 29

Sec. 631 (a) Election

Hypothetical Sec. 1231 gain or loss	
Fair market value, as standing timber, of timber cut during a taxable year. (Value determined as of beginning of year.)	$100
Less actual cost or other basis	60
Gain (loss)	$ 40
Subsequent gain or loss	
Actual selling price	$150
Less fair market value as standing timber (given above)	100
Ordinary gain (loss)	$ 50

Computation Without Election

Actual selling price	$ 150
Less – actual cost or other basis	60
Gain (Loss)	$ 90

Source: Sec. 631(a) election treatment (above) derived from Regs. Sec. 631-1(a)(I) and (e).

Cut Timber

Weigh Merits of Election to Treat Cutting of Timber as Hypothetical Sale. Sec. 1231(b)(2) includes timber (with respect to which Sec. 631 applies) among the properties eligible for favorable Sec. 1231 treatment (discussed in 203.4 above). In turn, Sec. 631(a) provides an election for specified taxpayers to treat the *cutting* of certain timber as equivalent to its sale or exchange and thus qualify for Sec. 1231 coverage. (See Illustration 29, opposite.)

The nature of this gain or loss (i.e., capital, ordinary, etc.) is determined under the usual rules which consider such factors as whether or not the cut timber was held primarily for sale to customers in the ordinary course of trade or business. (See Secs. 1221(1) and 1231 (b) (1) (A) and (B).)

	Comparative Effects	
	Election	*No Election*
1. Reportable gain or loss	Two taxable events (cutting and sale) permit gains and losses to be reflected in more than one year.	Entire gain or loss reported in year of sale.
2. Effective tax rates	Gain at cutting eligible for capital gain rates. Balance of gain or loss (at sale) is ordinary income. Loss at cutting could be ordinary loss.	Entire gain or loss is usually ordinary in nature.
3. Payment of tax	Part of tax (attributable to cutting operations) payable *in advance* of sale and prior to conversion of timber into liquid asset (cash, etc.)	Entire tax payable only for year of sale, *after* conversion into liquid asset.

Election Requirements. The election is made by a descriptive computation in the first applicable income tax return (presumably, including extensions). *However, it cannot be made in an amended return* (Regs. Sec. 1.631-1 (c)).

The election is binding for all future years unless the Commissioner permits revocation upon a showing of undue hardship. *A revocation precludes further elections without the Commissioner's consent* (Regs. Sec. 1.631-1 (a) (3)).

NOTE. For further discussion of timber as tax shelter, see 502.2.

Timber, Coal, and Domestic Iron Ore Royalties

Timber Royalties. A special Code provision (Sec. 631 (b)) enables timber royalties, which ordinarily would be ordinary income, to bask beneath the comforting rays of Sec. 1231 and thus qualify, on a mandatory basis, for long-term capital gain or ordinary loss treatment. However, the underlying timber property must have been held for more than six months prior to the "disposal" for which the royalties are received (Regs. Sec. 1.631-2 (a)).

Amounts subject to this special treatment are determined as follows:

Amounts realized from disposals during year*	$
Less – adjusted basis for computing depletion (pursuant to Sec. 611)*	
Sec. 631 (b) gain or loss	$

*However, depletion deductions are denied for royalties qualifying for Sec. 631 treatment (Regs. Sec. 1.611-1 (b)(2)).

Coal Royalties. Similar Sec. 1231 benefits are extended to coal (including lignite) royalties under Sec. 631 (c). However, Sec. 272 prohibits deductions against ordinary income for certain expenses pertaining to coal royalty contracts. Instead, they are added to the adjusted depletion basis in ascertaining the Sec. 631 (c) gain or loss. (This disallowance is inoperative if no royalties are realized for a particular year.)

Moreover, the date of mining is deemed to be the date of disposal.

Domestic Iron Ore Royalties. Royalties from iron ore are in the same tax "boat" as the coal royalties just discussed (whether or not shipped in the same vessel for transportation purposes). However, unlike coal, the iron ore must be mined in the United States. In addition, iron ore royalties, alone, must also navigate the following shoals:

1. Sec. 631 (c) does not apply to any disposal to a person whose relationship to the disposer would result in the disallowance of losses under Sec. 267 (certain blood, business, matrimonial, fiduciary, and other legal relationships) (Sec. 631 (c) (1)).
2. The Sec. 631 (c) boat will also be sunk if the disposal is "to a person owned or controlled directly or indirectly by the same interests which own or control the person disposing of such iron ore" (Sec. 631 (c) (2)).

203.9 Sales or Exchanges of Patents

Planning Technique

Attempt to qualify transfers (except gifts or bequests) of patent rights for "automatic" capital gain treatment under Sec. 1235. If not possible or desirable, consider other means of obtaining this favorable treatment.

Sec. 1235

Where the requirements of Sec. 1235 can be met upon the transfer of a patent, capital gains treatment can be obtained. Sec. 1235 provides that:

> ... a transfer (other than by gift, inheritance, or device) of all substantial rights to a patent, or of an undivided interest in all such rights to a patent, by a holder to a person *other than a related person* constitutes the sale or exchange of a capital asset held for more than six months, whether or not payments therefor are:
>
> 1. Payable periodically over a period generally coterminous with the transferee's use of the patent, or
> 2. Contingent on the productivity, use, or disposition of the property transferred. [Regs. Sec. 1.1235-1 (a); emphasis supplied.]

Does Sec. 1235 Have a "Patent" on Capital Gains Treatment for Patent Income? Regs. Sec. 1.1235-1 (b) states, in part, that "a transfer by a person other than a holder or a transfer by a holder to a related person is not governed by Sec. 1235. The tax consequences of such transfers shall be determined under other provisions of the internal revenue laws. . . . " To the same effect, see Rev. Rul. 69-482 (IRB 1969-36, 16) which held that the contrary Tax Court decision in *Myron C. Poole*[94] will not be followed.

NOTE. Rev. Rul. 59-210 (1959-1 CB 217) provides that if there is a transfer of all substantial rights in a patent by a holder to a corporation in which the transferor owns 80 percent or more of the stock, the transfer does not fall within Sec. 1235 but is a sale of property described in Sec. 1239, and the proceeds are taxable as ordinary income.

Definitions

Related Persons Rule. The related persons, to whom transfers are taboo under Sec. 1235, are those described in Sec. 267 (b) (for the

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[94] *Poole,* 46 TC 392 (1966), acq. 1966-2 CB 6. However, Rev. Rul. 69-482 states that this acquiescence concerns a deduction for royalty payments made by the corporation.

purpose of disallowing losses, expenses, and interest between tax relatives) with the following modifications (prescribed by Sec. 1235(d)):

1. An individual's family consists of only his spouse, ancestors, and lineal descendants. Hence, transfers to brothers or sisters will not, *per se*, be disqualified.
2. A holder cannot obtain capital gain treatment on royalties received from a corporation in which he owns 25 percent or more *in value* of the outstanding stock.

   Thus, a transfer by a holder would not be disqualified, *per se*, if made to a corporation owned as follows: [95]

	Percent of Value Owned
Mr. Keeper, (a "holder")	24%
Mr. Keeper's brother	76%

NOTE. Regs. Sec. 1.1235-2 (f)(4) states that "if a relationship described in Sec. 267 (b) exists independently of family status, the brother-sister exception . . . does *not* apply. . . . "

For example, a transfer to a fiduciary of a trust, of which the holder is the grantor, would be disqualified regardless of whether the fiduciary and holder are siblings.

Holders. Code Sec. 1235 (b) defines a holder as

> . . . any *individual* whose efforts created the patent property transferred, by which is meant the "first and original" inventor (or joint inventor) within the meaning of Section 31 of Title 35 of the United States Code. Individuals not eligible to qualify as such "first and original" inventor will not qualify under this definition: for example, the inventor's employer may not here qualify, even though he may be the equitable owner of the patent by virtue of an employment relationship with the inventor. . . . [Emphasis supplied.] [96]

COMMENT. Regs. Sec. 1.1235-2 (d)(3) states that "an individual may qualify as a holder whether or not he is in the business of making inventions or in the business of buying and selling patents."

Thus, Sec. 1235 treatment can "apply to all qualifying individuals,

[95] See Regs. Sec. 1.1235-2(f)(3).
[96] S. Rep. No. 1622 (83rd Cong., 2nd sess.), p. 440.

whether amateur or professional, regardless of how often they may have sold their patents . . . . "[97]

NOTE. In addition, the Senate Finance Committee was "desirous of extending the scope of this section to cover (in addition to inventors) those individuals who contribute financially toward the development of the invention. . . ." (See Sec. 1235(b)(2) and Regs. Sec. 1.1235-2(e) for requirements in this regard.)

Financial backers that can never qualify as holders are (1) an employer of the inventor or creator and (2) the inventor's tax relatives (as previously defined). In addition, Sec. 1235 "is not applicable to any other purchasers or assignees."[98]

Other Vital Terms. The following terms are defined in these sections of the regulations:

- Patents, 1.1235-2(a)
- All substantial rights to a patent, 1.1235-2(b)
- Undivided interest, 1.1235-2(c)

203.10 Converse Effect of Capital Losses

Planning Technique

Capital losses are, of course, the antithesis of capital gains — both financially as well as tax-wise. Consequently, they tend to be shunned if ordinary losses can be obtained instead, since capital losses are only deductible against ordinary income to the extent of $1,000 per year. Moreover, only 50 percent of net long-term losses can be used for this purpose.

Nevertheless, capital loss planning has its place in the following situations:

1. *Only type of loss available.*
2. *Lifetime carryover against future capital gains and ordinary income.*
3. *Long-term versus short-term considerations.*
4. *Converting capital losses into ordinary losses.*

Only Type of Loss Available

In this better-than-nothing situation, a client may own capital assets (defined in Sec. 1221) which have deteriorated in value and whose

[97] *Ibid.*
[98] *Ibid.*

disposition, therefore, may be prompted by either *or* all of the following considerations.

1. The property should be turned over, from an investment standpoint, in order to prevent further deterioration of value or to improve the financial yield on the funds invested.
2. The client has realized capital gains which can be offset by realizing these paper losses on this otherwise undesirable property.
3. Sales should be made in contemplation of death to recognize losses otherwise eliminated by stepped-down basis acquired at death. (See discussion of declined in value properties at 402, herein.)

NOTE. In view of Rev. Rul. 54-207 and Regs. Sec. 1.1212-1 (c)(see following discussion), a *decedent's* unused capital losses could not, apparently, be carried over by his surviving spouse — even though joint returns were filed prior to death.

Lifetime Carryover Against Future Capital Gains and Ordinary Income

Sec. 1212(b)(1) enables individuals to carry over unused capital losses against future capital gains, or against future ordinary income (subject to the $1,000 annual limitation). These unused losses can be carried over indefinitely by the taxpayer sustaining the original loss. That is, they are good for *his* lifetime. However, this carryover expires upon death (along with the taxpayer and, hence, is one of the few examples of what you *can* "take with you"). See Rev. Rul. 54-207 (1954-1 CB 147) which holds that "there can be no capital loss carryover from the decedent to his estate for the reason that . . . (they) are separate tax entities. . . . "

The 1964 Revenue Act, which introduced the lifetime carryover (only for noncorporate taxpayers), also requires carryovers to retain the short or long-term character of the original loss.

However, under the pre-1969 TRA transitional rule set forth in former (but still effective) Sec. 1212(b)(2), unused prior losses which were available as capital loss carryovers to the first year subject to the 1964 Act (i.e., 1964 for calendar year individuals) can be carried over indefinitely as a short-term capital loss carryover (irrespective of whether the originating loss was long-term).

This transitional rule thus reaches back into 1959 (calendar year clients) and perpetuates losses from that year forward as short-term capital loss carryovers.

In computing carryovers to subsequent years, capital losses (including

prior carryovers) which are applied against current years' ordinary income (up to the $1,000 maximum) are first taken from any short-term losses (with any remaining ordinary income reduction offset against long-term capital losses). (Sec. 1212 (b) (2).)

The computation of capital loss carryovers is further discussed and illustrated in the technical resume, pages 162-164.

Long-Term vs. Short-Term Considerations

The 1969 Tax Reform Act has made long-term losses less desirable than short-term losses from a tax viewpoint.

Formerly, an individual who had an excess of net long-term capital losses over net short-term gains could deduct such losses against ordinary income on a dollar-for-dollar basis up to $1,000 annually.

For years beginning after 1969, only 50 percent of an individual's net long-term capital losses may be used to offset ordinary income up to the $1,000 limit. Thus, $2 of long-term losses are necessary to obtain a $1 deduction (Sec. 1211 (b)). Furthermore, the unused 50 percent can't be carried over to future years and is lost forever (Sec. 1212(b)). See example on page 162.

It is now imperative for tax advisers to impress upon their clients the importance of reviewing all new security positions prior to the expiration of the six month short-term holding period. Where it is evident that the possibility for gain in the immediate future is unlikely, clients should be advised to take a short-term loss. Perhaps Congress in its effort to promote tax equity has imparted even more validity to the age-old adage "don't marry a loser."

However, in some cases it may be impossible to identify a loser in time, and a long-term loss will result. In those cases, long-term losses should be taken when they will result in a net long-term loss which may be used to offset net short-term capital gains. In that way, the $2 for $1 rule applicable to long-term losses can at least be used to make short-term gains more attractive. (It is quite possible that the 1969 Tax Reform Act may prove an unexpected boon to the brokerage business.)

In addition, the record-keeping requirements imposed by the 1964 Revenue Act (discussed previously) for keeping track of loss carry-forwards have been expanded under the 1969 Act. Under the new law, it will be necessary to keep track of both pre-1970 losses and post-1969 losses in order to fully deduct the pre-1970 losses from ordinary income on a dollar-for-dollar basis as illustrated in the technical resume, pages 162-164.

Converting Capital Losses Into Ordinary Losses

Like football teams at half-time, the participants in the eternal capital asset/ordinary asset struggle will "reverse field" and take their opponents' position if assets are disposed of at a loss rather than at a gain. Congress has stepped into this fray between taxpayers and the "protectors of the revenue," as sort of a part-time umpire, by calling a few specific plays through the enactment of several provisions which transform capital losses into ordinary ones. These alchemistic provisions of particular interest to individuals are:

1. Losses on small business stock (Sec. 1244), which are described comprehensively in 505.5 of Tax Study No. 1.
2. Losses on small business investment company (SBIC) stock (Sec. 1242).

Unlike Sec. 1244, there are presently no monetary limits beyond which the Sec. 1242 transmutation fails. (In other words, *all* losses on stock of a company operating under the Small Business Investment Act of 1958, which would otherwise be capital losses, are treated as ordinary losses.) However in common with Sec. 1244 ordinary losses, Sec. 1242 losses are eligible for inclusion in net *operating* loss carrybacks or carryovers (under Sec. 172).

Technical Resume

Individuals (and fiduciaries) can deduct capital losses against capital gains and also are permitted a limited deduction for these losses against ordinary income. In computing this ordinary income deduction, which is subject to an annual maximum limitation of $1,000 ($500 for married persons filing separate returns), net capital losses are taken into account as follows:

Short-term	100%
Long-term	50%

Example

1970 salary	$8,000
Net long-term capital loss — $1,800	
Amount deductible against salary	900
Adjusted gross income	$7,100

Unused capital losses cannot be carried back (as in the case of unused *corporate* capital losses). Instead, an individual has an unlimited carryover of such losses during his lifetime. However, short-term and

long-term losses retain their respective character when carried to a future year.

The carryover of noncorporate net long-term capital losses sustained in years beginning after 1969 is reduced by the remaining 50 percent portion of such net losses which is *not* allowed as a deduction against ordinary income (up to the maximum of $1,000 or $500 for married couples filing separately). This treatment is shown in Illustration 30, below.

Illustration 30

1970 Return:	
Salary	$8,000
Net short-term capital loss – $200	
Net long-term capital loss – $1,800	
Maximum deduction against ordinary income	1,000
Adjusted gross income	$7,000
Computation of Carryovers to 1971	
Short term:	
1970 net short-term loss	$200
Less – deductible against ordinary income	200
Carryover to 1971	None
Long-term:	
1970 net long-term loss	$1,800
Less – amounts deemed consumed in 1970:	
Balance of amount deductible against ordinary income ($1,000 less $200) – $800	
Remaining 50% nondeductible amount (always equal to deductible balance) – $800	
Total amounts deemed consumed	1,600
Carryover to 1971	$ 200

If there are no other 1971 capital gains or losses, ordinary income can be reduced by $100 — with no further carryover.

Long-term capital losses arising in pre-1970 years are not subject to this 50 percent reduction in determining either their deductibility against ordinary income or their carryover to future years, as set forth in Illustration 31, page 164.

Illustration 31

1969		
Salary		$8,000
Net long-term capital loss – $3,000		
Maximum deduction against ordinary income		1,000
Adjusted gross income		$7,000
Carryover to 1970 ($3,000 less $1,000)		$2,000

1970

If there are no other 1970 capital gains or losses, ordinary income can be reduced by $1,000 – with a carryover of $1,000 to 1971 still available.

Point to Ponder Between Years

Capital loss carryovers from a separate return year can be combined on a joint return for a later year. However, the opposite is *not* true since a carryover from a joint return year to a separate return year must be allocated to each spouse on the basis of their individual losses which gave rise to the carryover. [99]

204 Deferred Income

The realization of tax-free income might be the end product expected under the tax system of a "never-never (a tax) land." However, even in a land of reality, such as ours, a similar result can be obtained, at least on a temporary basis, by embarking on a voyage through the "sea of deferred income." Such a voyage can lead to islands where the following types of tax shelters may be found:

1. Relief from the necessity of immediate tax payment. Of course, the piper may have to be paid eventually. For example, a deferral caused by a tax-free exchange also results in only a carryover basis for successor property.
2. Possible perpetual deferral. Tax postponement could be continued ad infinitum through a series of tax-free transactions or the intervention of death. (This latter "benefit" can usually only be expressed, naturally, in financial terms.)

However, death does not excuse the taxation of "income in respect of a decedent," such as installment sale collections and compensation

[99] See Examples (1) and (2), Regs. Sec. 1.1212-1(c)(2).

earned prior to death. Under Sec. 691 (a), these items continue to be taxable to the actual recipients. (See 403, herein, for corresponding and related deductions in respect of decedents.)

There are various kinds of islands that dot this sea, each with its own set of peculiar ground rules, which shall be explored herein.

204.1 Sale or Exchange of Residence

Planning Technique

Replacement of residence should be timely to prevent unwanted tax. Conversely, only untimely replacement precludes mandatory nonrecognition of gain and carryover of basis.

In case of certain involuntary conversions, weigh merits of electing either Sec. 1033 or Sec. 1034 treatment.

In 201.1, we considered the first of a one-two punch aimed at knocking out the tax otherwise due on the sale or exchange of a *principal* residence at a gain. The second part of this congressional package for outgoing home owners permits a tax postponement to the extent that the proceeds received from such sales (or exchanges) are reinvested in a new principal residence within the time limits specified in Sec. 1034 (as explained below).

The average *man* does not, ordinarily, relocate his personal (and principal) residence just for tax purposes. On the contrary such moves are usually dictated by business or personal (family) reasons as, for instance, the suggestion of an employer or the urging of a wife. Therefore, the ensuing discussion of this after-the-fact subject is based upon the following factual assumptions:

1. The homeowner has sold, or has decided to sell, his present home.
2. He either desires, or is willing, to invest the proceeds in a new home.
3. He is financially able to make such an investment.

Accordingly, we can launch our review of Sec. 1034 with the following count-down of its salient characteristics:

Section 1034

"The provisions of Sec. 1034 are mandatory, so that the taxpayer cannot elect to have gain recognized where this section is applicable . . . " (Regs. Sec. 1.1034-1 (a)).

Thus, where Sec. 1034 is operative, the basis of the new residence must be reduced by the gain not recognized upon the old home's

disposition. Consequently, this fugitive from taxation (i.e., the unrecognized gain) will be caught when the new house is disposed of, unless any of the following apply:

1. The new residence is sold or exchanged in a transaction subject to Sec. 1034. (If, however, more than one residence is purchased within the Sec. 1034 time limits (described immediately below) and used as a principal residence within a year after the original residence is sold, only the last property qualifies as a new residence under Sec. 1034. (See Sec. 1034 (c) (4).)
2. The new residence is sold or exchanged in a Sec. 121 transaction (discussed at 201.1).
3. Death intervenes to give the new residence a stepped-up basis.

The Essence of Time. As mentioned earlier in 203.6, dealing with subdivided real estate, the new residence must be purchased or constructed within specified time limits. These limits are prescribed by Sec. 1034 (a) and can be charted as follows:

	One Year Before	*Date of Old Residence's Disposal*	*One Year After*	*18 Months After*
New residence:				
Purchased	←——	——————	——→	
Constructed	←——	——————	——————	——→

NOTE. (a) Physical occupancy within these time limits is required, notwithstanding unavoidable delays and (b) actual construction must begin by the end of the one-year-after period.

See Rev. Rul. 68-594, (1968-2 CB 339) which considered construction to have started timely where a taxpayer within a year of selling his old residence, did the following:

1. Acquired a building site.
2. Obtained a construction loan.
3. Received approval of his plans and a building permit from the city to build a new residence.

On the other hand, untimely replacement can avoid the mandatory operation of Sec. 1034. Such a taxable transaction could be desirable as a means of income acceleration. See 104.2.

Advisability of Filing Form 2119. Sec. 1034(j) keeps the statute of limitations open for a period of three years from the date the IRS

receives a notice from a taxpayer who sells his principal residence at a gain. However, only the deficiency attributable to such gain can be assessed during this otherwise closed period.

The information required in this notice pertains to the cost of any new residence, an intention not to purchase a new residence within the Sec. 1034 time limits, or the lack of a purchase within such time limits.

As a practical matter, compliance with this statutory requirement can be easily accomplished by attaching IRS Form 2119, "Statement Concerning Sale or Exchange of Residence," to an appropriate original or amended income tax return.

In addition, Form 2119 contains provision for a husband and wife to execute the consents that may be necessary in order that they may be treated as one taxpayer for Sec. 1034 purposes. (See Sec. 1034 (g) and Regs. Sec. 1.1034-1 (f).)

Furthermore, Form 2119 is also quite useful in determining the various components of the Sec. 1034 formula such as "fixing-up expenses" (defined in Schedule III, Form 2119). Fixing-up expenses are reductions of the selling price (along with "expenses of sale," e.g., commissions) in arriving at the "adjusted sales price." In turn, the adjusted sales price is matched against the cost of the new residence to ascertain the amount of gain, if any, which is unrecognized with respect to the old residence. However, unlike expenses of sale, fixing-up expenses do *not* enter into the computation of the gain realized upon the old residence's disposition. These intricacies are outlined on Form 2119.

Definitions. The following terms are defined in these sections of the regulations:

- Principal residence, 1.1034-1 (c)(3)
- Cost of acquiring new residence, 1.1034-1 (b)(7) and (9) (summaries), and 1.1034-1 (c)(4) (detailed definition).

Other Code Sections

There are other Code provisions, dealing with certain personal residence dispositions, which should be simultaneously considered.

Election of Either Sec. 1033 or Sec. 1034 Treatment for Certain Involuntary Conversions. Sec. 1034 (i)(2) grants a homeowner the option of using either Sec. 1033 or Sec. 1034 where his principal residence is involuntarily converted through seizure, requisition, condemnation (or through sales or exchanges under threat or imminence thereof). However, the destruction or theft (such as the theft of a

houseboat or house trailer) of a principal residence *must* be treated under Sec. 1033.

This option is exercised by filing an *irrevocable* election in the manner prescribed by Regs. Sec. 1.1034-1 (h) (2) (iii).

NOTE. See 204.5 for further discussion of involuntary conversions.

What should the client do? The CPA, as practitioner, is again in the best position to make a comparative evaluation of the benefits afforded by Secs. 1033 and 1034 and pinpoint them to the precise, and perhaps unique, facts of the client's involuntary conversion predicament. However, consider the following general observations:

1. *Sec. 1033 allows extensions of time for replacing "lost" property. In contrast, Sec. 1034's replacement time limits are rigid.*
2. The exclusion privilege of Sec. 121 (for clients 65 and older) is equally available in conjunction with either Sec. 1033 or 1034. (See Sec. 121 (d) (7).

Repossession and Resale of Principal Residence. Sec. 1038 contains special rules for determining gain upon repossession of real property previously sold on credit. Under Sec. 1038 (e), however, *no* gain is recognized if (1) gain was not recognized on the original sale because of Sec. 1034 and (2) the residence is resold within one year of its repossession. (See Regs. Sec. 1.1038-2.)

Specialized Types of Homeowners

Cooperative Tenant-Stockholders. Sec. 1034 (f) enables this type of homeowner to be covered by Sec. 1034 if the apartment (or house) is occupied as his principal residence.

Members of the Armed Forces. The rigid time limits for replacing property under Sec. 1034 are suspended for members of the Armed Forces by Sec. 1034 (h). Thus, the one-year-after-sale period for new purchases or the corresponding 18-month period for construction of a new residence is waived while a taxpayer serves on extended active duty. "However, in no event may such suspension extend for more than four years after the date of the sale of the old residence . . ." (Regs. Sec. 1.1034-1 (g) (1)).

204.2 Deferred Compensation Plans

Deferred compensation plans are extensively portrayed in Tax Study No. 1 (Chapter 2, at 208). They are also examined in connection with

their capital gains potential in 203.1 herein. Hence, further elaboration of this subject would be redundant. Consequently, it suffices at this point to summarize the various tax attributes of these plans in the juxtapositions shown in Illustration 32, pages 170-171.

Nonqualified Deferred Compensation Plans

The tax treatment of nonqualified deferred compensation plans is comparable to the treatment accorded restricted property (which is further discussed in 204.3).

For example, if an employer contributes cash to a nonqualified trust or a nonqualified annuity plan and the employee's rights are forfeitable when the contribution is made but subsequently become nonforfeitable, the employee is taxed on the contribution at the first time his rights are not subject to a substantial risk of forfeiture (instead of the later time when the contribution is actually distributed to him).[100]

In such cases, the amount subject to tax when the employee's interest becomes nonforfeitable is the value at that time of his interest in the trust (or the then value of the annuity contract), as opposed to the fair market value of the accumulated employer contributions or premium payments. However, the value of amounts subsequently contributed by the employer (or premiums subsequently paid) are included in the employee's income when contributed to the trust (or paid to the insurer), if the employee's interest in such amounts is nonforfeitable.[101]

On the other hand, income earned by nonqualified trusts will not be taxed to the beneficiaries prior to its distribution.[102] Of course, such income would be taxable currently to the nonexempt trusts.

Employers will be allowed deductions for contributions to nonexempt trusts at the time employees recognize income (if separate accounts are maintained for each employee) (Sec. 404 (a) (5)).

Controlling the Timing of Deductions. Employers can obtain ordinary deductions by vesting an employee's interest in a nonqualified trust. Of course, the effect of such vesting on the employee's continued services must be considered as well as the increases in the employee's compensation income and income tax that would be precipitated by such action.

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[100] H. Rep. No. 91-413, 8/2/69, Part 1, p. 89.

[101] S. Rep. No. 91-552, 11/21/69, p. 122.

[102] Sec. 402(b); H. Rep. No. 91-413, 8/4/69, Part 2, p. 64.

Illustration 32

Type of Plan	Immediate Employer Deduction	Deferral of Employee's Tax Attributable to		Lump-Sum Distributions (2)		Exemption from Estate and Gift Taxation (3)
		Employer's Contribution	*Earnings on Contributions (1)*	*Capital Gain*	*Special Averaging*	
I. Qualified						
(a) Pension, profit-sharing, or stock bonus	Yes	Yes	Yes	Yes (4)	Yes (4)	Yes
(b) "Principal" shareholder-employees of Subchapter S Corporation (5)	Yes	Yes (6)	Yes	Yes (4)	Yes (4)	Yes
(c) Self-employed retirement plans:						
(1) Owner-employee (more than 10% capital or profits interest; Sec. 401(c)(3))	(7)	Yes	Yes	No	Yes (8)	No
(2) Other self-employed "employees" (partners whose capital *and* profits interest are 10% or less)	(7)	Yes	Yes	No	Yes (8)	No
(3) Common-law employees	Yes	Yes	Yes	Yes (4)	Yes (4)	Yes
II. Nonqualified	No	Contribution deferred (9)	No	No	No	No

1. Includes both employer and employee contributions.
2. See discussion in 203.1.
3. Pursuant to Estate Tax Sec. 2039(c) and Gift Tax Sec. 2517. However, estate tax exemption is *not* available if the deferred compensation is payable to the employee's executor or for amounts attributable to employee contributions.
4. Capital gain treatment applies to entire taxable portion of lump sum distribution except the portion consisting of employer contributions for post-1969 plan years. This latter portion, however, is eligible for a seven-year "forward" averaging computation, as more fully explained in 203.1.
5. "Principal" shareholder-employees are employees or officers of a Subchapter S Corporation who own more than 5 percent of the outstanding stock on *any* day during the corporation's taxable year. This 5 percent test includes indirect stock ownership under the *family* attribution rules of Sec. 318(a)(1).
6. Employee's tax is *not* deferred on employer's contribution exceeding the *lesser* of (a) 10 percent of reportable compensation from corporation during *its* taxable year or (b) $2,500.
7. Limited to *lesser* of $2,500 or 10 percent of earned income, for each self-employed person.
8. A five-year "forward" averaging computation applies to lump sum distributions received by self-employed persons (or their beneficiaries) as opposed to the seven-year computation for employees (as described in Note (4) above).
9. Under nonqualified plans, generally, employer contributions are made, and the employee taxed thereon, during the latter's retirement years.

   A nonqualified plan, essentially, constitutes a contractual guarantee of compensation to an employee at a future time when his income tax bracket may usually shrink. Therefore, the employer's *actual* (physical) contribution is customarily deferred in order to avoid immediate taxation to the employee. (See discussion, page 169.)

204.3 Restricted Property and Phantom Stock

Planning Technique

The timing of compensation income can be controlled by transferring property subject to restrictions. Generally, such income is recognized only when the property is no longer subject to a "substantial risk of forfeiture." Phantom stock is taxed similarly to restricted property but has different economic characteristics which should be weighed.

Compensation can consist of cash, other property or other economic benefits. Any type of property can be used as a compensatory device, including stock in the employer corporation, stock of another company — such as an unrelated growth company, or even shares of a mutual fund. For a variety of business and tax reasons, certain restrictions are often placed upon such property which affects its value.

The general rule for taxing transfers of restricted property, set forth in Sec. 83 (a), deals with property transferred, in connection with the performance of services, to any person (except the person for whom such services are performed). This broad language could include the following categories of taxpayers within its ambit:

1. Employees.
2. Independent contractors such as underwriters of securities, and so forth, promoters, and real estate developers.
3. Third parties who receive property without performing any services.
4. Employees receiving property from third parties (e.g., parties affiliated with employer).

When Receipt of Restricted Property Is Taxed

Under Sec. 83 (a), the receipt of a beneficial interest in property for the performance of services will be taxable currently unless the recipient's interest is subject to a "substantial risk of forfeiture." In this latter event, taxation will occur when such risk is extinguished.

A substantial risk of forfeiture exists if the rights to full enjoyment of property "are conditioned upon the future performance of substantial services by any individual . . . " (Sec. 83 (c) (1)). There is no other apparent statutory definition of "substantial risk of forfeiture." However, both congressional committee reports [103] state that "in other cases,

[103] H. Rep. No. 91-413, 8/2/69, Part 1, p. 88 and S. Rep. No. 91-552, 11/21/69, p. 121.

the question of whether there is a substantial risk of forfeiture depends upon the facts and circumstances . . . ."

To mitigate future controversies which may arise in applying this facts-and-circumstances test, which is expressed only in the committee reports and not in the statute, it might be advisable for future regulations to provide greater certainty by illustrating other instances of substantial risks of forfeiture. Of course, these regulations should also permit taxpayers to resort to facts and circumstances when appropriate.

It might be noted that the Nixon Administration's Tax Reform Proposal,[104] upon which new Sec. 83 is based, contains the following examples of *insubstantial* risks of forfeiture: (a) a requirement that property be returned to the employer if the employee commits a crime against the employer or (b) acceptance of employment with a competitor of the employer.

Interestingly, these examples were omitted from the reform legislation and its accompanying committee reports.

Sec. 83 (a) also taxes the receipt of restricted property which is transferable without subjecting the transferee to the forfeitability conditions. This can occur, for example, where an employee receives a forfeitable interest in stock, but the fact of forfeitability is not indicated on the stock certificate, and a transferee would have no notice of it. [105]

On the other hand, an employee does not realize income merely because he can give his forfeitable interest to another person — if the donee would also be subject to the forfeitability condition. However, where such gifts are made, the *employee* would first be taxable when the *donee's* rights become nonforfeitable.[106] Similar treatment, supposedly, might be available where restricted property can be, or actually is, transferred by death; [107] although the application of these rules appears unclear. For example, how will the employee be taxed if his heir's rights do not become nonforfeitable, under the particular facts and circumstances involved, until ten years after his death? It would seem desirable for future regulations to cover those situations which would involve the employee's death.

In this regard, the AICPA's federal taxation division presented the

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[104] Technical Explanation of Treasury Tax Reform Proposals, 4/20/69, p. XII-2.

[105] S. Rep. No. 91-552, 11/21/69, p. 122.

[106] *Ibid.*

[107] See the Summary of H. R. 13270 prepared for the Senate Finance Committee (11/18/69), p. 45, and the underlying Treasury's Technical Memorandum submitted to the Finance Committee (9/30/69), p. 53. However, the Senate Report does not discuss situations involving death in this context.

following specific recommendations to the IRS and the Treasury Department (under date of April 8, 1970):

1. The property might be treated as nonforfeitable upon death and compensation income recognized in the deceased employee's final return unless forfeitability restrictions continue to apply to his estate or other holders of the property.
2. In this latter instance, income may not have to be recognized even when property becomes nonforfeitable as the "person who performed such services" (Sec. 83 (a)) is no longer a taxpayer. "This may appear to be a windfall arising from the death of the person who performed such services but there is precedent for such treatment. . . ."

In any event, current income will be precipitated if an employee sells property at arm's length even though his interest therein was forfeitable.[108] Presumably, this income will be treated as compensation and will be reduced by any employee payments for such property.[109]

Finally, it should be emphasized that Sec. 83 (c) (2) defines transferability as follows:

> The rights of a person in property are transferable only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture.

Thus, the statutory determination of when property is transferable and taxable may not always coincide with the actual restrictions placed upon the property's financial transferability. For example, assume that the rights to full enjoyment of property are no longer conditioned upon the future performance of substantial services (Sec. 83 (c) (1)). Therefore, a substantial risk of forfeiture would cease and the property would be deemed transferable (Sec. 83 (c) (2)). However, actual transfer may still be precluded because the property involved is unregistered stock of a

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[108] The Summary of H. R. 13270 indicates (p. 45) that the Senate Finance Committee's amendments, which were presumably adopted by the Conference Committee, also provide that an interest in property is not forfeitable unless the employer can compel the property's owner to return the identical property upon the happening of certain events. However, this provision does not appear to be embodied in the statute, nor is it discussed in the Senate Report.

[109] The Technical Memorandum (referred to in footnote 107) states (p. 53) that such income would be equal to the amount received in the sale; while the congressional committee pronouncements are silent in this regard. Nevertheless, the regulations should follow the pattern otherwise present in Sec. 83 and allow all income recognized thereunder to be reduced by any employee payments for restricted property.

public corporation or its sale is barred during a designated time.

The following illustration is taken from the April 1970 issue of the *New York CPA* (p. 343):

> Taxpayer renders marketing advice to X corp, a publicly owned company. He is compensated with 200 shares of X corp stock selling at $100 a share. Taxpayer's stock is, however, not registered and it is agreed that he may not register it for two years. Taxpayer has immediate taxable income of $20,000 even though the most he can sell the unregistered shares for is $12,000.

This pitfall can cause liquidity problems by creating taxable income in the form of property which cannot be converted to cash in order to pay the resulting tax. Further salt is placed on this wound by the requirement that such income must be measured without considering any restrictions which may eventually lapse. (See discussion on page 176.)

Even if these financial restrictions permit a sale, their very existence may cause a substantial discount to be realized which might be reflected only as a capital loss. Such losses, of course, have limited tax value and may likely be unable to offset the ordinary income initially precipitated by this financially restricted property. (See discussion of capital losses in 203.10.)

Election To Be Taxed Immediately

An election is granted by Sec. 83 (b) whereby these restricted property rules can be bypassed even though restricted property is received and is nontransferable or subject to a substantial risk of forfeiture. Such an election will have the following effects:

1. Compensation is recognized when the property is received, based upon its current fair market value, and computed in the usual manner to be described later.
2. Any future appreciation in value will not be treated as compensation, but will permit capital gain treatment — if otherwise available — where such appreciation is subsequently realized upon a sale or other taxable disposition of the property.
3. If the property is later forfeited, no deduction or refund is allowable "in respect of such forfeiture."

   Future regulations should expressly confine this denial of deduction or refund to amounts previously taxed under the original election and permit tax relief for any forfeited cash or other consideration previously paid to acquire the property. (If, instead, the risk lapses and the property becomes transferable, a sale at a nominal price could yield a capital loss.)

This election must be made not later than 30 days after the property is transferred, in the manner prescribed by Temp. Regs. Sec. 13.1. It cannot be revoked without IRS consent.

Sec. 83 (b) (1) specifies that this election to report compensation currently may be made by *the person performing the services* which are responsible for the property's transfer "to any person." In contrast, the Senate Report [110] states that this election is available to *recipients* of restricted property while the Conference Committee Report [111] and the Finance Committee Summary[112] refer to *employees* receiving property.

Not surprisingly, Temp. Regs. Sec. 13.1 makes this election available only to *a person who performs services* related to the transfer of restricted property.

In addition, Regs. Sec. 13.1 (a) also states that this election is not necessary in the case of property subject only to a restriction which by its terms will never lapse. (See discussion later).

Amount and Character of Income Generated Through Receipt of Restricted Property

Whether restricted property is taxed upon receipt or when a substantial risk of forfeiture is eliminated, ordinary compensation income is computed as follows:

Fair market value of property, determined without regard to any restriction – except a restriction which by its terms will never lapse	$
Less – any amounts paid for such property	______
Compensatory income	$

The fair market value of the property, at the time it is to be taxed, is used in the foregoing computation. The AICPA's federal taxation division has suggested to the government that future regulations specify that only contractual restrictions should be ignored in valuing such property, thus permitting recognition of all other pertinent factors such as, in the case of corporate stock, a closely held corporation, lack of

[110] S. Rep. No. 91-552, 11/21/69, p. 123.

[111] H. Rep. (Conf.) No. 91-782, 12/21/69, p. 303.

[112] See Summary of H. R. 13270, prepared for the Senate Finance Committee, 11/18/69, p. 45.

marketability, blockage, SEC restrictions, and so forth.

The question of valuation is particularly acute in the case of stock subject to an investment letter, which might sell at a discount of 30 percent below the selling price of stock not subject to such a letter.

Restrictions Which Will Never Lapse

An example of a restriction which will never lapse is a requirement that an employee sell his stock back to the employer at book value or some other reasonable price if he terminates his employment. [113] In such cases, where the selling price must be determined under a formula, Sec. 83 (d) (1) requires the formula price to be considered the fair market value of the property, unless the government, bearing the burden of proof, can establish the contrary.

If such a "never-lapse" restriction is canceled, the owner of the property realizes additional compensation in the year of cancellation, calculated as follows:

Fair market value of property at time of cancellation, without regard to restriction		$
Less:		
Fair market value immediately before cancellation, taking restriction into account	$	
Any amount paid for the cancellation	______	______
Additional compensation		$

However, such additional compensation will not be recognized if the owner of the property establishes that:

1. The cancellation was not compensatory.
2. The employer, who would be entitled to a deduction for a compensatory cancellation, will not treat the transaction as compensatory — in a manner to be prescribed by regulations.

Presumably, this additional compensation is recognized only as an adjustment of income previously taxed under these restricted property rules, in view of the following explanation contained in House Report No. 91-413 (Part 1, 8/2/69, p. 88), "If a restriction on property, which by its terms would never lapse, is canceled, the owner of the property, in

[113] S. Rep. No. 91-552, 11/21/69, p. 121.

effect, is to include in income as compensation, for the taxable year in which the cancellation occurs, *the amount on which he originally was not taxed* because of the decrease in value attributed to the restriction." (Emphasis added.)

Tax Planning Implications

Should Employer Restrict Property With a Substantial Risk of Forfeiture? The effect of such a restriction is to treat any appreciation in the property's value — between the date of its acquisition by the employee and the time when the substantial forfeiture risk expires — as ordinary compensation (by employee and employer) rather than capital gain (by only the employee). In essence the tax burden is thus shifted from employer to employee and should be considered by both parties in determining the net after-tax impact of this compensatory device. In some cases, additional before-tax compensation may result because of this shift in tax burden.

The net tax expense of both parties combined may actually decrease, even where the employee is in the maximum tax bracket. One reason for this overall tax decrease could be the new maximum tax rates (60 percent for 1971, 50 percent for 1972 and thereafter) to which this particular form of deferred compensation might be subject. (See discussion of maximum tax rate which appears later.)

The restricted property rules heretofore considered in 204.3 are those instituted by the Tax Reform Act of 1969. The computations in Illustration 33, page 179, illustrate the effect of these legislative changes upon the parties involved (ignoring any tax surcharge and the new maximum capital gain rates on gains exceeding $50,000):

This overall decrease will be accentuated where employees are in lower brackets, with the gap thus narrowed between their tax increase and the employer's tax savings.

On the other hand, the combined net tax expense may be increased if the employer is only in the 22 percent tax bracket.

In any event, the business reasons for imposing such restrictions, such as retention of the employee's services, must also be considered.

Should Employer Cancel a Restriction Which by Its Terms Will Never Lapse? (If So, Should It Treat Such Cancellation as Compensatory?) The tax effects of such action should be weighed along the lines indicated in the immediately preceding discussion.

In addition, the business consequences of the cancellation must also

Line			
	Assumed Facts		
	Fair market value of property*		
1.	At date of transfer	$ 50,000	
2.	At date no longer subject to substantial risk of forfeiture	$100,000	
3.	Appreciation since transfer (line 2 less line 1)	$ 50,000	
	Treatment Under Pre-Existing Regulations†		
	Tax on individual:		
4.	Ordinary income (50% of line 1)	$ 25,000	
5.	Capital gain (25% of line 3)	12,500	
6.	Total tax on individual	37,500	
7.	Less tax benefit to employer corporation (48% of line 1)	$ 24,000	
8.	Net tax expense		$13,500
	Treatment Under New Law		
9.	Tax on individual (50% of line 2)	$ 50,000	
10.	Less tax benefit to employer corporation (48% of line 2)	48,000	
11.	Net tax expense		2,000
	Effect of Legislative Change		
12.	Decrease in net tax expense (line 8 less line 11)		$11,500

* Net of employee's purchase price.
†Secs. 1.61-2 (d)(5) and 1.421-6 (d)(2).

be carefully examined. For example, where the employer's stock is involved, it may not be desirable to forego control over its subsequent disposition.

Should an Employee Exercise His Election To Be Taxed Immediately Under Code Sec. 83 (b)? The opportunity to convert ordinary income into capital gain may be most enticing. However, the employee will then be compelled to bear the risk of subsequent forfeiture — without any consoling tax relief if the forfeiture materializes. Moreover, if the property is not *financially* (e.g., legally) transferable, it will not be

available as a liquid source for payment of the resulting tax. Finally, the employee's current tax bracket should be compared with his projected bracket for the future year in which this income would be recognized (without the election). This comparison might reflect actual or estimated effective rates for ordinary income and capital gain, as well as other factors, as shown in Illustration 34, below.

Limited Income Shifting by Employee. To the extent economically feasible, an employee can sell restricted property at arm's length while his interest therein is still forfeitable. This will shift post-sale appreciation to the purchaser and might be desirable if the sale is to such family members as parents or children.

Such intra-family sales should be permissible if based upon arm's-length consideration. For this purpose, the principles of Regs. Sec. 1.482-2 (e), regarding tangible property sales between controlled entities, may be useful.

Comparing Restricted Property With Other Forms of Compensation. Comparisons should be made of the tax effects and business ramifications of such alternative means of compensation as:

1. Additional bonuses in cash or employer stock.
2. Qualified and nonqualified deferred compensation plans.

Illustration 34

	Election Exercised	*Election Not Exercised*
Current year:		
Ordinary income	$15,000	None
Future year:		
Ordinary income	—	$25,000
Capital gain	$10,000	—

Notes:

1. The amounts used to illustrate this treatment of restricted property were derived from the following assumed facts:

	Fair Market Value
Current year (when property received)	$15,000
Future year (when substantial risk of forfeiture expires)	$25,000

2. Ordinary income bracket for current year may be considerably higher than future year's bracket if current year is an "active" year and future year a "retirement year." However, current year's bracket could be lowered through income averaging. (See 104.1, Chapter 1.)
3. Retirement year status for future year could also provide lower effective rate for capital gain. However, capital gain deduction constitutes a tax preference for the 10 percent minimum tax. (See 105.1.)
4. Other factors to consider are the expected appreciation, or, perhaps, reduction in the restricted property's value, and the adverse monetary effect of the immediate tax payment.

3. Stock options (both qualified and nonqualified).
4. Phantom stock plans.

Comprehensive and detailed comparisons of this nature are beyond the scope of our tax study. However, it should be noted that deferred compensation will be ineligible for the new maximum tax rates on earned income — with the notable exception of certain restricted property and, possibly, non-lump-sum distributions from qualified plans. In addition, both the bargain element in a qualified stock option and the capital gain deduction for "capital gain compensation" constitute tax preferences for purposes of the 10 percent minimum tax. (See 105.1 and 203.3.).

Eligibility for 50 Percent Maximum Tax Rate. Sec. 1348 (b) (1) excludes "any deferred compensation within the meaning of Sec. 404" from eligibility for the prospective 50 percent maximum tax rate on earned income. (This rate is effective for taxable years beginning *after* 1971. A 60 percent rate applies for calendar year 1971 and corresponding fiscal years. See 105.2.) However, this provision also states that "deferred compensation does not include any amount received before the end of the taxable year following the first taxable year of the recipient in which his right to receive such amount is not subject to a substantial risk of forfeiture (within the meaning of Sec. 83 (c) (1))."

Since restricted property is ordinarily received before the year in which this risk expires and is taxable within such year, this form of compensation should usually qualify as earned income.[114] Moreover, if the *immediate* taxability election granted by Sec. 83 (b) is exercised (as previously described), the resulting income — by its very nature — can hardly appear to be classified as deferred compensation.

In addition, Sec. 83 (h) allows employer deductions for restricted property compensation under Sec. 162 rather than Sec. 404. Thus, the language of Sec. 1348 (b) (1) is somewhat puzzling as to its inference that restricted property could be Sec. 404 deferred compensation since Sec. 404 (a) expressly states that such deferred compensation is not deductible under Sec. 162.

Related Technical Provisions

Tax-Free Exchanges and Conversions. Tax will not be precipitated if restricted property is exchanged in a tax-free exchange, or an exchange

[114] See the discussion by Messrs. Elder and Kennedy, "Relief for Earned Income — the 50% Maximum Rate," *The Tax Adviser* (April 1970), at p. 230.

pursuant to the exercise of a conversion privilege, for other property which is subject to substantially the same restrictions. However, the property received will constitute restricted property.[115]

The same principle applies where property not subject to these new rules, because of the effective date, is exchanged in a tax-free exchange or pursuant to a tax-free exercise of a conversion privilege. The property received will not be governed by new Sec. 83 if it is subject to substantially the same restrictions.[116]

Holding Period. The holding period for property subject to these new restricted property rules begins when the taxpayer's rights therein are transferable or not subject to a substantial risk of forfeiture, whichever is earlier (i.e., when compensation is realized) (Sec. 83 (f)).

Inapplicability of Rules. Sec. 83 does not apply to (1) a transaction involving stock options covered by Sec. 421; (2) transfers to or from qualified employees' trusts, transfers under qualified annuity plans, or premiums excluded from an employee's income in the case of annuities purchased by certain exempt organizations; (3) the transfer of an option without a readily ascertainable fair market value; or (4) transfers pursuant to exercising an option with such an ascertainable value at date of grant (Sec. 83 (e)).

Effective Dates. Although Sec. 83 is effective for property transferred after June 30, 1969, several transitional exceptions exist for property transferred under contracts or plans in effect on various 1969 cut-off dates (as specified in Sec. 83 (i)).

Phantom Stock Plans

Operation. (1) Stock is not actually issued. Instead, units are awarded to represent shares of the employer's stock. (2) Units are credited with (a) amounts equal to dividends paid on stock actually outstanding and (b) increase in market value of stock represented by said units. If market value is difficult to ascertain, book value could be substituted (as, for example, in the case of a closely held employer).

Taxation. Employee's income and employer's deduction postponed until employee receives cash equal to the value of the original units and

[115] Sec. 83(g); S. Rep. No. 91-552, 11/21/69, p. 123.
[116] Sec. 83(i) 5; S. Rep. No. 91-552, 11/21/69, p. 123.

subsequent credits. This form of compensation is entirely ordinary (i.e., noncapital) in nature and, therefore, not usually received until after the employee retires.

Unlike restricted property, the employer also receives a deduction for dividend equivalents (see 2(a) above).

Economics. The following economic factors should be considered:

1. The employee is able to enjoy all benefits of ownership (with the possible exception of voting), without requiring and risking investment of his own funds.
2. The employer's shareholders do not suffer dilution of their equity.
3. On the other hand, this type of compensation has speculative qualities since it may measure factors somewhat extraneous to employee merit, such as overall market performance of the employer's stock and the directors' dividend policy. Thus, its ultimate amount is unknown and could be too low for the employee or too high for the employer.

This characteristic is commonly shared with qualified stock options and stock bonuses (see 203.3). Yet, phantom stock does not offer comparable capital gain opportunities.

CAUTION. The validity of phantom stock plans under local law should be thoroughly investigated. There have been several stockholder suits which have attacked these plans, with mixed success, as providing compensation unrelated to the employees' services.

204.4 Nonqualified Stock Options

Planning Technique

Nonqualified stock options, whose value can be readily ascertained, may offer capital gain opportunities even more favorable than qualified options and without their somewhat confining statutory conditions. However, such nonqualified options must overcome their own regulatory obstacles.

Other nonqualified stock options (no readily ascertainable fair market value) have less capital gain potential but are often more practical and feasible compensatory vehicles.

On the other hand, all types of options, unlike restricted property, usually require employee investment.

The taxation of nonqualified stock options depends upon whether they have a "readily ascertainable fair market value" when granted. (See Illustration 35, below.)

Illustration 35

Year	*Event*	*Fair Market Value of Stock*	
		Option 1	*Option 2*
1970	Option granted	$100	$100
1971	Option exercised	300	300
1973	Stock sold	800	800

Note: Only Option 1 has a "readily ascertainable fair market value," which amounts to $50.

Tax Treatment	Option 1	Option 2
1970:		Not Applicable
Fair market value of option	$ 50	
Less amount paid for option	—	
Ordinary income	$ 50	
1971:	Not Applicable	
Fair market value of stock		$300
Less purchase price		100
Ordinary income		$200
1973:		
Proceeds	$800	$800
Less:		
Purchase price	$100	$100
Prior ordinary income	50 *	200 †
Total basis	$150	$300
Long-term capital gain ‡	$650	$500

* Fifty dollars included in basis pursuant to Regs. Sec. 1.421-6(e)(4) and Rev. Rul. 58-234 (1958-1 CB 279).

† Two hundred dollars included in basis pursuant to Regs. Sec. 1.421-6(e)(1).

‡ Fifty percent of this gain constitutes a tax preference (if not offset by capital losses) for purposes of the 10 percent minimum tax which was more fully discussed in 105.1.

"Readily Ascertainable Fair Market Value"

As we have seen, the capital gains potential of nonqualified options can be considerably enhanced (by eliminating ordinary income taxation of the *full* spread between option price and value of the stock when the option is exercised) if the option has a readily ascertainable fair market value. Of course, this value of the option, at the date of its grant, does precipitate some degree of ordinary income.

Thus, where qualified stock options are undesirable or unattainable (because of the rigors of Secs. 421, 422, and 425), the search for capital gains compensation may turn to nonqualified options. In this event, the phrase "readily ascertainable fair market value" assumes crucial importance. As might be suspected, this rather key term has already been administratively defined in Regs. Sec. 1.421-6(c), as follows: the option must be actively traded on an established market or all of the following conditions exist:

1. The option is freely transferable by the optionee.
2. The option is exercisable immediately in full by the optionee.
3. The option or the property subject to the option is not subject to any restriction or condition (other than a lien or other condition to secure the payment of the purchase price) which has a significant effect upon the fair market value of the option or such property.
4. The fair market value of the option privilege is readily ascertainable, considering the following factors:
   - Whether the value of the property subject to the option can be ascertained.
   - The probability of any ascertainable value of such property increasing or decreasing.
   - The length of time during which the option can be exercised.

Planning Implications

In the absence of public markets for the option or its underlying property, a readily ascertainable fair market value is practically beyond reach. Furthermore, where the option is not publicly traded but its underlying property can be valued, the additional requirements set forth in Regs. Sec. 1.421-6 (c) may be undesirable, from a *business* standpoint, for the following reasons:

Requirement	*Possible Adverse Business Consequence*
Option freely transferable.	Employer intention that particular employee become a stockholder could be thwarted.
Option immediately exercisable.	Date of option's exercise cannot be delayed in order to retard employee turnover.
Neither option nor underlying stock can be subject to restrictions or conditions significantly affecting value.	Employer corporation could not, usually, have a right of first refusal to prevent outsiders from owning its stock.

As a result, the capital gain opportunities offered by nonqualified stock options may be subject to somewhat formidable practical limitations.

PLANNING SUGGESTION. As an alternative, consider a sale of convertible debentures to the employee (which could be financed with employer-guaranteed loans).[117]

Comparison of Various Types of Options

An employee's take-home pay, under qualified and nonqualified stock options, can be compared (on the basis of facts previously given) as shown in Illustration 36, below and Illustration 37, page 187.

Illustration 36

	*Qualified Stock Option**	*Nonqualified Option 1*	*Nonqualified Option 2*
Proceeds	$800	$800	$800
Less:			
Ordinary income tax (50%†)	–	25	100
Capital gains tax (25%†)	175	163	125
Total taxes	$175‡	$188	$225
Cost of acquiring stock	100	100	100
Total expenditures	$275	$288	$325
Retained compensation	$525	$512	$475

* See 203.3.
† Assumed rates.
‡ Exclusive of any 10 percent minimum tax on tax preferences created upon exercise of the option and sale of the stock (as further described in 105.1)

NOTE. The above (previously paid) ordinary income tax does not appear to be a proper capital expenditure (within the meaning of Regs. Sec. 1.1016-2(a)) and thus could not be construed as an additional cost of acquiring the stock for purposes of determining gain or loss on its (subsequent) disposition. Regs. Sec. 1.1016-2(c) disqualifies *deductible* (state and local) income taxes from the capitalization election granted by Sec. 266 (presumably on the grounds that income taxes are not proper charges).

[117] See LeFevre, "Nonrestricted Stock Options," 20 NYU Inst. on Fed. Tax. (1962), p. 353, at 365.

Comparative Evaluation

	Qualified Stock Option	*Nonqualified Option 1*	*Nonqualified Option 2*
1. Take-home pay (see Illustration 36).	$525	$512	$475
2. Employee investment required (see discussion in 203.3).	Yes	Yes	Yes
3. Three-year holding-period necessary to avoid ordinary income on *full* spread between option price and value of stock when option is exercised.	Yes	No	See factor (4)
4. Ordinary income on bargain element (see factor (3)) recognized even though cash not realized on disposal of stock.	Generally, no*	No	Yes
5. Tax preference for purposes of 10% minimum tax:			
(a) Preference equal to bargain element when option is exercised	Yes	No	No
(b) Preference equal to 50% of net long-term capital gains in year stock is sold	Yes	Yes	Yes
6. Statutory or regulatory requirements *may* cause qualification to be undesirable or impossible	— Possibly yes —		No

* However, see discussion of the ordinary income consequences for failure to meet exact valuation requirements in 203.3.

This rationale could be extended to encompass nondeductible (federal) income taxes as well.[118]

[118] *Taylor,* CA-4, 298 F2d 198, aff'g TC Memo 1960-105.

204.5 Involuntary Conversions

Planning Technique

Calculations should be made to determine which of the following alternatives is preferable:

	Alternatives	
Current tax on converted property	*Gain not recognized*	*Gain recognized*
Effect on future taxes:		
Replacement property's basis is:	*Reduced by unrecognized gain*	*Equal to undiminished cost*

Other planning considerations involve whether or not conversions can and should be fragmented, their effect upon investment credits, the use of stock as replacement property, and the advisability of requesting a ruling.

Should Client Elect Not to Recognize Gain?

Advantages of Election. By electing not to recognize gain, one could achieve the monetary benefit (interest yield) obtained through the tax deferral and the possibility of a stepped-up basis through death.

Disadvantage of Election. The basis of the replacement property is reduced by the unrecognized gain. If this property is depreciable, its basis may be recoverable against ordinary income over the depreciation span.

Where the gain, if recognized, would be taxable at capital gain rates, nonrecognition has the effect of eliminating immediate capital gains at the expense of forfeiting potential ordinary income deductions over a period of time. Of course, the possibility of capital gains taxation, in the case of personal property dispositions, continues to diminish as time goes by because of the depreciation recapture demanded by Sec. 1245. (On the other hand, recapture of depreciation on buildings and other Sec. 1250 property is not as severe. See the recapture discussion in 203.7).

Conclusion. The decision of whether to pay *capital* gains tax *now* and *reduce ordinary* income *later* may have persistent significance for involuntary conversions of certain real property, abetted by the liberal like kind rule explained below. In contrast, a similar decision regarding

involuntarily converted Sec. 1245 property will have tapering consequences.

Thus, both favorable and unfavorable effects should be projected in attempting to provide *some* answers to a client's election question.

Illustration 38

A Case Study

Mr. I. M. Client
360 Computer Row
Martinsburg, West Virginia 01401

Dear I. M.:

In accordance with your request, we have prepared a summary of various income tax consequences that should be considered as a result of the replacement of your plant which was destroyed by fire on May 1, 1970. The following are the gains and losses that are expected to be realized:

	Book Value May 1, 1970	*Anticipated Insurance Receipts*	*Gain (Loss)*
Buildings	$ 59,364	$ 83,000	$ 23,636
Machinery and equipment	17,075	66,500	49,425
Dies	2,686	15,000	12,314
Inventory	140,508	121,000	(19,508)

Since these properties will be replaced with new or used properties that are similar or related in service or use (to the destroyed properties), an election can be made to postpone the recognition of these realized gains. However, this election is not applicable to realized losses. Accordingly, the inventory loss should be deductible as an ordinary loss.

If the above election is made, the gains would *not* be taxable *to the extent that the insurance proceeds are used to purchase replacement properties*. However, the cost of such new property would be reduced by any gains that are not recognized.

Whether or not such an election would be advantageous may be determined through the computation shown in Exhibit 1, page 190. (It is assumed that your taxable income, exclusive of any present gains or future additional depreciation deductions resulting from the involuntary conversion, would be $50,000 during the years involved. This would put you in the 50 percent ordinary income tax bracket (joint returns), without regard to any tax surcharges.)

Monetary Factor

This net tax savings will, of course, be diminished by an "interest expense" factor, reflecting the cost of the funds used to pay the taxes on these gains in

Exhibit 1

Line	*Total*	*Buildings*	*Machinery, Equipment, and Dies*
1. Total gain realized on involuntary conversion	$	$ 23,636	$ 61,739
2. Less ordinary income portion*		(Not applicable)	26,700
3. Long-term capital gain		$ 23,636	$ 35,039
4. Tax on line 2		$ -	$ 14,366
5. Tax on line 3 (at 25%)†		5,909	8,760
6. Total current taxes (lines 4 and 5)‡	$ 29,035	$ 5,909	$ 23,126
7. Total cumulative tax savings through increased future depreciation (Exhibit 2)	$ 42,500		
8. Less total current taxes (line 6)	29,035		
9. Net tax savings if gains are recognized in 1970	$ 13,465		

* Since all of the destroyed assets were depreciated under the straight-line method, the ordinary income portion of the gain consists of depreciation allowed or allowable since January 1, 1962, with respect to only the machinery, equipment, and dies.

†No other long-term capital gains assumed, thereby permitting use of 25 percent maximum tax rate.

‡Surcharge ignored.

1970. However, this financial cost itself should be offset by the following sub-factors.

1. *Favorable self-generated tax effects.* This interest expense factor should furnish its own tax reduction since it will represent either (a) deductible interest paid for borrowed money or (b) decreased gross income, where this current tax is paid out of funds otherwise available for investment or business use.
2. *Monetary gain from future tax savings.* The "interest income" factor attributable to the annual tax savings (shown in Exhibit 2, page 191) will have a reverse thrust during the replacement assets' lives. Of course, this latter element must also be tax-effected, with results opposite to those set forth in (1) above.

   Furthermore, the annual tax savings calculated in Exhibit 2 reflects straight-line depreciation. The utilization of accelerated depreciation would expedite these savings and thus hasten the recovery of your "tax in-

vestment." In this event, the negative monetary impact of your 1970 tax payment would be even further curtailed.

Investment Credit

There is no recapture of investment credit previously claimed on the destroyed property. On the other hand, no credit is allowable for the replacement property.

We shall be pleased to discuss this report with you at your convenience.

Yours truly,
John Doe, CPA
Doe, Jones and Smith, Inc.

Exhibit 2

I. M. Client

Projection of Future Tax Reductions if Involuntary Conversion Gains Are Recognized

Line	*Buildings*	*Machinery, Equipment, and Dies*
1. Additional cost basis available if gains are recognized	$ 23,636	$ 61,739
2. Estimated useful lives of replacement properties	*30 years*	*10 years*
3. Annual additional depreciation	$ 788	$ 6,174
	Subsequent Years	
	1-10	11-30
4. Annual taxable income (before additional depreciation)	$ 50,000	50,000
5. Less additional depreciation:		
Years 1-10 (788 plus 6,174)	6,962	
Years 11-30		788
6. Revised taxable income	$ 43,038	$ 49,212
7. Tax on line 4	$ 17,060	$ 17,060
8. Tax on line 6	13,598	16,666
9. Annual tax savings	$ 3,462*	$ 394
10. Cumulative savings	34,620	$ 7,880
	7,880	
11. Total cumulative savings	$ 42,500	

* Effect of 1970 surcharge ignored

Planning Considerations After an Involuntary Conversion

Fragmented Conversions. The just-concluded case study dealt with two basic kinds of converted property; namely, buildings and machinery, equipment, and so forth. Each of these properties has its own set of depreciation recapture rules which may be triggered by an involuntary conversion. As we have seen, it is possible for buildings (and other Sec. 1250 property) to completely escape recapture if they have been depreciated under the straight-line method. In stark contrast, the inevitable recapture consequences inherent in machinery (and other Sec. 1245 property) tend to retard the advantages of paying a capital gains tax now in order to obtain ordinary income deductions later. In fact, as the years advance, the post-1961 accumulations of *all* depreciation allowed or allowable on Sec. 1245 property should eventually obliterate this particular capital-gains-tax/stepped-up-basis syndrome.

Therefore, the question arises as to whether it would be possible, for example, to recognize gain on the conversion of a non-recapturable building while simultaneously electing not to recognize gain on machinery (pursuant to Sec. 1033); presupposing that both properties have been fully replaced.

Regs. Sec. 1.1033(a)-2(c)(1) and (2) appears silent on this particular point.

However, a somewhat analogous question has presented itself in the past with regard to the allocation of conversion proceeds (such as insurance or condemnation awards) in order to determine the amount of money that must be reinvested where nonrecognition of gain was desired.

These allocation situations can be summarized as follows.

Lump Sum Award. In *Ticket Office Equipment Co.*,[119] the Tax Court stated that "it is not essential that insurance be allocated in any specific manner to individual items destroyed" (citing *Massillon-Cleveland-Akron Sign Co.*).[120]

The Massillon case involved an insurance contract which provided joint, as opposed to separate, coverage for all assets comprising the damaged manufacturing plant.[121]

[119] *Ticket Office Eqpt. Co.*, 20 TC 272, aff'd per curiam on another matter by CA-2, 213 F2d 318.

[120] *Massillon-Cleveland-Akron Sign Co.*, 15 TC 79 (1950), acq. 1950-2 CB 3.

[121] Also see *Orders*, 64-2 USTC ¶9551 (DC, S.C.).

Separate Awards. If separate items of property are involuntarily converted in one transaction or event and "separate awards or recoveries are made for such separate categories of items, the result has been subject to controversy, as where there is a condemnation of a building and fixtures within it. *There is impressive authority for treating the condemnation as a single transaction, and also some authority for finding multiple transactions* . . . ." (Emphasis supplied.)[122]

NOTE. See citations at Mertens[123] for possible precedent allowing deductible losses without offset against unrecognized gains.

If converted properties are not replaced, capital and noncapital assets can be treated separately. In *Lehman Company of America, Inc.*,[124] ordinary losses were allowed for destroyed inventory while long-term capital gain was permitted on depreciable assets.

Involuntary Conversions Vis a Vis Prior Investment Credits. The investment credit recapture provisions have ground rules of their own, which operate wholly independently of the basic involuntary conversion rules (Sec. 1033), the depreciation recapture rules (Secs. 1245 and 1250), or any other statutory rules, for that matter. Thus, the effect of an involuntary conversion upon a client's investment credit recapture must be considered completely apart from the matter of *whether or not* an election is made to recognize gain under Sec. 1033.

These ground rules are summarized at the conclusion of the technical resume, page 195.

Stock as Replacement Property. In some cases, converted property can be replaced by purchasing at least 80 percent control of a corporation owning replacement property. Where such replacement property has been mortgaged, it will have a higher basis in the hands of the corporation than if purchased outright.[125]

CAUTION. If the destroyed building had incubated Sec. 1250 recapturable depreciation, its replacement with stock in lieu of another building would cause ordinary income to be recognized (Sec. 1250(d)(4)(B)).

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[122] Mertens, *Law of Federal Income Taxation,* Sec. 20.173.
[123] *Ibid.*, footnote 95.
[124] *Lehman Company of America, Inc.*, 17 TC 422 (1951), acq. 1952-1 CB 3.
[125] See *Working with the Revenue Code — 1967* (AICPA), edited by A. J. Dixon and D. Zack, Sec. 1033, p. 207.

Comparable provisions exist for like situations involving personal property (and other Sec. 1245 property).[126]

The use of stock as a substitute for property may also be detrimental if investment credit recapture could be avoided by acquiring replacement property (as further explained at the conclusion of 204.5).

Should a Ruling Be Requested? If a client desires not to recognize his involuntary conversion gain, an advance ruling may be advisable as to whether a proposed purchase is a "like kind" replacement or a replacement with "property similar or related in service or use." (These terms are explained in the technical discussion below.)

However, the following negative factors should be most carefully considered:

1. Rulings take time. Therefore, the client's plans would have to be suspendible pending the Revenue Service's deliberation on the ruling request. In this situation, an option to purchase the replacement property may be desirable and even necessary.
2. Ruling requests can, usually, also be invitations to audit. Whether this factor would be a calculated risk depends, naturally, on the state of your client's affairs (from a *factual* viewpoint, of course).

Degree of doubt surrounding the Sec. 1033 qualifications of the intended replacement property should be weighed against the degree of any exposure your client may have to potential IRS adjustments.

Choice of Forum Where a Ruling Is Desired. Rulings are obtained from the IRS national office under the procedures enunciated in Rev. Proc. 69-1 (1969-1 CB 381). However, "the national office will *not* issue rulings with respect to the replacement of involuntarily converted property, even though replacement has not been made, *if the taxpayer has filed a return for the taxable year in which the property was converted . . . .*" (Sec. 3.01, Rev. Proc. 69-1; emphasis supplied.)

In such instances of filed returns, the district director is authorized to issue a determination letter (in lieu of a ruling) (Sec. 4.06, Rev. Proc. 69-1).

The choice of the national office forum does not at all decrease the odds on your client's file finding its way into his local district audit division's grasp. In this regard, Sec. 13.02 of Rev. Proc. 69-1 prophetically reveals that "as part of the determination of a taxpayer's liability, it is the responsibility of the district director to ascertain whether any ruling previously issued to the taxpayer has been properly applied . . . ."

[126] See Sec. 1245 (b)(4)(B) and Regs. Sec. 1.1245-4 (d)(2), Example (2).

Not surprisingly, Sec. 14.01 of the procedure prescribes a similar fate for determination letters, upon examination of the taxpayer's return.

A choice of a suitable forum for answering a client's replacement property question boils down to such practical considerations as conference sites and intangible factors such as dealing with local as opposed to out-of-town IRS personnel.

Technical Resume

What Is an "Involuntary Conversion"? Involuntary conversions are defined in Sec. 1033(a) as the compulsory or involuntary transformation of property into (1) other property which is similar or related in service or use or (2) cash or other property which is not similar or related in service or use.

Further, the original property must have been compulsorily or involuntarily disposed of as a result of any of the following events:

- Complete or partial destruction.
- Theft.
- Seizure.
- Requisition or condemnation.
- Threat or imminence of requisition or condemnation.

Treatment of Gain Realized Upon Conversion. No gain is recognized if the involuntarily converted property is replaced by property similar or related in service or use. On the other hand, the entire realized gain is recognized if the replacement property consists of cash or nonrelated property unless (1) generally, property which is similar or related in service or use is purchased during the "replacment period" (defined below) and (2) the taxpayer elects to have the gain recognized only to the extent that the amount realized upon the conversion exceeds the cost of the replacement property (Sec. 1033 (a) (3) (A)).

NOTE. Replacement property includes a controlling stock interest in a corporation owning "similar or related property" (Sec. 1033(a)(3)(A)). In addition, there is a liberalized special rule affecting real property which is discussed below.

Treatment of Losses. "Sec. 1033 applies only with respect to gains; losses from involuntary conversions are recognized or not recognized without regard to this section" (Regs. Sec. 1.1033(a)-1(a)).

The Replacement Period. Sec. 1033(a)(3)(B) prescribes the following period within which replacement property must be acquired in order to

qualify for the nonrecognition-of-gain treatment permitted for involuntary conversions:

1. Beginning of period — date of converted property's disposition or earliest date of threat or imminence of requisition or condemnation, if sooner.
2. End of period — two years after the close of the first taxable year during which any gain is realized from the involuntary conversion.

Extending the Replacement Period. The replacement period can be extended by designating a later date on an application (in the form of a letter) submitted to the district director (with whom the return was filed for the first taxable year in which any of the conversion gain was realized). However, Regs. Sec. 1.1033(a)-2(c)(3) states that "no extension of time shall be granted pursuant to such application unless the taxpayer can show reasonable cause for not being able to replace the converted property within the required period of time."

The application must be submitted:

> . . . Prior to the expiration of two years after the close of the first taxable year in which any part of the gain from the conversion is realized, unless the taxpayer can show to the satisfaction of the district director (i) reasonable cause for not having filed the application within the required period of time, and (ii) the filing of such application was made within a reasonable time after the expiration of the required period of time . . . [Regs. Sec. 1.1033(a)-2(c)(3)].

Thus, it may even be possible to obtain an extension of the extension application itself!

CAUTION. In practice, such extended extensions have been granted, *if at all,* only in extenuating circumstances. Consequently, they should *not* be relied upon for planning purposes but used only as a last resort.

Special Rule for Real Property

A *Mini-View of Sec. 1033(g).* In order to avoid recognition of gain, the replacement property, generally, must be similar or related in service or use to the converted property. However, a significant exception to this general rule allows involuntarily converted real property to be replaced by real property which is merely of a "like kind." This special rule applies only where the conversion is caused by (a) seizure, requisition, or condemnation or (b) threat or imminence thereof.

Note that conversions due to destruction or theft are covered *only* by the general "similar or related" rule.

Eligible Property. Both the replaced and replacement properties must be held either for productive use in a trade or business or for investment.

However, inventory or other property held primarily for sale is excluded from this like kind test.[127] *This special rule also does not apply if the replacement property consists of a controlling stock interest in a corporation owning qualifying property* (Sec. 1033(g)(2)(A)).

Application of Special Rule. The special rule of Sec. 1033 (g), which was a 1958 technical amendment, merely supplements the pre-existing provisions of Sec. 1033. Accordingly, qualifying "like kind" property is treated as though it was "similar or related in service or use" to the converted property. *Furthermore, nonrecognition of gain would still be available even though corporate stock is purchased as replacement property if the older "similar or related property" rule is satisfied.* (Mertens, *Code Commentary,* Sec. 1033(g): 1; emphasis supplied.)

Distinction Between "Similar or Related" and "Like Kind." "The Internal Revenue Service and courts have held that Sec. 1033 requires a relatively narrow construction of the words 'property similar or related in service or use,' with the result that the converted property must be substantially similar to that destroyed":

> It has been held not to include, for example, improved real estate which is converted into unimproved realty, nor a barge substituted for a tug. Similarly, it has been held not to include property used in the operation of a business which was substituted for rented property. Likewise, it has been held not to include city real estate exchanged for a farm or a ranch . . . .
>
> The phrase "like kind to be held either for productive use in trade or business or for investment" has been given a broader interpretation than the similar or related phrase. "Like kind," for example, has been held to include unimproved real estate which is exchanged for improved real estate, so long as both properties are held either for productive use in trade or business or for investment. Thus, the "like kind" phrase has been held to include the exchange of city real estate (used in a trade or business) for a farm or ranch . . . [Senate Finance Committee Report No. 1983, p. 993].

NOTE. "Like kind" for purposes of Sec. 1033 has the same meaning as in Sec. 1031, pertaining to (not unexpectedly) like kind exchanges (which are further discussed in 204.11).

[127] S. Rep. No. 1983 (85th Cong., 2nd sess.), 1958-3 CB 994.

Investment Credit Aspects

Any Involuntary Conversion, Except Casualty or Theft, Such as Condemnations, and So Forth. In effect, this type of transaction is treated, for investment credit purposes, as a sale of the replaced property with the following consequences:

1. Normal recapture rules apply based upon variations between actual and estimated lives. There is no recapture in any event if an actual life is eight years or more.
2. Any recapture under these normal rules can still be avoided if replacement property is acquired within six months after the involuntary conversion. However, such property must have been eligible for the investment credit, absent its repeal, and be acquired after April 18, 1969 (Sec. 47(a)(5)).

Casualty or Theft. There is *no* investment credit recapture in the case of these particular types of involuntary conversions where they occur after April 18, 1969 (Sec. 47(a)(4)).

If the casualty or theft occurred before April 19, 1969, recapture can be avoided by replacing the destroyed or lost property, after April 18, 1969, with property eligible for the credit (absent its repeal). In this case, however, there is *no* six-month replacement requirement. In fact, neither Code Sec. 47 (a) (5) nor Senate Finance Committee Report No. 91-552 (11/21/69, p. 247) indicates *any* specific replacement period in this situation.

204.6 Installment Sales

Planning Technique

High on the list of taxpayer-oriented code sections is Sec. 453 which, if its terms are met, expressly approves the use of the installment method as a means of reporting income for federal tax purposes. Therefore, this section may enable clients to achieve the following goals:

1. *Control over timing of income.*
2. *Equating tax payments with cash collections.*
3. *Mitigating effects of depreciation recapture.*

Other planning considerations involve financial aspects and avoiding contemporary pitfalls.

Installment sale reporting is available to dealers in personal property (Sec. 453 (a)) and for sales of real and personal property (Sec. 453 (b)).

A discussion of the installment sale provisions pertaining to dealers is outside the scope of this tax study. (However, see 504.5, Chapter 5, Tax Study No. 1.)

Installment sales of real or personal property are subject to the following basic requirements:

1. Payments in the year of sale cannot exceed 30 percent of the selling price.
2. In the case of personal property, the selling price must exceed $1,000.

NOTE. Personal property which is includible in inventory is only eligible for installment reporting under the rules applicable to dealers.

Control Over Timing of Income

Controlling taxable income between years, in order to derive soothing tax effects from such a smoothing-out process, was the concern of 104.2. The postponement of income was mentioned as one of four major contributors towards this ideal matching of income and deductions (along with accelerated income, postponed deductions, and accelerated deductions).

Installment sales are a major, reliable, and time-tested way of regulating the flow of income through clients' returns, in view of their fairly certain and detailed congressional and administrative blessing.

EXAMPLE: *Delaying tax payment.* Client purchased land in 1960 for $40,000. In December 1970, Mr. Byer offers Client $100,000 for immediate passage of title to this property.

CPA advises Client to arrange the following installment sale:

$30,000	due	December 15, 1970
70,000	due	January 15, 1971
$100,000		Total selling price

No provision for interest is necessary since all payments are due within a year of the sale. (See Sec. 483(c)(1)(A).)

By postponing receipt of 70 percent of the selling price for only one month, Client was able to secure a year's delay in paying the related tax (assuming estimated tax payments are based on the prior year).

EXAMPLE: *Avoiding offset against ordinary income.* Assume the same facts as in the example above except that Client would otherwise sustain

a net operating loss for 1970. In this case, CPA's recommendation is as follows:

$ 10,000	due December 15, 1970
90,000	due January 15, 1971
$100,000	Total selling price

The 1970 loss can be carried back to 1967 and be deducted against ordinary income. The 1967 refund would also bear 6 percent interest. The possibility that this carryback could precipitate an IRS audit is dismissed because (a) 1967 has already been examined, (b) 1970 is fairly "clean," and (c) a 1970 review is likely, in any event.

As a result, Client is able to match ordinary deductions against ordinary income and thereby obtain unvitiated capital gains treatment for 90 percent of the gain arising from the sale of his land.

Similar matching principles apply if the land was Sec. 1231 property and Client had Sec. 1231 losses in 1970. (See 203.4)

It should be noted that under Rev. Rul. 69-462 (1969-2 CB 107), installment sale treatment would not be available for a 1970 sale if 100 percent of the selling price was due in 1971. See the discussion later in 204.6 of minimum number of installment payments.

Inapplicability to Loss Sales. The installment method cannot, presumably, be used to stagger losses throughout the payment period. See Regs. Sec. 1.453-1(c)(1), which limits this method to the reporting of *income* from dispositions of realty or casual dispositions of personal property.

However, this possible bracket impairment may be rectified by such defense mechanisms as:

1. *The lifetime carryover of unused capital losses* (See 203.10).
2. *Income averaging for post-loss years.* As indicated in 104.1 of Chapter 1, statutory income averaging is only a forward-moving device. Thus, a loss sustained in 1970, for example, cannot have a reducing effect on a client's income tax for any *preceding* taxable years. However, such a loss *will* cause 1970 to be a lower base year for averaging *future* years' income.
3. *Controlling taxable income, for the year of the loss sale, in relationship to the taxable income of contiguous years.* Where the loss on a particular sale unduly lowers taxable income, its effect can be reversed through accelerating other income and/or postponing other deductions. (See 104.2.)

Equating Tax Payments With Cash Collections

Another goal reachable through the installment sale technique is the opportunity to pay tax on installment sale profits commensurately with the receipt of installment payments, where such payments are desired by the purchaser.

Mitigating Effects of Depreciation Recapture

The benevolent contribution of installment sales towards regulating a client's ordinary income bracket, which would otherwise be overly augmented by depreciation recapture, was highlighted in 203.7.

In addition, this previous passage also discussed the regulatory quid pro quo with respect to reporting ordinary income first and capital gains later.[128]

Financial Aspects

Since installment sale clients will not be able to have their cake and eat it too, it is important not to overlook the economic consequences of such a transaction (i.e., the installment seller's sluggish collection of his selling price).

To ignore this obvious financial fact of life would be to put the tax cart before the horse of overall economic well-being. (See discussion of monetary factors at 104.2.)

Of course, the significance of this matter varies commensurately with the length of the installment period and the size of the unpaid selling price.

Since Sec. 453 does not operate in an economic vacuum, keen business judgment must also be exercised with regard to the necessary credit risk associated with installment payments. Collaterally, the adequacy of the arrangements for securing the installment debt should have overriding influence on the actual consummation of the installment sale. The rationale of "a bird in hand is worth two in the bush" is exceedingly well taken in this situation.

The evaluation of these financial factors is, naturally, beyond our tax province. We can only emphatically suggest that they be scrupulously considered.

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[128] See discussion of Regs. Sec. 1.1245-6 (d) and pre-1969 Proposed Regs. Sec. 1.1250-1 (b) (6) at 203.7, herein.

Coping With Contemporary Pitfalls

1. Imputed interest complications.
2. The required election.
3. Payments in year of sale.
4. Minimum number of installment payments.
5. Disposing of installment obligations.

Imputed Interest Complications

Where (1) property is sold or exchanged under a contract with one or more payments due more than one year later and (2) stated interest is less than 4 percent simple interest per annum, payable with each installment of principal (Regs. Sec. 1.483-1 (d)(2)), the Code's minimum interest requirement is not met and imputed interest complications arise.

Statutory Remedy. Where insufficient interest exists, Sec. 483 will impute interest — at a rate of 5 percent compounded semiannually — to all payments due more than six months after the sale or exchange. See Illustration 39, below. (Of course, imputed interest is reduced by any stated interest.)

NOTE. Sec. 483 is inapplicable if (a) the sales price does not exceed $3,000 or (b) no part of the gain would be considered gain from the sale or exchange of a capital asset or Sec. 1231 property. (Exception (b) applies only to sellers.)

EXAMPLE. On December, 31, 1970, A sells property to B under a contract which provides that B is to make three payments of $2,000 each,

Illustration 39

Imputed Interest Formula

Line		
1. Total payments due under contract		$ ______
Less — present value of:		
2. Payments shown on line 1	$	
3. Interest due under contract (stated interest)	______	
4. Subtotal of lines 2 and 3		______
5. Imputed interest (line 1 less line 4)		$ ______

NOTE. Present values are based upon a discount rate of 5 percent per annum compounded semiannually. This rate as well as the 4 percent simple interest rate referred to above is prescribed by regulations, under statutory delegation, which also provide tables of present value factors (at both rates) of deferred payments for periods of up to sixty years.

such payments being due, respectively, at the end of each year for the next three years. No interest is provided for in the contract. The total unstated interest under the contract is $559.88, computed as shown in Illustration 40, below.

Illustration 40

Sum of payments to which Sec. 483 applies	$6,000.00
Less present value of $2,000 due every 12 mos. for 3 yrs.	
($2,000 times 2.72006 (factor for 3 yrs., col. (b), Table III*)	5,440.12
Total unstated interest	$ 559.88

Note: The portion of each $2,000 payment which is treated as interest is $186.63, determined as follows:

$$\$2{,}000 \times \frac{\$\ 559.88}{\$6{,}000.00}$$

* Regs. Sec. 1.483-1(g)(2).

Effect of Imputed Interest. Interest manufactured by Sec. 483 "shall constitute interest for all purposes of the Code . . ." (Regs. Sec. 1.483-2(a)(1)(i)). Thus, the installment sale provisions of Sec. 453, being no exception, are confronted with the infiltration problem of Sec. 483. This hazard is most manifest in connection with the 30 percent test for payments in the year of an installment sale.

For example, property is sold for $10,000 of which $3,000 is payable at the closing and the balance in seven annual installments of $1,000 each. Under prior law, there was no question that the sale qualified for the installment method since the 30 percent requirement has been met. But under present law, $1,200 is considered as unstated interest (the present value of the $7,000 balance is $5,800) and the selling price is reduced to $8,800. Since the $3,000 received in the year of sale is 34 percent of the reduced selling price, the taxpayer is disqualified from using the installment method of reporting income.

In addition, Sec. 483(e) requires recalculations of unstated interest if there are changes in the contract terms. However, Regs. Sec. 1.483-1(f)(2) states that such changes are not reflected retroactively. For an illustration of such nonretroactive application in connection with qualifying for the 30 percent installment sale test, see Rev. Rul. 68-247 (1968-1 CB 199).

Protecting the Installment Sale Election. It may be possible to avoid disqualification of an installment sale by reducing year-of-sale payments. If payments are not fixed, disqualification can be avoided by reducing

the amount paid in the year of sale to less than 30 percent of the reduced sales price.

In addition, another method of avoiding disqualification is to receive all payments more than six months after the sale. Because imputed interest is spread evenly over the payments, except those during the first six months (which contain no imputed interest), the receipt of all payments more than six months after the sale would result in each payment containing the same portion of interest. Therefore, the proportion of payments that represent purchase price received in the year of sale and subsequent years will be undisturbed.

For instance, if the $3,000 in the above example were received more than six months after the sale but within the year of sale, it would also become subject to the imputed interest rules. Assume that this increases the unstated interest by $100 to a total of $1,300 and reduces the sales price to $8,700. Under Regs. Sec. 1.483-1(a), the unstated interest in each payment will be 1,300/10,000 or 13 percent. Thus, 13 percent of the $3,000 received in the year of sale is interest ($390) while the balance ($2,610) is principal. Since $2,610 is exactly 30 percent of the $8,700 sales price, the sale would still qualify for the installment election.

The Required Installment Method Election

An election to adopt the installment method is made by computing the gross profit under this method with respect to a sale or other disposition. Such computation must be set forth in the return for the year of sale or in a statement attached thereto (Regs. Sec. 1.453-8(b)).

Election Is Irrevocable. An election cannot be revoked for the year of sale, nor can it be changed for subsequent years.[129]

Failure to Elect. Suppose a client sells property at a small loss. Upon subsequent audit, the Revenue Service determines, instead, that the property was actually sold at a gain. Can this gain be reported on the installment method? In Rev. Rul. 65-297 (1965-2 CB 152), the IRS designated the following limited circumstances under which it would recognize as valid the election to report income from certain sales on the installment method, *if such election was not made on a timely filed*

[129] *Felton*, 57-1 USTC ¶9391 (DC, Ga.); *Marks*, CA-2, 98 F2d 564, cert. denied. Also see *Pollack*, 47 TC 92 (1966), where the taxpayer was prevented from reversing his original election not to use the installment method (in order for the entire gain to be absorbed by "Subchapter S losses" which were subsequently disallowed).

original return for the year of sale (including extensions):

1. Those cases where election of the installment method was made on an amended return for the year of sale not barred by the statute of limitations or the operation of any other law or rule of law, *if the facts indicate no election inconsistent with the installment election had been made with respect to the sale.*
2. Those cases where the election had been made on a delinquent return for the year of sale.

However, the following conditions must be met:

• The failure to elect the installment method on a timely filed original return must have been a "good faith failure."

• Statute of limitations:

> . . . An installment election made after the due date *(including extensions thereof)* for filing the return for the taxable year of the sale will *not* be recognized as a valid election if the assessment or collection of any portion of the tax for any taxable year resulting from the application of the installment method to such sale is prevented by the operation of the statute of limitations or of any other law or rule of law (*Howbert* v. *Norris*, 72 F2d 753 (1934)). . . . [Rev. Rul. 65-297; emphasis supplied.]

NOTE. Rev. Rul. 65-297 was released in response to several cases cited therein, pending the revision of the above-quoted Regs. Sec. 1.453-8(b) (which has yet to be promulgated).[130]

Statute of Limitations Prolonged (in Effect). Installment sales may give the IRS more time to evaluate the manner in which the transaction has been treated by the seller for tax purposes. For example, capital gain treatment for installments, received at a time when the year of the sale is closed, can still be reclassified as ordinary income. Without the installment sale election, and using hindsight, it would have been possible, in this situation, for the entire gain to be taxed at capital gain rates.

Such a result was approved in *Municipal Bond Corporation* (41 TC 20; ultimately reversed on other grounds by CA-8, 382 F2d 184) under the following circumstances:

1. A sale was consummated in a year that had since closed.
2. The installment method was elected for such year and the reportable gain treated as long-term capital gain.

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[130] Also see *Mamula*, CA-9 (rev'g and rem'g TC), 346 F2d 1016.

3. Installment collections continued during years that were still open.
4. The IRS contended that payments received in open years were taxable as ordinary income.

Payments in Year of Sale

In determining whether payments in the year of sale exceed 30 percent of the selling price, in order to qualify for installment reporting, "payments" consisting of the purchaser's "evidences of indebtedness" are excluded (Sec. 453(b)(2)(A)(ii)). However, the following types of debt instruments cannot be considered as a purchaser's evidence of indebtedness:

1. A bond or other obligation payable on demand, which is issued by a corporate *or noncorporate* obligor.
2. Corporate or governmental bonds or other obligations which (a) have interest coupons attached or are in registered form (except those in registered form which the seller establishes will not be readily tradable in an established securities market) or (b) are in any other form designed to render them readily tradable in such a market.[131]

These obligations have been removed from "buyer indebtedness" by the 1969 Tax Reform Act because they were deemed to be cash equivalents. Thus, they can no longer be used, particularly in corporate acquisitions, to give the purchaser a stepped-up basis for appreciated assets (which can be acquired by timely liquidating the acquired corporation) while allowing the seller to postpone his tax payment (by receiving long-term obligations, even though the equivalent of cash, in exchange for his stock in the acquired corporation).

Third Party Indebtedness. "In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall, for the purpose of determining whether a sale is on the installment plan, be included as a part of the 'selling price'; *and for the purpose of determining the payments* and the total contract price *as those terms are used in Sec. 453*, and Secs. 1.453-1 through 1.453-7, *the amount of such mortgage shall be included only to the extent that it exceeds the basis of the property . . . .*" (Regs. Sec. 1.453-4 (c); emphasis supplied.)

[131] Sec. 453 (b) (3), effective for sales (or other dispositions) after May 27, 1969, unless made pursuant to a binding written contract entered into before May 28, 1969.

The above-quoted regulation is silent with regard to the treatment of *unsecured* third-party debts. The IRS is currently of the opinion that such debts are *not* within the regulation's purview.

In other words, *all* of the seller's unsecured liabilities which are assumed by the buyer, *not merely those in excess of the basis of the property sold*, would be includible as year-of-sale-payments under the Service's view. This approach has had the following judicial reception.

It was approved by the Tax Court in *Horneff* (50 TC 63 (1968)) and *Irwin* (45 TC 544 (1966)).

However, the Tax Court's decisions are restricted to situations where the assumed liability is also extinguished (through payment, novation, or cancellation) in the year of sale.

It was rejected by the Fifth Circuit Court of Appeals (390 F2d 91), reversing *Irwin*, and the Ninth Circuit Court of Appeals (*Marshall*, 357 F2d 294 (1966)), affirming a 1964 California District Court decision.

Until this issue is conclusively settled, it appears wise to avoid the problem by taking such steps as the following:

1. Adjust consideration received from buyer:
   (a) Seller liquidates liabilities; other consideration, received after year of sale, is increased.
   (b) In the alternative, other consideration, *received in the year of sale*, should be curtailed in order to prevent any possible violation of the 30 percent limitation.
2. Contractually require the buyer to avoid payment of such tainted debt before the seller's year end. Where necessary, current liabilities should be extended through refinancing before the sale.[132]
3. If feasible, delay the sale so that debt payments will occur in the taxable year subsequent to the year of sale.

NOTE. See Rev. Rul. 68-13 (1968-1 CB 195) for detailed discussion regarding allocation of selling price and year-of-sale payments where several assets are disposed of in the sale of a business. However, this ruling does not specifically deal with assumed liabilities.

In appropriate instances, it might be advisable to request the Revenue Service to extend the ruling's rationale to encompass fragmentized transactions involving assumed liabilities.

[132] In "Installment Sales with Assumed Liabilities" by B. Berger, *The Journal of Accountancy* (Aug. 1966), it is also suggested that the buyer's covenant against early payments be buttressed by a liquidated damages clause.

Minimum Number of Installment Payments

Rev. Rul. 69-462 (1969-2 CB 107) holds that the installment method will apply only to those sales of real property that provide for two or more payments in two or more taxable years. Thus, a lump sum payment after the year of sale would not qualify for installment reporting.

Moreover, the rationale of this revenue ruling could be extended to personal property sales because of the similarity in statutory language governing installment sales of both personal and real property.

On the other hand, there is no requirement that payments be spread relatively evenly over the installment period. Such a proposal was contained in the House version of the 1969 Tax Reform Act but was rejected by the Conference Committee.[133]

Disposing of Installment Obligations

Installment obligations are receptacles for storing potential income. Certain types of dispositions release this income into the obligee's tax bracket.

PLANNING SUGGESTION. *Use Taxable Dispositions to Achieve Desirable Acceleration of Income.* Chapter 1 (104.2) described various advantages attainable through controlling taxable income between years, such as (a) leveling annual tax brackets or (b) absorbing expiring carryovers (e.g., net operating losses, investment credits, and so forth).

Deliberate dispositions of installment obligations, which would trigger this latent income, enable additional income to be immediately produced — if needed for the above purposes.

Nontaxable Dispositions Permit Income Deflection. In Rev. Rul. 67-70 (1967-1 CB 106), the interest on an installment obligation was able to be shifted to a two-year charitable trust (repealed by 1969 TRA) since the grantor-obligee retained the right to the principal payments.

The ruling held that "the transfer in trust of the installment obligation is *not* a disposition of the installment obligation *since* the grantor is treated as the owner of the portion of the trust consisting of the deferred profit included in the obligation. The grantor is taxable on the deferred profit as the installment payments are received by the trust (Cf. Rev. Rul. 64-302, 1964-2 CB 170). . . ." (Emphasis supplied.) Rev. Rul. 64-302 reached a similar result in the case of deferred U.S. government bond interest transferred to a ten-year trust. Since the grantor continued to own the interest, he was spared immediate taxation.

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[133] See H. (Conf.) Rep. No. 91-782, 12/21/69, p. 307.

Ineffective Deflection. A grantor, while an installment obligation still had eighteen years to run, transferred the installment note in trust for the benefit of his sister. *The trust instrument provided that the entire amount of each installment and interest payment on the note was currently distributable to the beneficiary.*

The trust instrument also provided that the trust would terminate after ten years and two months at which time the balance due on the installment obligation reverted to the grantor.

Under these facts, Rev. Rul. 67-167 (1967-1 CB 107) held that:

> . . . The transfer of an installment obligation in trust results in a disposition of the installment obligation *with immediate tax consequences to the grantor in all cases where . . . the grantor is not the owner of any part of the trust* (under the provisions of subpart E of subchapter J of the Code). Under the circumstances of this case, the grantor is not the owner of any part of the trust . . . .
>
> Accordingly, the transfer in trust of the installment obligation effected a "disposition" of the obligation. The grantor is taxable in the year of the transfer on the difference between the basis of the obligation and its fair market value at the time of transfer. [Emphasis supplied.] [134]

NOTE. The effective use of ten-year trusts is described at 202.3.

Technical Resume

Sec. 453 (d) requires that gain or loss be recognized whenever installment obligations are (1) satisfied at other than face value or (2) distributed, transmitted, sold or otherwise disposed of. See Regs. Sec. 1.453-9 (b) for computing the amount of realized gain or loss.

However, significant statutory exceptions exist for (1) transmissions by reason of death (Sec. 453(d)(3), discussed below) and (2) distributions in certain corporate liquidations (Sec. 453 (d) (4), which is beyond the scope of this tax study).

In addition, Regs. Sec. 1.453-9(c) (2) provides further exceptions for "certain transfers to corporations under Secs. 351 and 361; contributions of property to a partnership by a partner under Sec. 721; and distributions by a partnership to a partner under Sec. 731 (except as provided by Sec. 736 and 751)."[135]

Transmission at Death. Income residing in installment obligations transmitted at death is subsequently taxed to its actual recipient (estate

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[134] To the same effect, see *D.A. Springer* (DC, Ala., 1969), 69-2 USTC ¶9567.

[135] See Garian, Studies in Federal Taxation No. 1, at 602.3, for a more intensive discussion of this regulatory exception relating to Sec. 351 incorporations.

or heirs) as "income in respect of a decedent" (Sec. 691(a)(4)). Of course, the fair market value of the obligation, *including* its income element, is also includible in the decedent's estate for estate tax purposes.

However, this double taxation is somewhat eased through an income tax deduction for estate tax attributable to income included in a gross estate. (See 403.)

Special Rules for Repossessed Real Property. A new relief provision, *only* applicable to repossessed *real* property, was added to the Code in 1964 as Sec. 1038.

> . . . The new provision specifies that where real property is sold and the seller accepts indebtedness secured by the real property in return, then if the seller repossesses the property, no gain or loss is to be recognized to the seller as a result of the repossession of the property except to a limited extent.
>
> The only gain to be recognized upon the repossession of the property is to be the amount of money (and fair market value of any property other than the debt of the purchaser) received as payments on the property before the repossession to the extent that these amounts have not previously been reported as income. (Gain may also result from the restoration of deductions taken before repossession where the debt was considered worthless . . . .)
>
> Moreover, in no event is the gain attributable to the payments received before repossession to exceed the potential gain attributable to the initial sale reduced by amounts received before repossession . . . already reported as income and also reduced for expenses incurred by the seller in connection with the repossession of the property . . . .[136]

204.7 Short Sales

Planning Technique

Short sales can be an effective technique for accomplishing the following objectives:

- *Equalizing tax brackets.*
- *Offsetting existing short-term gains against any subsequent capital losses.*
- *Postponing or completely avoiding tax payments.*
- *Freezing profits on volatile stock acquired through qualified options.*

[136] S. Rep. No. 1361 (88th Cong., 2nd sess.), 1964-2 CB 828 at p. 832. For the further specialized application of Sec. 1038 to repossessed residences, see 201.1 and 204.1, herein.

Equalizing Tax Brackets

A short sale can function, with precision, as a vehicle for controlling taxable income between years in order to equalize tax brackets. (See 104.2)

Offsetting Existing Short-Term Gains Against Any Subsequent Capital Losses

EXAMPLE. Client buys 100 shares of Rock Oil Co. (September 15, 1970) at $15 per share. Rock Oil has advanced to $50 per share (December 15, 1970), its high point in Client's opinion.

Client does not have any capital loss deductions.

CPA then advises Client to sell Rock Oil short against the box on December 15, 1970, and close the sale on January 4, 1971. Although this technique will not convert the short-term gain into a long-term gain, it will still have the following advantages:

1. Client will be able to sell stock at optimum selling price (in his judgment).
2. Client will have an additional 12 months in which to utilize any capital losses that may be incurred as offsets against this ordinary income.
3. Since any resulting net gain would be taxable in 1971, Client obtains additional time for tax payments. (See immediately succeeding discussion.)

Postponing or Completely Avoiding Tax Payments

If Client actually sold his Rock Oil shares in 1970, any applicable tax would be due by April 15, 1971. The suggested short sale enables Client to obtain a full year's grace period, assuming that estimated tax requirements are based on either the tax or income of the preceding year.

A short sale against the box, which is not closed until the seller's death, might completely avoid tax since the securities sold short would, apparently, obtain a new basis. However, financial costs should be taken into account. (See discussion of nontax considerations, page 212.)

Freezing Profits on Volatile Stock Acquired Through Qualified Options

As indicated at 203.3, Sec. 422 (a) (1) requires that stock acquired under a qualified stock option be held for a minimum of three years in

order to obtain the *full* favorable treatment normally accorded such stock (namely — taxation, at capital gain rates, and only when stock is disposed of). However, where such stock is extremely volatile, this three-year requirement could be a severe financial detriment. In this circumstance, a short sale against the box could freeze the gain, during the three-year period, if the employee is motivated by a compelling selling price.

CAUTION. Officers, directors, or 10 percent shareholders of companies whose stock is traded on a national securities exchange *cannot* hold short positions open for more than 20 days (Section 16 (c), Securities Exchange Act of 1934). If substantially identical property is acquired while the short sale is open, any gain realized when the sale is closed will be a *short*-term capital gain regardless of the actual holding period of the property used to close such sale (Sec. 1233(b), further explained at the conclusion of 204.7).

Consequently, other options to acquire employer stock could not be exercised without sacrificing long-term capital gain treatment for such previously acquired stock; a rather self-defeating cycle.

Nontax Considerations

The following financial factors should always be considered since, in some cases, they may detract from the tax benefits previously described:

1. *Short sale expenses* such as a premium charge for the loan of shares. (Selling expenses, such as commissions, are usually not material and would be incurred, in any event, upon an actual sale. Thus, they usually can be ignored, particularly in comparing the effects of short sales with actual sales.)
2. *Large short positions* which may either make such loans difficult to obtain or else compel their repayment at an unfavorable time.
3. *Unproductive investment* since the seller is not entitled to any earnings on his investment after the short sale. (For example, in a short sale against the box, the seller must repay any dividends received to the lender of the stock sold short.)

This problem can be compounded where the short sale securities have been purchased on margin, and additional collateral is required (which can increase in a rising market).

On the other hand, a long position can be offset against a short position to the seller's advantage.

EXAMPLE. Client deposits 100 shares of Rock Oil Co. with his broker to be applied against loan of an equal number of shares for short sale. Only

10 percent of short sale proceeds need be retained by the broker as additional collateral, with the remaining 90 percent payable to Client.

This 90 percent retention should be compared with the net proceeds from an actual sale (proceeds less capital-gains tax) in order to determine which alternative will provide greater working capital for future investment.

Short Sales Described

> . . . In a typical short sale, an investor, anticipating a decline in price, effects a sale of stock which he does not own. He consummates the sale by delivering to the buyer stock borrowed from a third person, usually his broker. The proceeds of the sale are held by the broker or other lender as collateral for the loan. Ultimately, the investor purchases the stock, hopefully at a lower price, remits these shares to his lender and recovers the proceeds of his original sale, thereby "closing" the sale.
>
> The investor can go through the same process, effecting a sale with borrowed stock, even though he or his spouse holds the same or a larger number of shares of stock identical or substantially identical to the shares sold short. That type of short sale is referred to as a "short sale against the box" . . . . [137]

Income Tax Consequences

> . . . In general . . . a short sale is not deemed to be consummated until delivery of property to close the short sale. Whether the recognized gain or loss from a short sale is capital gain or loss or ordinary gain or loss depends upon whether the property so delivered constitutes a capital asset in the hands of the taxpayer.
>
> Generally the period for which a taxpayer holds property delivered to close a short sale determines whether long-term or short-term capital gain or loss results [Regs. Sec. 1.1233-1(a)(1) and (3)].

Short-term gains *cannot* be converted into long-term gains by using short sales in the following manner.

EXAMPLE. On February 1, Client buys 100 shares of Venus Air Conditioning at $25 a share. Venus Air rises to $65 on May 1 and Client decides to take his profit. However he does not sell the shares he actually owns but, instead, sells short. He closes short sale August 5 by delivering securities purchased February 1.

Although property used to close the short sale has been held more than

[137] William L. Morrison, "Tax Planning for the Usual Securities Transaction," *The Journal of Taxation* (Oct. 1968), p. 240.

six months, a special rule prescribed by Sec. 1233(b) requires the gain to be treated as a short-term capital gain since property substantially identical to that sold short was held six months or less on the date of the short sale. The same result would be obtained if Client did not own such property at the time of the short sale but acquired it while the short sale was open.

204.8 Options to Sell Property

Planning Technique

"Optional" tax deferment is available through options which furnish clients with vital timing flexibility in conducting their financial lives by (a) permitting economic consequences to be fixed (i.e., gains realized) in one year, while (b) recognizing such results for tax purposes in a later year.

An option to sell property is a legal commitment which permits its holder to sell the subject property at a stated price within a stated time. (In the case of securities, options to sell are termed "puts" while options to purchase are called "calls" and both are customarily obtained for a separate consideration known as a premium.)

In Rev. Rul. 58-234 (1958-1 CB 279), it was held that "there is no closed transaction nor ascertainable income or gain realized by an optionor upon mere receipt of a premium for granting such an option." Further "there is no federal income tax incidence on account of either the receipt or the payment of such option premiums, i.e., from the standpoint of either the optionor or the optionee, unless and until the options have been terminated, by failure or exercise, or otherwise, with resultant gain or loss."

Comparison of Options and Short Sales

The deferral techniques possible under an option's delayed reaction potential can be compared with those offered by short sales, as shown in Illustration 41, page 215.

NOTE. Sec. 1233(b) treats options as short sales in preventing substantially identical property from being used to convert short-term gains into long-term gains. (See the prior discussion of income tax consequences of short sales, 204.7.) However, this prohibition does not

Deferral Techniques Attainable Through Short Sales (discussed in detail in 204.7)	*Relevancy to Options*
Equalizing tax brackets	Applicable
Offsetting existing short-term gains against any subsequent capital losses.	Applicable (See note below.)
Tax payments:	
(a) Postponement	Applicable
(b) Complete avoidance	Not feasible
Freezing profits on volatile stock acquired through qualified options.	Generally, the *tax* advantage and limitations would appear to be similar.

Query: Do any SEC restrictions apply to options (i.e., "puts") comparable to those applicable to short sales (pursuant to Sec. 16 (c) of the Securities Exchange Act of 1934)?

apply to puts used as hedges (option and its subject property simultaneously acquired) since the property's holding period cannot be extended without financial risk (Sec. 1233(c)).[138]

Options and short sales can be further compared as follows:

> . . . By buying a six-month and ten-day put an investor speculating on the decrease in the price of a stock can cast his profit in the form of a long term gain by selling the put itself after holding it six months. *His investment alternative, the short sale, would result only in a short term gain* . . . .[139] [Emphasis supplied.].

On the other hand, the use of short sales to create artificial short-term losses is banned by Sec. 1233(d). Interestingly, this latter measure does *not* apply to options (Regs. Sec. 1.1233-1 (c)(4)).

Economic Aspects

As in the case of short sales, options cannot be divorced from the world of economic reality. They, too, have costs (i.e., premiums) that militate against the ultimate *tax* savings achievable. Thus, the financial, as well as the tax effects of these deferment vehicles should be compared to arrive at the most desirable *overall* answer. (See the nontax considerations regarding short sales described in 204.7.)

[138] Also see Mertens, *Code Commentary*, Sec. 1233:1.

[139] Morrison, op. cit.

204.9 Executory Contracts

Planning Technique

Executory contracts can be used as a vehicle for treading a path somewhat parallel to that mapped previously for short sales and options.

Law Opinion 928 (1920-2 CB 84) reads as follows:

> *No realization of gain or loss arises from a mere contract to sell real estate in the future. The sale is held to occur at the time a deed passes or at the time possession and the burdens and benefits of ownership are from a practical standpoint transferred to the buyer, whichever occurs first.* Payments made prior to the sale are to be applied in reduction of cost so far as they do not exceed cost; being treated as income to the extent, if any, to which cost is exceeded. [Emphasis supplied.]

Contemporary Utilization of an Executory Contract

An illustration of contemporary utilization can be found in Rev. Rul. 67-100, 1967-1 CB 76:

> Taxpayer, the owner of stock in a corporation which is collapsible under the terms of Sec. 341 (b)(1) of the Internal Revenue Code of 1954, entered into an executory contract of sale of the stock of the collapsible corporation on January 10, 1967. The contract provided in part that the transaction will be closed on July 2, 1967, at which time the stock certificates will be transferred to the purchaser, and that an appropriate adjustment in the purchase price will be made for any material changes in the agreed amount of the underlying assets and liabilities of the corporation occurring between the date the contract was entered into and the date of closing. The contract also indicated that all of the other benefits and burdens of ownership will remain with the seller until closing. On the date the executory contract was entered into, the three-year limitation of Sec. 341 (d)(3) of the Code had not run; however, the three-year limitation will have run by July 2, the date of closing.
>
> Held, that since the gain on the transaction will be realized when the transaction is closed and not when the executory contract of sale was entered into, the taxpayer is not precluded from the application of Sec. 341(d)(3) of the Code.

NOTE. Sec. 341 (d)(3) provides that the collapsible corporation provisions of Sec. 341 shall not apply to gains attributable to Sec. 341 assets (defined in Sec. 341 (b)(3)) which are realized more than three years after manufacture, and so forth, or purchase of the assets has been completed.

204.10 Exchange of Stock or Securities Pursuant To Corporate Reorganizations

Planning Technique

Under highly limited conditions, stock or securities can be "turned over" without incurring tax.

Generally, exchanges of stock for stock are taxable events. For example, if Mr. Swapper exchanges 100 shares of Space Fuels, Inc., with his neighbor in return for 100 shares of Moonlite Industries, both parties will recognize gain or loss on their transaction.

However, Secs. 354 through 358 have carved out an exception to this general rule by requiring the tax consequences of certain exchanges to be deferred where they result from "the financial readjustment of a corporation. Included within the scope of the applicable sections are mergers, consolidations, recapitalizations, and exchanges or distributions made in connection with the separation of a corporation into two or more of its economic components . . . ."[140]

In other words, "the exchanges to which Sec. 354 applies must be pursuant to a plan of reorganization as provided in Sec. 368(a) and the stock and securities surrendered as well as the stock and securities received must be those of a corporation which is a party to the reorganization . . ." (Regs. Sec. 1.354-1 (a)).

In turn, Sec. 368(a) recognizes six different types of corporate reorganizations (labeled, in practice, as Types A through F) that will generate such tax-free results. It should be stressed that these particular nonrecognition provisions are activated *only* where the underlying reorganization fits *precisely* into any one of the six statutory definitions. Furthermore, the long-standing Sec. 368 regulations impose additional criteria, such as the "business purpose test" enunciated by Regs. Sec. 1.368-1(b), which generally must be meticulously adhered to.

This deferment is accomplished by the rather prosaic process of not recognizing the gain or loss realized at the time of the current exchange. Of course, the basis of the old property carries over to the successor property. Hence, the latent gain or loss will be recognized in the next *taxable* transaction.

On the other hand, as previously mentioned in the introduction to 204, perpetual deferral may be possible if (a) the tax postponement is continued ad infinitum through a series of tax-free exchanges and/or (b)

[140]Mertens, *Code Commentary,* Secs. 354-358: 1.

death intervenes to provide a stepped-up basis.

Therefore, to continue with our example, Knowledgeable (in contrast to Mr. Swapper) can exchange his shares of Sophisticated Enterprises for shares of Galaxian Products, Inc. *without* recognizing any gain or loss where such a transfer is made pursuant to a "Type B reorganization." (That is, the type of reorganization defined in Sec. 368 (a) (1) (B) whereby Galaxian acquires a controlling interest in Sophisticated solely in exchange for all or part of Galaxian's own voting stock. This required control is itself defined in Sec. 368 (c) as "at least 80 percent of the total *combined* voting power of all classes of voting stock and the ownership of at least 80 percent of the total number of shares of each class of outstanding nonvoting stock . . . .")[141] (Emphasis supplied.)

Since an in-depth discussion of *corporate* reorganizations is beyond the scope of a tax study concerned with individuals, further pursuit of this highly complicated area must await an appropriate future study.

204.11 Like Kind Exchanges

Planning Techniques

Use like kind exchanges to achieve greater equities in eligible properties and to replace properties of like kind — without incurring tax in either process.

Reduce taxable boot by advantageously arranging exchanges involving mortgaged properties.

Like kind exchanges represent another breed of deferment vehicle, somewhat similar in operation and effect to the exchanges of stock that were described in 204.10. (See comparative chart, Illustration 43, page 224.)

When Are Tax-Free Exchanges Under Sec. 1031 Desirable?

Whether or not a transaction should be, in substance, within or without Sec. 1031's domain resembles, in many respects, the question pertaining to the involuntary conversion election under Sec. 1033. (See 204.5.)

Accordingly, the following factors are equally germane in this context.

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[141] Rev. Rul. 59-259, 1959-2 CB 115. Also see Rabkin and Johnson, "Federal Income, Gift, and Estate Taxation," Sec. 32.02 (2).

Favorable Factors. These are (1) the monetary benefit (interest yield) obtained through the tax deferral and (2) the possibility of a stepped-up basis through death.

Unfavorable Factor. The basis of the replacement property is reduced by the unrecognized gain. If this property is depreciable, its basis may be recoverable against ordinary income over the depreciation span.

Where the gain, if recognized, would be taxable at capital-gain rates, nonrecognition has the effect of eliminating immediate capital gains at the expense of forfeiting potential ordinary income deductions over a period of time. Of course, the possibility of capital-gains taxation, in the case of personal property dispositions, continues to diminish as time goes by because of the depreciation recapture demanded by Sec. 1245. (On the other hand, recapture of depreciation on buildings and other Sec. 1250 property could be less of a problem.) (See the recapture discussion at 203.7.)

Therefore, the decision of whether to "pay *capital* gains tax *now* and *reduce ordinary* income *later*" may have persistent significance for like kind exchanges of real property. In contrast, a similar decision regarding Sec. 1245 property will have tapering consequences.

If the client has a "like kind question," projections should be made of both the favorable and unfavorable factors. (See case study at 204.5.)

Where the capital-gains-tax/ordinary-income-deduction syndrome is *not* favorable, Sec. 1031 can be, and has been, advantageously utilized to increase clients' equities in eligible property (see comparative chart, page 224) *without* incurring tax in the process. This has been a standard operating procedure with respect to real estate, in particular, and is, of course, specifically made possible through the mortgage provisions of Regs. Sec. 1.1031(d)-2 (discussed later herein) which allow boot received by way of client mortgages assumed by the other party to be offset by consideration given by a client in the form of his assumption of said other party's mortgages.

This conclusion is especially apt in the case of land exchanges where no concern need be registered regarding the depreciation element (either with respect to recapture on the old property or as to the depreciable basis of the new property).

Controlling the Application of Sec. 1031

Since Sec. 1031 is mandatory (nonelective), your client can invoke its provisions by arranging his transaction so as to comply with the statute's

requirements. (In overly simplistic terms, transact an exchange of like kind property.) Conversely, where Sec. 1031 treatment is not desired, your client's transaction should be cast, in *substance* as well as in form, as a sale and purchase.

CAUTION. In Rev. Rul. 61-119 (1961-1 CB 395), it was held that "where a taxpayer sells old equipment used in his trade or business to a dealer and purchases new equipment of like kind from the dealer under circumstances which indicate that the sale and the purchase are reciprocal and mutually dependent transactions, the sale and purchase is an exchange of property within the meaning of Sec. 1031 . . . even though the sale and purchase are accomplished by separately executed contracts and are treated as unrelated transactions by the taxpayer and the dealer for record keeping purposes."

Does Sec. 1031 Require a Business Purpose? Aside from the inferences to be drawn from the express statutory requirements regarding the exclusive utilization of only business or investment properties in like kind exchanges, there are no apparent business purpose criteria to be found in either Sec. 1031 or its accompanying regulations.

In contrast, see Regs. Sec. 1.368-1 (b) for an *express* business purpose requirement in the case of exchanges of stock pursuant to corporate reorganizations (as discussed in 204.10).

Nevertheless, it seems most imprudent to attempt to exchange properties tax free under Sec. 1031 in the complete absence of any bona fide business reasons — such as having no intentions of *holding* the property received for business or investment use.

Reducing Taxable Boot Through Advantageous Handling of Exchanges Involving Mortgaged Properties

Planning Technique

Boot to be received by client in the form of cash should, instead, be applied first to reduce the mortgage on property to be acquired.

Regs. Sec. 1.1031(d)-2 (Example (2)) comprehensively illustrates the effect of mortgages on boot given and received in like kind exchanges. Generally, "the amount of any liabilities of the taxpayer assumed by the other party to the exchange (or of any liabilities to which the property exchanged by the taxpayer is subject) is to be treated as money received by the taxpayer upon the exchange . . . " (Regs. Sec. 1.1031(d)-2).

However, observe the one-way street result required by said Example (2):

> . . . Consideration given in the form of cash or other property *is offset* against consideration received in the form of an assumption of liabilities or a transfer of property subject to a liability . . . . [Nevertheless], consideration received in the form of cash or other property *is not offset* by consideration given in the form of an assumption of liabilities or a receipt of property subject to a liability . . . . [Emphasis supplied.]

EXAMPLE: *Avoiding recognition of gain on exchange of mortgaged property.* Client and Wheeler each own an apartment house with the following statistics (as of December 1, 1970):

	Client House	*Wheeler House*
Fair market value	$220,000	$250,000
Mortgage payable	$ 80,000	$150,000
Adjusted basis	$100,000	$175,000

The two owners agree to exchange their properties, subject to their respective mortgages. In addition, Wheeler will transfer $40,000 cash to Client. The recognized (taxable) gains would be computed in two steps, as shown in Illustration 42, page 222.

To avoid recognition of gain by his client, CPA points out to Client that, unlike Wheeler, he will not be able to fully apply all boot given as consideration in order to reduce taxable boot received. Specifically, the $70,000 excess boot given ($150,000 less $80,000) *cannot* be offset against the $40,000 cash receipt. (In contrast, this same $40,000 which is paid by Wheeler will reduce his recognized gain.)

Therefore, CPA suggests that Wheeler *not* pay this $40,000 to Client but, instead, apply it against his own $150,000 liability. Of course, the total consideration received by the parties would still be equal (i.e., $330,000 for each) and Wheeler would continue to be taxed on $30,000. *However, Client will not have any recognized gain* since he will not receive any cash and his boot received would be determined as follows:

i	Liabilities transferred	$ 80,000
ii	Less liabilities assumed	110,000
	Net liabilities transferred (line (i) less line (ii), but not less than zero)	$ None

Line			Client		Wheeler
	Realized Gain				
1.	Value of building received		$250,000		$220,000
2.	Cash received		40,000		–
3.	Liabilities transferred		80,000		150,000
4.	Total consideration received		370,000		370,000
	Less:				
5.	Basis of building transferred	$100,000		$175,000	
6.	Cash paid	–		40,000	
7.	Liabilities "assumed"	150,000		80,000	
8.	Total consideration given		250,000		295,000
9.	Realized gain (line 4 less line 8)		$120,000		$ 75,000
	Recognized Gain				
	Boot received:				
10.	Cash (line 2)		$ 40,000		$ –
11.	Liabilities transferred	$ 80,000		$150,000	
	Less:				
12.	Cash paid	–		40,000	
13.	Liabilities assumed	150,000		80,000	
14.	Total offset	$150,000		$120,000	
15.	Net liabilities transferred (line 11 less line 14, *but not less than zero*)		–		30,000
16.	Total boot (lines 10 and 15)		$ 40,000		$ 30,000
17.	Recognized gain (lesser of lines 9 or 16)		$ 40,000		$ 30,000

Three-Way Exchanges

Three-way exchanges[142] are caused by mismatched consideration and can be illustrated as follows.

Mr. Ready owns land (Site 10) which Mr. Willing will only buy for cash. Mr. Ready refuses such consideration since he abhors the tax it will

[142] This discussion, by its nature, can only scratch the surface of the three-way exchange. For those interested in further pursuing this subject, see Stephen T. Dean, "Real Estate: Defining the Outer Limits in a Sec. 1031 Three-Party Exchange," *The Journal of Taxation* (May 1968), p. 294.

generate. Of course, Mr. Ready would be eager to sell for "other land" and thereby avoid this tax in accordance with Sec. 1031.

As a solution to this problem, Mr. Able enters into the transaction, with these prime qualifications: He owns land (Site 31) which Mr. Ready finds desirable and has no hesitancy about selling for cash.

Thus emerges the Ready, Willing, and Able deal as follows: Willing buys Able's land (Site 31) for cash, and Ready and Willing exchange the land they each own.

There can be a very fine line between a taxable sale and purchase on the one hand and a nontaxable three-way exchange on the other hand. The following is offered as a summary of selected activities which the client should or should not avoid to preserve a nontaxable three-way exchange.

Permissible Activities. The following will preserve such an exchange:

1. An alternative cash sale can be provided for in the exchange contract.
2. The client may:
   (a) Require the purchaser to finance improvements on client's new property.
   (b) Make all arrangements for buying and exchanging the new property.
   (c) Contract to buy new property outright.
3. Two of the parties may be related provided all dealings are at arm's length.

Nonpermissible Activities. Client shouldn't receive the cash purchase price (for the former property) either directly or through an agent (e.g., broker). Limit client's contractual relationship only to the other exchanging party.

Tangible vs. Intangible Property Exchanges

The accompanying comparative chart (Illustration 43, page 224) compares various attributes of like kind exchanges under Sec. 1031 with exchanges of stock or securities pursuant to Sec. 368 reorganizations. Please note that these two Code sections are *mutually exclusive*. Thus, equities in stock cannot be traded upward by investors, without precipitating taxable income at each trade, as is the case with land and other tangible investments. The only recourse to such treatment for intangible investments (stocks and securities) is through the narrower *corporate* reorganization provisions (Sec. 368) with their explicit business purpose requirements, and so forth.

Comparative Chart

Tax Attribute	*Like Kind Exchanges Under Sec. 1031*	*Exchanges of Stock or Securities Pursuant to Sec. 368 Reorganizations*
1. Eligible property	Assets held either for productive use in a trade or business, or for investment; with the following exceptions: (a) Inventory or other property held primarily for sale, and (b) *Stocks*, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest. (Sec. 1031(a); emphasis supplied.)	Stock or securities of corporations that are parties to reorganizations (within the definitions set forth in Sec. 368 (a)).
2. Deferment process* mandatory or elective where statutory conditions are met	Mandatory	Mandatory
3. Can other property (known as boot) be involved in the exchange?	Yes	Only for certain specified types of Sec. 368 reorganizations.

* Deferment process for both stock and like kind exchanges consists of (a) gain or loss not recognized on current exchange and (b) carryover basis for successor property. (See 204.10.)

Technical Resume

There are various characteristics peculiar to Sec. 1031 exchanges which can be summarized as follows:

1. *Business property can be exchanged for investment property and vice versa* (Regs. Sec. 1.1031(a)-1 (a)).

2. *Definition of like kind.*

> As used in Sec. 1031 (a), the words "like kind" have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class . . . .[Regs. Sec. 1.1031 (a)-1 (b)].

3. *Investment property versus property held primarily for sale.*

> Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale [Regs. Sec. 1.1031 (a)-1 (b)].

4. *Examples of like kind exchanges.*

> . . . A taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose . . . .
>
> A taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee *with 30 years or more to run* for real estate, or exchanges improved real estate for unimproved real estate . . . .
>
> A taxpayer exchanges investment property and cash for investment property of a like kind . . . [Regs. Sec. 1.1031(a)-1(c); emphasis supplied.]

204.12 Designating Loan Repayments as Principal or Interest

Planning Technique

In appropriate circumstances, consider having debtor and creditor designate loan repayments as either principal or interest, to the maximum advantage of both parties.

Tax planning opportunities may be present when there is sufficient coalescence of the often contradictory "tax interests" of debtor and creditor to permit interest deductions and interest income, respectively, to be reported at a mutually advantageous time.

This timing control is possible by virtue of Rev. Rul. 63-57 (63-1 CB 103) summarized as follows:

> Where a borrower and a lender designate, in a bona fide and arm's length agreement, that loan installment payments by the borrower on a loan, made at a discount, shall be applied first to loan principal, the

lender, employing the cash receipts and disbursements method of accounting, is not required to include in gross income as interest received any portion of such payments received until after the amount he actually advanced to the borrower has been recovered. Conversely, no interest paid deduction will be allowed the borrower, on the cash receipts and disbursements method of accounting, until after the amount he actually received has been repaid . . . .

The planning implications of this ruling are self-evident. Its actual implementation, naturally, depends upon the extent that the converse situations of the two parties "fit."

Planning Considerations

Administrative Application. In issuing this ruling, the Service simultaneously withdrew its 1956 nonacquiescence in *O'Dell* (26 TC 592 (1956)) and substituted an acquiescence. However, this 1963 reversal of the policy enunciated by the Service in 1956 should be carefully weighed, and cautiously used, by clients and their advisors in the light of what, perhaps, may be another shift in the way the wind blows. This latest thinking on the subject is expressed in Rev. Rul. 68-586 (1968-2 CB 195) which reads as follows:

A taxpayer entered into a long-term savings arrangement with a bank. The plan purports to make any interest credited under the plan nonwithdrawable until the maturity date specified in the agreement but at the same time provides for free withdrawal of amounts not in excess of the amount of the principal.

Held, since the taxpayer is permitted to make withdrawals at any time up to an amount equaling his deposits of principal, until that amount has been withdrawn there is no substantial limitation or restriction, within the meaning of Sec. 1.451-2 of the income tax regulations, which would operate to prevent constructive receipt of the interest as credited.

Inapplicability to Sales of Exchanges of Property. This planning technique does *not* appear to lend itself to installment sales of property in view of the regulatory conditions extracted for avoiding the imputation of interest income. Specifically, to bypass such imputed interest (at the rate of 5 percent per annum compounded semiannually), Regs. Sec. 1.483-1 (d) (2) requires a minimum rate of "4 percent simple interest per annum, *payable on each installment of principal at the time such installment is payable . . . .*" (Emphasis supplied.) (See the further discussion of the effect of imputed interest on installment sales at 204.6.)

204.13 Return of Capital Distributions

Planning Technique

After-tax yields of stock as well as bonds should be among the factors involved in investment decisions.

A taxable dividend is defined as a distribution by a corporation to its shareholders of money or other property out of either its current or accumulated earnings and profits. If a distribution exceeds the corporation's earnings and profits, the excess amount is considered a "nontaxable dividend" and receives the following favorable treatment:

(a) No income, of any variety, need be reported until the basis (e.g., cost) of the stock has been fully recovered.

(b) "That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, *shall be treated as gain from the sale or exchange of property.*" (Sec. 301 (c) (3) (A); emphasis supplied.)

NOTE. In view of this potential capital gains tax, it is misleading to consider these distributions as true "nontaxable dividends."

Effect of Depreciation and Depletion on Earnings and Profits

Earnings and profits generally are reduced by the amount of depreciation deducted in determining a corporation's annual tax liability. Thus, the use of accelerated depreciation can increase the amount of such nontaxable dividends. This practice appears to have been especially prevalent in the public utility and real estate industries.[143]

On the other hand, a corporation that uses percentage depletion in computing taxable income must, nevertheless, use cost depletion in determining its earnings and profits. (Regs. Sec. 1.312-6(c)(1).)

Future Restriction to Straight-Line Depreciation. Consequently, for taxable years beginning after June 30, 1972 (e.g., calendar year 1973), only straight-line depreciation can be used to compute earnings and profits (or any similar method providing ratable depreciation over an asset's useful life) (Sec. 312 (m)).

When property depreciated under this provision is sold, and so forth, the gain or loss for earnings and profits purposes is based on depreciation

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[143] See S. Rep. No. 91-552, 11/21/69, p. 176.

allowed or allowable in computing earnings and profits — and not on depreciation allowed or allowable for determining taxable income.

EXAMPLE. Laser Power Co. acquired equipment in 1973 for $1,000,000 which it sold in 1980 for $500,000. Using a ten-year useful life, it claimed sum-of-the-years digits depreciation of $910,000 on its tax returns during this period, but was limited to straight-line depreciation of $700,000 in calculating its earnings and profits. Therefore, only $700,000 is used to compute the gain for earnings and profits purposes, as follows:

Proceeds of sale		$500,000
Less — adjusted basis of equipment:		
Original cost	$1,000,000	
Less — depreciation allowed or allowable	700,000	
Adjusted basis		300,000
Gain (increase in earnings and profits)		$200,000

The gain based on depreciation claimed for tax return purposes would be $210,000 greater (or $410,000).

Nontax Factors

Judged solely from a tax viewpoint, so-called nontaxable dividends obviously have extremely attractive features. However, whether they constitute the *best* investment medium for the client is, naturally, another matter. Of course, their favorable tax characteristics — as well as the prospective adverse change in the law — should be taken into account, along with all other financial facets, in arriving at the most advisable *overall investment* decision. It is at this point though, that the CPA, as a tax man, must himself defer to the investment adviser in order to achieve the well-rounded opinion so vital to the client's best interests.

204.14 Avoiding Actual or Constructive Receipt Of Unwanted Income

Planning Technique

1. *Use installment sales.*
2. *Avoid actual or constructive receipts, including escrow arrangements without substance.*
3. *Consider feasibility of restricted receipts, such as bona fide loans, substantive escrow or trust arrangements in appropriate circumstances, and nonnegotiable contractual obligations.*

One method of income deferral that is explicitly authorized by Sec. 453 is, of course, the installment method for reporting sales of property, which was further discussed in 204.6.

Other methods of avoiding unwanted income must depend upon successful passage of the extremely realistic and stringent tests developed over the years by the courts and the IRS. Generally, these tests require that *income* be reported when actually *or constructively* received in the form of cash, cash equivalent or other economic benefit.[144] Thus it is axiomatic that the path to income postponement demands scrupulous navigation around these shoals of tax-revenue protection. Any planning in this area must satisfactorily answer these questions:

1. Can actual, physical receipt be deferred?
2. If so, can the "constructive receipt doctrine" be successfully overcome? To what extent will the "economic benefit theory" apply to an escrow arrangement without substance?
3. Do all receipts necessarily constitute income? When will loan, escrow or trust arrangements, and nonnegotiable contractual obligations effectively defer income?

Naturally, precise answers to these questions can only be supplied for a given situation by the practitioner and his client. However, perhaps the stage can be set at this point with some broad-gauge factors to consider when wrestling with these problems.

NOTE. As stated in 101, this tax study is concerned with individuals on the cash-basis method of accounting. Therefore, this discussion does not consider the reporting of income by accrual method individuals.

Nevertheless, mention might be made of new rules to be issued by the IRS (announced on August 6, 1970) which would allow accrual method taxpayers to defer the inclusion of advance payments in their income under specified circumstances.[145]

Deferring Actual Physical Receipt

As was similarly stated in connection with the postponement of deductions, this action must be viewed within the context of realistic financial possibility *and desirability*. Therefore, the matter of postponing income for tax purposes must also be concerned with inherent business

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[144] Regs. Sec. 1.446-1(c)(1)(i) and Sec. 1.451-1(a); *Sproull*, 16 TC 244, aff'd CA-6, 194 F2d 541.

[145] See Proposed Regs. Sec. 1.451-5 regarding advance payments for future delivery of goods and Rev. Proc. 70-21 (IRB 1970-35) dealing with payments (or amounts due and payable) for services to be performed by the end of the next taxable year.

exigencies, including monetary factors (discussed in 104.2), as well as legal requirements that would be involved in such a decision. This requires, for example, an evaluation of the debtor as a continued credit risk.

Moreover, do not forget that some debtor will always be the inevitable other party to this transaction. Consequently, the effect of a stated payment on the debtor's tax plans may also have to be considered.

Avoiding the Snares of Constructive Receipt And Economic Benefit

Planning Technique

Merely contractually arranging for future receipts, presently belonging to others, avoids their immediate taxability. However, do not buttress such contract with any external segregation of funds through a trust, escrow agent, and so forth. Also, earnings on these receipts, while held by the payor, should not *inure to the payee.*

The constructive receipt doctrine was previously mentioned in our discussion of income acceleration. In essence, it turns upon the *availability* of income *except* where such control over its receipt is subject to substantial limitations or restrictions.[146]

This doctrine is further delineated in Rev. Rul. 60-31 (1960-1 CB 174). The general principles of this ruling can be stated as follows:

1. A mere promise to pay, not represented by notes or secured in any way, is not regarded as a receipt of income within the intendment of the cash receipts and disbursements method.
2. Taxpayers on a receipts and disbursements basis are required to report only income actually received although a binding contract may entitle them to receive more in future years.
3. This should not be construed to mean that under the cash receipts and disbursements method income may be taxed only when realized in cash. For, under that method, a taxpayer is required to include in income that which is received in cash or cash equivalent. And, the "receipt" contemplated by the cash method may be actual or constructive.
4. Thus, under the doctrine of constructive receipt, a taxpayer may not deliberately turn his back upon income and thereby select the year for which he will report it. Nor may a taxpayer, by a private agreement, postpone receipt of income from one taxable year to another.

[146] See Regs. Sec. 1.451-2(a).

5. However, the statute cannot be administered by speculating whether the payor would have been willing to agree to an earlier payment.

It is clear that the doctrine of constructive receipt is to be sparingly used; that amounts due from a corporation but unpaid are not to be included in the income of an individual reporting his income on a cash receipts basis unless it appears that the money was available to him, that the corporation was able and ready to pay him, that his right to receive was not restricted, and that his failure to receive resulted from exercise of his own choice.

6. Consequently, it seems clear that in each case involving a deferral of compensation a determination of whether the doctrine of constructive receipt is applicable must be made upon the basis of the *specific* factual situation involved.

The ruling then proceeds to apply these principles to five situations involving deferred compensation arrangements. Although Rev. Rul. 60-31 is concerned with deferred compensation, its precepts would appear equally appropriate to other types of income.

Factual Situations That Avoid Constructive Receipt. According to Rev. Rul. 60-31, mere contractual rights, in the following situations, were sufficient to overcome application of the constructive receipt doctrine.

Employees Taxable Only on Actual Receipt of Installment Payments in Cash or Other Property Previously Credited to Their Accounts: Under the terms of an employment contract, an employer is under a merely contractual obligation to make payments when due. The parties did *not* intend that amounts in a bookkeeping reserve account be held by the employer in trust for the employee.

There is no specific provision in the contract for forfeiture by the taxpayer of his right to distribution from the reserve; and, in the event he should die prior to his receipt in full of the balance in the account, the remaining balance is distributable to his personal representative at specified rates.

NOTE. Pre-1969 Regs. Sec. 1.402(b)-1(a)(1) provides that non-forfeitable contributions, on behalf of an employee, to a nonexempt trust are immediately taxable to the employee. However, this provision is inapplicable to situations, such as examples (1) and (2), where a trust for the employee's benefit is *not* created. Moreover, the restricted property rules (204.3) would not apply since these types of arrangements are *unfunded.*

Author Taxable Only on Royalties Actually Received in Cash or Other Property Pursuant to Supplemental Agreement Made Before Royalties Were Earned: A principal agreement provided that royalties were payable substantially as earned, and this agreement was supplemented by a further concurrent agreement which made the royalties payable over a period of years. The supplemental agreement was made on the same day as the principal agreement and the two agreements were a part of the same transaction.

Under this supplemental contract, the publisher cannot pay the author more than a designated amount in any one year. Sums in excess of this amount, that accrue in any one year, are to be carried over by the publisher into succeeding accounting periods; *and the publisher is not required either to pay interest to the author on any such excess sums or to segregate them in any manner.*

QUERY. Can constructive receipt be avoided if the creditor is willing to make immediate payment?

In *Ray S. Robinson* (44 TC 20 (1965), acq. IRB 1970-34, 6) the Tax Court noted that the government did not base its constructive-receipt argument on the creditor's willingness to make full payment immediately after the fight in issue. "Indeed the government refers to Example (3) in Rev. Rul. 60-31 . . . *implying that a bona fide contract providing for deferred payments would be given effect notwithstanding that the obligor might have been willing to contract to make such payments at an earlier time* . . . . (Page 36; emphasis supplied.)[147]

Factual Situations That Do Not *Avoid Constructive Receipt.* According to Rev. Rul. 60-31, two situations that would trigger application of this doctrine are deferral arrangements with co-members of a joint venture and escrow arrangements without substance, described respectively below.

Actor Immediately Taxable on His Share of Net Profits Belonging to Him as Member of Joint Venture Producing Theatrical Performance: In this case, the actor and the producer are each "acting" in their own right, the proposed performance is a joint venture, and the actor's status, as concerns the producer, is neither that of employee nor independent contractor. The actor's annual share of the play's net profits are currently taxable to him, even though the joint venture retains physical possession of 75 percent of such profits during the run of the play pursuant to arrangement with the actor. Thus, the actor has authorized such

[147]Also see B. J. Abrams, "Income Deferral," 25 NYU Proc. 577 (1967).

possession and subsequent distribution of the accumulated profits (which are payable after the play closes). See Rev. Rul. 70-435 (IRB 1970-34, 12), modifying Rev. Rul. 60-31.

Football Player Taxable on Bonus Paid, at His Suggestion, to Escrow Agent Designated by Him: A player could have demanded and received a bonus when he signed a standard player's contract. However, an escrow agreement was executed under which the football club paid the bonus to a bank who, as escrow agent, agreed to pay this amount, *plus interest*, to the player in installments.

The agreement also required the escrow account to be in the player's name and, in the event of his death during the escrow period, the balance due is to become part of his estate.

In holding that the entire bonus was constructively received when paid to the escrow agent, Rev. Rul. 60-31 also invoked the economic benefit theory espoused in the *Sproull* decision (to follow) in addition to the general principles described above.

Application of Economic Benefit Theory: In 1945, Mr. Sproull's employer transferred $10,500 to a *trust* in consideration of his prior services. Fifty percent of this amount was payable to Sproull in 1946; with the balance, including income, payable in 1947. In the event of prior death, these sums were payable to his personal representative or heirs. The Tax Court (affirmed by the Sixth Circuit) held the entire amount taxable in 1945, reasoning as follows:

> . . . It is undoubtedly true that the amount which the Commissioner has included in petitioner's income for 1945 was used in that year for his benefit . . . in setting up the trust of which petitioner, or, in the event of his death then his estate, was the sole beneficiary . . . .
>
> The question then becomes . . . was "any economic or financial benefit conferred on the employee as compensation" in the taxable year. If so, it was taxable to him in that year. This question we must answer in the affirmative. The employer's part of the transaction terminated in 1945. It was then that the amount of the compensation was fixed at $10,500 and irrevocably paid out for petitioner's sole benefit. . . [16 TC 244 (1951), at page 247].

The Revenue Service then applied the principles stated in the Sproull case to the football player's facts and concluded that his bonus was fully taxable in the year in which the club unconditionally paid such sum to the *escrow agent*.

NOTE. See further discussion regarding "substantive escrow arrangements" where factual variations may yield opposite results.

Restricted Receipts May Not Constitute Income

Planning Technique

Financial position permitting, create nontaxable "loans" by encumbering cash receipts with substantial restrictions as to their use or disposition by the recipient. Also consider the use of escrow or trust arrangements, when feasible, as well as nonnegotiable contractual obligations.

> . . . It is fundamental that not all receipts of money or property by a taxpayer constitutes a part of his gross or taxable income. Two examples of receipts which are not income are money borrowed by a taxpayer, which the circuit court in *Consolidated-Hammer Dry Plate & Film Company* v. *Commissioner* (317 F2d 829, CA-7) considered the advances there at issue to be, and deposits so restricted as to use by the recipient as to cause them in effect to be loans, as was held to be the substance of the transactions in the other cases relied on by petitioner. . . [*Hagen Advertising Displays, Inc.*, 47 TC 139 (1966); at page 145.]

The present state of our administrative and judicial climate regarding the taxation of gross receipts can be broadly summarized as follows:

1. Practically all types of receipts are taxable where the recipient has uncontrolled dominion over their utilization.
   The "matching concept" employed in financial accounting is irrelevant for tax purposes. (The matching concept attempts to equate revenues with expenses in order to ascertain net income.)
2. At the same time, exceptions to immediate taxation exist for various types of receipts, such as the proceeds of bona fide loans or certain deposits received under carefully defined circumstances.

It is becoming increasingly obvious that clients will not be able to "have their cake and eat it too" in the area of gross receipts taxation. This means, in effect, that all taxpayers are being compelled by the taxing authorities, slowly but surely, to account for their receipts on a strict cash basis. This climate has considerably narrowed the advice to be given in planning for the deferral of tax on actual cash receipts. Where a client's financial requirements or desires dictate the uncontrolled and outright possession of funds received (or to be received) from customers, one's advice can only be limited to preparing for current payment of tax thereon. However, such consolation can be replaced by more constructive suggestions if the client's financial environment is more flexible. It is still possible to avoid immediate taxation of certain receipts where they

are, in effect, tantamount to the proceeds of authentic borrowing — albeit from customers. Therefore, where customers' advances are needed only for temporary working capital requirements, current taxation can be prevented by casting these gross receipts transactions as loans, in substance as well as in form.

In addition, where factually possible, certain deposits can still be received without generating immediate tax where open or contingent transactions are involved or where the deposits are received in trust.

Illustrative suggestions follow which may enable a taxpayer to avoid actual or constructive receipt of unwanted income (i.e., the borrowing of working capital from customers, receiving deposits in open, contingent transactions, receiving deposits in trust as escrow accounts and arranging for nonnegotiable obligations).

Borrow Needed Working Capital From Customers. In essence, this recommendation requires a reversal of the debtor-creditor relationship between the client and his customer. It cannot be sufficiently emphasized that the dividing line between taxable receipts and nontaxable loan proceeds is extremely thin and depends upon the genuineness of the purported loan transaction. For example, in *Modernaire Interiors, Inc.* (TC Memo 1968 - 252), the Tax Court stated:

> . . . The instant case is distinguishable on its facts from the foregoing cases relied upon by petitioner involving loans or restricted deposits. In the present case the deposits are without restriction as to use by the petitioner and the petitioner is under no legal obligation to refund them. Clearly the customers intended them as payments for goods and not as loans subject to repayment . . . .

Receive Deposits in Open, Contingent Transactions. The following situations exemplify various types of nontaxable deposits.

Sale of Real Estate: In Rev. Rul. 69-93 (1969-1 CB 139), the IRS held that a nominal payment made when a real estate purchase contract is signed is treated as a deposit and is taken into account as income in the year the actual sale is consummated.

A deposit was received by A in October 1967. The Service ruled that:

> A did not realize gain or loss in October 1967 since on that date there was a mere execution of the contract to sell real estate in the future. The sale occurred at the time the deed passed or at the time possession and the burdens and benefits of ownership were, from a practical standpoint, transferred to the buyer. Since these events all

took place on March 1, 1968, that is the date on which the sale occurred. The payment made prior to the sale is deemed to be in the nature of a deposit on the purchase price of the property and is to be taken into account in determining the character and amount of income or gain or loss, in the year of sale . . . .

Executory Contracts for the Sale of Unascertained Goods: Taxpayer was in the business of buying coal and coke at wholesale and selling at retail. The products were in short supply and the taxpayer was able to obtain deposits from its customers to be applied on the price when and if the coal and coke was delivered to them. The balance of deposits at the end of 1943 would apply to the price of deliveries made the next year or refunded if the taxpayer could not obtain the products. The taxpayer did not know what the cost or selling price would be in 1944. The Court said:

> In the instant case the transactions were executory contingent contracts for the sale of unascertained goods, and they were in no sense closed transactions. The deposits made incident to these transactions would be gross income only if they represented gains from closed and completed sales, or at least from contracts of sale. Since they were not gains from such sales, they were not gross income, and therefore, were not taxable to petitioner in 1943.[148]

Contingent Contracts for Sale of Space: In *Woodlawn Park Cemetery Co.* (16 TC 1067 (1951)), the taxpayer was planning to build an additional unit to its mausoleum and entered into contracts for sale of burial space therein. The contracts did not require the company to complete the construction and it could refund the purchasers' deposits and be relieved of liability. Also, the purchasers could under certain conditions refuse to accept the space offered, and be entitled to a refund.

The Court noted that a sales agreement from which either party may withdraw is not a completed sale and that the contracts at that time were executory and contingent contracts to sell and not completed sales. The Court held, following *Veenstra & De Haan Coal Co.*, that no part of the deposits made by purchasers under these contracts was taxable income to the taxpayer in the years received, which were prior to completion of construction and before the costs of building were ascertainable.

Conditional or Tentative Partial Payments: Partial payments received under DOD contracts for construction of equipment were reportable as income only upon delivery and acceptance of the product.

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[148] *Veenstra & De Haan Coal Co.*, 11 TC 964 (1948). Also see *Watkins*, CA-1, 287 F2d 932.

The Court observed that the partial payments were to be made prior to acceptance of the finished product and viewed them as attributes of a financing arrangement in the nature of a loan, the taxpayer's right to retain them being conditional or tentative until such final acceptance.[149]

Use of Trust or Escrow Accounts. In *Angelus Funeral Home,*[150] taxable income was not created by the receipt of funds under written instruments of trust which were deposited in segregated accounts.

NOTE. Interest on these deposits was paid to the funeral home. However, this did not alter the decision since the Court looked upon this as the equivalent of a trustee's fee.

Nonnegotiable Contractual Obligations. Rev. Rul. 68-606 (1968-2 CB 42) states the following principles:

1. Taxable income is not limited to cash receipts, but may also include the fair market value of other property received.
2. Certain evidences of indebtedness are property deemed equivalent to cash, but not all evidences of indebtedness are includible in income.
3. "... However, a deferred-payment obligation which is readily marketable and immediately convertible to cash is property the fair market value of which is income to a cash-method taxpayer in the year of receipt to the extent of that fair market value. . . . "

Consequently, it was held that a contract providing for future installment payments precipitated income when it was executed. Income could not be reported upon receipt of the installment payments since (a) they were unconditionally payable by a solvent obligor, with unquestioned credit, whose liability was evidenced by an enforceable contract and (b) the contract rights were freely transferable and readily saleable.

Conversely, the ruling expressly indicated that income would not be realized until actual receipt of cash payments if the installment obligation had not *been transferable and readily saleable.*

Whether it would be desirable to defer income in this manner would also depend upon nontax factors such as the obligor's credit standing and a client's financial position, which may or may not permit relinquishment of immediate cash conversion rights such as discounting or factoring. (The installment sale method described in 204.6 might also be considered, when appropriate.)

[149] *Consolidated-Hammer Dry Plate & Film Co.*, CA-7, 317 F2d 829.

[150] *Angelus Funeral Home,* 47 TC 391 (1967), acq.; aff'd on other grounds.

Maximizing Income Tax Deductions

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Chapter 3

Maximizing Income Tax Deductions

As a result of reading Chapter 2, we assume that the CPA has been able to function as a catalyst for his clients, empowering them with greater and faster accumulations of income. Naturally, such increased wealth often serves, in turn, as a stimulant to commensurately greater and faster spending of these carefully accumulated resources. It will be the object of this chapter (as well as Chapter 4, to a considerable extent) to minimize this dissipation of a client's wealth by illuminating those paths that lead to the pleasurable "land" of shared financial burdens, otherwise known as tax deductions.

In this sojourn to Valhalla, we shall, of course, only be dealing with expenditures that are primarily motivated by *nontax* considerations or needs. Thus, "Livingstone-type" transactions (i.e., those designed solely to achieve a tax profit), which have met with administrative and judicial disfavor, will be bypassed in order to concentrate on mitigating the financial impact of disbursement decisions emanating from business or personal desires or necessities.

NOTE. For an insight into the current evaluation of the surrealistic tax-oriented device, see the court of claims decision in *Sumner E. Brown* (396 F2d 459) which concludes as follows:

> . . . The absence of any economic substance was the underlying rationale for denying an interest or a business expense deduction in the Livingstone-type transaction. Those same factual circumstances have no more economic reality when the out-of-pocket expense is characterized as a capital loss, in the absence of proof that the entire transaction was entered into for profit. Plaintiffs therefore are not entitled to recover, and the petition is dismissed. . . .

Also see Rev. Rul. 70-333 (IRB 1970-26, 12) where the Service stated that it will *not* follow a Tax Court decision (*Nichols*, 43 TC 842, nonacq.)

allowing a theft loss deduction for out-of-pocket expenses connected with a tax-savings sham transaction which was entered into in reliance upon fraudulent misrepresentation.

Of course, even though we shall only be cruising within the purified realm of economic realty, we must also always be mindful of the permeating and rigorous "doctrine of legislative grace." As the Supreme Court said in *New Colonial Ice Company, Inc.* v. *Helvering* in 1933: "Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed. . ." (292 US 435).

301 The Standard Deduction

You may be somewhat skeptical about the planning opportunities present in so mundane a subject as the standard deduction. However, even in this fairly straitjacketed area there are a few planning techniques that might be kept in mind, even though their tax-savings effect may not be monumental.

301.1 Doubling-Up on Itemized Deductions

Planning Technique

In carefully selected circumstances, it may be possible to increase the client's total deductions over a span of two or more years through the following process: (1) shift as many itemized deductions as possible from a standard deduction year into a contiguous year or years, and (2) elect the standard deduction for the desired year.

Alternating itemized and standard deductions in this fashion is a further extension of the subject "tax savings through proper timing" which was previously discussed in 104.2.[1] The alternating standard-deduction techniques, illustrated below, can embellish the general timing techniques highlighted in Chapter 1.

[1]See Controlling Taxable Income Between Years by Accelerating or Postponing Income and Deductions, 104.2.

Matching Deductions With Fluctuating Income. One particularly useful application of this technique can occur when retirement is anticipated for an executive, professional person, or any other client rendering personal services. In this type of situation, it is usually quite worthwhile to double up on itemized deductions in the client's last active year — especially where a severe drop-off in income is visualized for his first retirement year.

Coordination With the Medical Deduction. In 104.2, it was stated that "the existence of the one percent and 3 percent (of adjusted gross income) limitations on the deductibility of medical expenses strongly compels proper attention to the timing of medical payments. Accordingly, they should be concentrated in a year in which the limitations have already been exceeded as opposed to a year in which such payments would be wasted by these statutory obstacles. . . . "

Thus, the desirability of concentrating medical payments in a given year may tend to set the stage for concentrating other itemized deductions as well.

Alternating Between Years. Alternating the standard deduction between itemized deduction years can increase aggregate deductions for the time span involved by the amount of the actual standard deduction allowable for each non-itemized deduction year.

However, one cannot afford to win the battle of additional deductions only to lose the war of overall tax savings. This unfortunate, embarrassing, and (to say the least) costly consequence can occur if one's zeal for shifting deductions collides head-on with the cardinal principle of avoiding undue fluctuations in annual taxable incomes. (See 104.2.) Thus, one must never lose sight of the effect of doubling-up upon the clients' tax brackets for the entire span of years involved in a doubling-up/alternating standard deduction cycle.

For example, in actual practice, the tax savings generated by the additional standard deductions may be frequently eroded by the higher brackets to which the client's income is exposed in the standard deduction year. Therefore, this technique requires much foresight and advance planning.

Economic Practicality

The doubling-up approach is firmly based on the supposition that economic conditions will enable tax benefits to be achieved by initially

permitting the shifting of deductions. Thus, the express or tacit cooperation of the client's creditors is necessary in order to be able to postpone and (to a lesser extent) accelerate deductions. For example, a shift of a medical payment from 1970 to 1971 may be possible where the service is rendered in November, 1970 but virtually impossible for services performed in February, 1970.

In addition, the monetary implications of shifting deductions should be taken into account. The interest expense factor inherent in the acceleration of deductions will have a retarding effect on the attainable tax benefits. Of course, the extent of this retardation will vary commensurately with the length of the acceleration (i.e., prepayment) period. As indicated in the discussion of monetary factors in 104.2, the shift of a property tax payment from January 1, 1971 to December 31, 1970 should be financially neutral — in contrast to a 1970 prepayment of a charitable contribution pledge not due until 1975.

On the other hand, the financial overtones are just the opposite when deductions are postponed.

Finally, certain deductions are not susceptible to shifting and may thus reduce the total tax savings possible through doubling-up. Examples of these nonshiftable deductions are state sales and gasoline tax and state income taxes where periodic withholding and/or estimated tax payments are required, unless state law permits their prepayment (as is the case in Wisconsin).

Technical Resume

Under Code Sec. 141 (a), for years beginning after 1969, the standard deduction will be the larger of the (a) percentage standard deduction or (b) low income allowance. (See 301.2.)

The percentage standard deduction, which previously had been 10 percent of adjusted gross income with a $1,000 maximum deduction, remains unchanged for 1970 but will increase in stages over the succeeding three years, as follows:

Year Beginning	*Percentage*	*Maximum amount*
1970	10%	$1,000
1971	13%	1,500
1972	14%	2,000
After 1972	15%	2,000

Married couples filing separately use the same percentages but are limited to only one-half of the maximum amounts shown above.

301.2 Utilizing the Low Income Allowance

Planning Technique

Gifts of income-producing properties should be made to take full advantage of the low income allowance.

In 1964, the minimum standard deduction was introduced in order to remove the burden of the federal income tax from low-income persons. This minimum deduction has been updated with a low-income allowance, as follows:

Beginning in:	*Allowance*
1970	$1,100
1971	1,050
After 1971	1,000

In 1970 and 1971 only, the low-income allowance in excess of the prior minimum standard deduction (which would have been available but for its repeal) is reduced if adjusted gross income exceeds the new nontaxable levels of income ($1,100, or $1,050 for 1971, plus amount of exemptions). These reductions are termed "income phase-outs" and are further explained in the technical resume to appear later.

Planning Applications

As a result of the low income allowance, each of a client's unmarried children would be entitled to the standard deduction of $1,100 in 1970. In addition, of course, each child would have the benefit of his (or her) own personal exemption of $625. Therefore, $1,725 of automatic deductions are available to completely offset equivalent amounts of gross income. While $1,725 of tax-free income may not be a staggering amount, the benefits of this technique can vary proportionately with the number of children and other suitable donees that can be brought into such a gift program.

Furthermore, this technique reflects an annual income tax savings. Therefore, its ultimate value should be measured on a cumulative basis.

Gifts of this nature are also advantageous for estate and gift tax purposes. See 202.2.

Technical Resume

The "income phase-outs" mentioned previously are computed as shown in Illustration 1, page 246.

Accordingly, assuming a joint return, the low income allowance would then be determined as shown in Illustration 2, page 246.

Illustration 1

	1970		1971	
1. Adjusted gross income		$10,000		$10,000
Less:				
2. Tentative low-income allowance	$1,100		$1,050	
3. Deduction for 4 exemptions:				
1970 (at $625 each)	2,500	3,600		
1971 (at $650 each)			2,600	3,650
4. Amount of adjusted gross income in excess of non-taxable level of income		$ 6,400		$ 6,350
5. Reduction in portion of low-income allowance exceeding prior minimum standard deduction:				
1970: 1/2 of line 4		$ 3,200		
1971: 1/15 of line 4				$ 423

Illustration 2

6. Basic allowance (generally equal to prior minimum standard deduction)		$ 600		$ 600
7. Additional allowance*	$ 500		$ 450	
8. Less: reduction (line 5, Illustration 1)	3,200	0	423	27
9. Low-income allowance		$ 600		$ 627
*Initial amount (Sec. 141 (c))	$ 900		$ 850	
Less – $100 multipled by number of exemptions	400		400	
To line 7 above	$ 500		$ 450	

It should be noted that such detailed computations of low-income allowances will be obviated by their reflection in the optional tax tables authorized by Sec. 3. Moreover, as previously indicated, the "income phase-out" reduction will be inapplicable after 1971.

In the case of married individuals filing separate returns, the following allowances are substituted:

Year	*Allowance*	*Maximum Allowance*
Beginning in 1970 and 1971	$100, plus $100 for each exemption	$500
After 1971	$500	$500

If such separate returns are filed, the low-income allowance is not allowed unless the taxpayer's spouse also claims the standard deduction (i.e., the larger of the percentage standard deduction or the low-income allowance). See Sec. 142(a).

Special Relief for Abandoned Families. Sec. 143 (b) provides special relief for a family abandoned by one of the parents; in such case, the other parent can claim either the full low-income allowance or the full maximum percentage standard deduction allowable for single individuals rather than for married persons filing separately. In addition, under Sec. 2 (c), the deserted spouse can use the head-of-household tax rates, if otherwise eligible.

To qualify for these relief measures, a deserted spouse must:

- File a separate return.
- Maintain as her or his home a household which is the principal place of abode of a dependent.
- The dependent in question must be a son or daughter (or stepson or stepdaughter).
- The individual must be entitled to a dependency deduction for the son or daughter.
- The individual must furnish more than one-half the cost of maintaining the household.
- During the entire taxable year the individual's spouse must not be a member of the household in question.

301.3 Planning for the Use of the Standard Deduction

Nonbinding Election. Miscalculations as to the use of the standard deduction can be remedied since Sec. 144(b) and Regs. Sec. 1.144-2 permit the standard deduction election to be cancelled and itemized deductions claimed for any year still open under the statute of limitations. This change can be reflected by a claim for refund or by an offset against an asserted deficiency. Such rescission is not possible if the tax liability for the year, for either the taxpayer or his spouse, has been compromised under Sec. 7122.

These same rules also apply to the reverse situation where itemized deductions are originally claimed.

Forfeiture of Certain Credits. Sec. 36 of the Internal Revenue Code disallows certain tax credits, such as the foreign tax credit authorized by Sec. 33, if the standard deduction is elected.

Miscellaneous. Spouses filing separate returns must make consistent choices regarding itemized or standard deductions (Sec. 142(a)). However, such consistency appears unnecessary for abandoned spouses. (See 301.2.)

The standard deduction is not available for a short period return arising from a change in accounting period (Sec. 142 (b) (3)).

302 Personal Exemptions

Planning for personal exemptions, at least from a tax standpoint, is primarily a defensive matter since the financial obligations involved in the support of others cannot usually be undertaken on a net after-tax profitable basis. Moreover, exemptions for age (65 and over) and blindness are beyond the control, and indeed desire, of taxpayers. Finally, the use of marriage as a tax planning tool, either to obtain an exemption (on a separate return) for a spouse who has no gross income (and without regard to the usual support requirements) or to obtain joint return benefits is a subject most obviously beyond the scope of this study for reasons of both discretion and valor.

Nevertheless, we shall proceed with a brief review of some of the more plannable areas in this basically "salvage-type" arena.

302.1 Planning to Meet Dependency Tests

Planning Technique

To preserve dependency exemptions, take cognizance of special requirements concerning parents and children. Also, use multiple support agreements where applicable.

Proper documentation is essential in sustaining these deductions.

The following five tests must be met before a person can be claimed as a dependent.

1. Support. More than 50 percent of the dependent's total support during the calendar year must be furnished by the taxpayer except where multiple support agreements are filed or children of divorced or separated parents are involved (as discussed later).

2. Gross Income. The dependent's gross income (i.e., total taxable income) for the year must be less than the following amounts:

Year	*Amount*
Beginning in:	
1970	$625
1971	650
1972	700
After 1972	750

However, the gross income test does not apply in the case of children, including foster children, who either are students or under 19 years old at year end (Sec. 151 (e)).

3. *Member of Household or Prescribed Relationship.* Persons, *whether or not related,* who live with a taxpayer and are members of his household during the taxpayer's entire taxable year can qualify as dependents (Regs. Sec. 1.152(b)).

However, "an individual is not a member of the taxpayer's household if at any time during the taxable year of the taxpayer the relationship between such individual and the taxpayer is in violation of local law . . . " (Regs. Sec. 1.152-1(b)). For example, "an individual who is a 'common-law wife' . . . would not qualify as a dependent . . . if the applicable state law does not recognize common-law marriages. . . . "[2]

Various relationships of either blood or marriage are set forth in Sec. 152 (a) which do not require the dependent to reside with the taxpayer or belong to his household.

4. *Citizenship.* Generally, dependents must be citizens or residents of the United States. For several exceptions to this rule regarding certain foreign residents, see Sec. 152(b)(3).

5. *Absence of Joint Return.* Exemptions are denied if the dependent has filed a joint return for the year (Sec. 151(e)(2)). However, the IRS has relaxed this requirement if neither the dependent nor his spouse is required to file a return and the joint return is filed only to claim a refund of withheld tax.[3]

Planning Pointers

The following are among the more fundamental planning pointers to observe in order to avoid costly or inadvertent losses for dependency exemptions.

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[2] S. Rep. No. 1983 (85th Cong., 2nd sess.); 1958-3 CB 936.

[3] "Your Federal Income Tax," IRS Publication 17 (1970 ed.), p. 22.

Controlling Potential Dependent's Gross Income. To the extent possible, precautions should be taken to prevent disqualification of a would-be dependent through his receipt of small amounts of income in excess of the limitations prescribed in Sec. 151(e).

EXAMPLE. As of December 15, 1970, Mr. Penny-Wise (in the 50 percent bracket) can claim an exemption for his mother-in-law, Mrs. Pound-Foolish since all five dependency tests are met. Her gross income at this point amounts to $620.

Mrs. Pound-Foolish accepts an offer to do some piece work at home during the end of December and thereby earns $25. This additional compensation is quite costly to Mr. Penny-Wise as it will increase his tax by $312.

Of course, this lesson is inapplicable to children who are either students or under 19.

Measure Value of Potential Dependent's Joint Return. The tax benefit of a dependency exemption for a taxpayer should be compared with the advantages that would result if the would-be dependent files a joint return with his or her spouse.

Obviously, the least expensive route should be selected with the tax savings, perhaps, split among the taxpayer and the dependent's spouse.

Support in the Form of Lodging Is Measured in Terms of Fair Market Value (Regs. Sec. 1.152-1(a)(2)(i)). Since many elderly parents own their own homes, they will be considered to have furnished the fair market value of their lodging towards their own support. This factor should be kept in mind in determining the amount of a taxpayer's support that will be necessary to qualify the parent or parents as dependents.

Exempt Income of Parents May Be a Support Factor. "In computing the amount which is contributed for the support of an individual, there must be included any amount which is contributed by such individual for his own support, including income which is ordinarily excludable from gross income, such as benefits received under the Social Security Act . . ." (Regs. Sec. 1.152-1(a)(2)(ii)).

EXAMPLE. "A father receives $800 Social Security benefits, $400 interest, and $1,000 from his son during 1955, all of which sums represent his sole support during that year. The fact that the Social Security benefits of $800 are not includible in the father's gross income does not prevent such amount from entering into the computation of the total amount contributed for the father's support. Consequently, since

the son's contribution of $1,000 was less than one-half of the father's support ($2,200) he may not claim his father as a dependent" (Regs. Sec. 1.152-1(a)(2)(ii)).

NOTE: Exempt income which is not expended for support can be eliminated from consideration. Examples include situations where social security checks are deposited in savings accounts or otherwise invested.

Observe the Operation of the Unit Rule As It Affects Support of Parents. Rev. Rul. 64-222 (1964-2 CB 47)[4] enunciates the following rules regarding allocation of support contributions.

a. Where several members of a household contribute toward expenses which are equally applicable to the support of each member of the household, the contributing members will be presumed, in the absence of evidence of actual support, to have pooled their contributions to the support of the household, and each member shall be considered to have received an equal part of the pooled contributions toward his support.

   For purposes of determining who provided more than one-half the support of a member of such a household, members receiving more than they contribute will be considered to have received support from members receiving less than they contribute, to the extent the amount considered to have been received exceeds the amount contributed.

b. In the absence of contrary evidence, support supplied by persons residing outside of a household will be applied equally towards the support of each member of the household.

Where specific contributions cannot be proven, these allocation rules operate on an all-or-nothing basis by, in effect, treating the entire household as one unit in determining the percentage of support contributed by its members compared with outside support contributions. In such situations, an outsider will obtain either no exemptions at all or exemptions for all household members depending upon whether or not he contributes more than 50 percent of the total support of the *entire household.*

If the client is contributing some support to another household but does not meet the more than 50 percent test, he may be able to at least salvage one or more exemptions by specific allocations of his contributions.

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[4] Cited with approval in *De La Garza,* 46 TC 446 (1966).

EXAMPLE. Client's parents live in a home owned by his father. Their total support of $4,000 is derived from the following sources:

Fair market value of father's residence	$1,000
Father's social security	1,000
Unallocated amounts received from Client	2,000
Total support	$4,000

Since Client's $2,000 support contribution has not been allocated to either parent, the unit rule applies to deprive him of any exemptions because he will not be deemed to have contributed more than 50 percent of either parent's total support pursuant to the following computation:

	Total Amount	Allocated to Father	Allocated to Mother
Support contributed by members of household	$2,000	$1,000	$1,000
Support contributed by Client	2,000	1,000	1,000
Total support	$4,000	$2,000	$2,000

PLANNING SUGGESTION. Client can mitigate such adverse operation of the unit rule by the following procedures:

1. Client specifically allocates his contributions towards his mother's support.
2. Father specifically earmarks his social security benefits for his own support.

As a result, Client will be able to obtain an exemption for his mother pursuant to the following computation:

	Total Amount	Allocated to Father	Allocated to Mother
Support contributed by father:			
Fair market value of residence	$1,000	$ 500	$ 500
Social security	1,000	1,000	—
Support contributed by Client	2,000	—	2,000
Total support	$4,000	$1,500	$2,500

In this revised situation, Client has contributed 80 percent of his mother's total support of $2,500.

NOTE. As a practical matter, proving specific allocations may be difficult. For instance, mere designation of the intended recipient on a support check may not suffice. To the extent possible, therefore, expenses of such potential dependents should be directly paid by a taxpayer. This practice should be especially implemented in the case of

medical expenses since it will increase the taxpayer's potential medical deduction.

The unit rule can be superseded by the following special statutory provisions, which are discussed hereafter:

1. Support test for children of divorced or separated parents (Sec. 152(e)).
2. Multiple support agreements (Sec. 152(c)).

Support of Children — Special Rule for Scholarships. Scholarships received by students are not considered in determining whether a taxpayer has furnished more than half of such child's support (Regs. Sec. 1.152-1(c)).

EXAMPLE. Client's son receives a $1,000 scholarship to attend Hardnocks University for one year. Client contributes $500, which is the balance of son's support for that year.

A dependency exemption is allowable to Client since the scholarship is eliminated from the support computation.

Providing for Exemptions for Children Upon Divorce or Separation. In order to curtail extensive litigation caused by conflicting treatment accorded dependency exemptions for children on income tax returns of their divorced or separated parents, Sec. 152(e) was added to the Internal Revenue Code — effective for 1967 and subsequent years. This provision enables parents contemplating divorce or separation to specify which of them shall be entitled to exemptions for their children if certain conditions are met.[5] If not, precise rules have been established which are custom-designed to eradicate such inconsistent treatment by these parents.

Effective Utilization of Multiple Support Agreements. A multiple support agreement (authorized by Sec. 152(c)) allows a taxpayer to meet the support test even though he has not contributed more than 50 percent of a dependent's support, provided the following conditions are met:

1. No one else contributed more than half of the dependent's support,
2. The taxpayer contributed over 10 percent of such support,
3. The dependent receives over half of his support from a group of persons each of whom could have claimed him as an exemption but for the 50 percent support test, and

[5] For a liberal example, see Rev. Rul. 70-73, IRB 1970-7, 10.

4. Each member of the group, except the taxpayer, who contributed more than 10 percent of the mutual dependent's support files a statement that he will not claim an exemption for such dependent.

NOTE. Regs. Sec. 1.152-3(c) requires these statements to be attached to the taxpayer's return for the year in which such a deduction is claimed. This required statement can be executed on IRS Form 2120.

Obviously, it will be most beneficial, taxwise, to allow the supporter in the highest bracket to claim the exemption. Where there are several such high bracket supporters, annual rotation may be equitable.

Adequate Documentation May Be Vital in Sustaining Dependency Exemptions. The importance of proper records to support the various requirements for dependency exemptions cannot be sufficiently stressed. As one minute example, consider the tracing problems involved in attempting to prove that a parent's social security benefits were invested in a savings account and were not expended for his support.

Finally, observe the following excerpt from a recent Tax Court opinion as to the method of accounting for a dependent's support:

> . . . The year in which the item of support was furnished is controlling in determining the year in which the value of that support shall be included. The method of reporting income and disbursements used by the taxpayer is not relevant to the concept of support. The statute requires us to measure the value of the support "received" from petitioner as against all other sources. Thus, the fact that the taxpayer incurred an indebtedness which would be satisfied in a future taxable year is not the controlling factor; rather we look to see whether the item of support "was received from the taxpayer" during the year in question! See Rev. Rul. 58-404, 1958-2 CB 56. See also Rev. Rul. 67-61, 1967-1 CB 27. . . .[6]

303 Medical Expenses

Tax planning regarding medical expenses is quite analogous to planning for the stepped-up basis of property through inclusion in a gross estate since they share the following characteristics:

1. Significant tax savings may often be produced.
2. Such savings, obviously, cannot be actively sought for humanistic reasons. Of course, their underlying events are also beyond mortal control.

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[6] *Rose D. Seraydar*, 50 TC 756 (1968), acq. IRB 1969-5, 6.

3. Planning for such tax savings, then, must necessarily assume a passive role; only attempting to salvage some financial (tax) relief out of extremely unfortunate personal experiences.

Accordingly, tax planning for medical expenses should involve basically an awareness of the various types of expenditures that give rise to deductions so that proper and effective accountability can be maintained. In the immediately succeeding discussion, we shall concentrate on the less obvious variety of medical deduction.

303.1 Insurance, Travel, and Other Definitions

Planning Technique

Detailed knowledge of medical expense definitions will prevent inadvertent failure to claim maximum deductions.

"The term 'medical care' includes the diagnosis, cure, mitigation, treatment, or prevention of disease. Expenses paid for 'medical care' shall include those paid for the purpose of affecting any structure or function of the body or for transportation primarily for and essential to medical care. . . " (Regs. Sec. 1.213-1 (e) (1) (i)).

A study of this broad nature cannot provide comprehensive definitions of every conceivable type of medical expense. It also seems unnecessary to discuss such commonly accepted medical expenses as payments to physicians, dentists, and so forth, for medical or dental treatment. Nevertheless, selected expenses will be discussed here because they possess any one of the following attributes: (a) they have been the subject of recent legislation designed to correct areas previously shown to be troublesome in practice, (b) they are expenses which continue to be controversial, or (c) limited active-planning possibilities are involved.

Medical Insurance

For 1967 and later years, insurance premiums qualify as medical expenses only to the extent that they are allocable to "medical care." (See the broad definition of this term as set forth in Regs. Sec. 1.213-1 (e) (1) (i).)

In the case of multi-coverage contracts, (such as policies providing indemnities for loss of income, or for loss of life, limb, sight, and so forth, in addition to providing for reimbursement of medical care expenses) the following rules apply:

1. No amount is treated as paid for insurance for medical care unless the charge for such insurance either is separately stated in the contract or is furnished to the policyholder by the insurance company in a separate statement.
2. The amount, taken into account as the amount paid for such medical insurance, may not exceed this separately stated charge.
3. No amount is treated as paid for such medical insurance if this separately stated charge is unreasonably large in relation to the total charges under the insurance contract. (Sec. 213 (e) (2).)

Supplementary medical insurance for the aged under Medicare represents qualified medical insurance. However, the portion of the social security tax that covers Medicare is ineligible. (See Regs. Sec. 1.213-1(e)(4)(i)(a) which excludes any governmental tax from the definition of medical insurance.)

Limited Outright Itemized Deduction. Fifty percent of medical insurance premiums, up to a maximum of $150, are deductible *without* regard to the 3 percent of adjusted gross income limitation. The balance is deductible as medical expense — subject to the 3 percent limitation.

As a relatively minor planning item, note that $150 constitutes the maximum outright deduction for such premiums on a joint return. If a married couple files separate returns, this deduction can be doubled.

Medical Travel

Transportation Costs. Transportation primarily for and essential to medical care is a valid medical expense. Such costs include public transportation fares and variable automobile operating expenses (gas, oil, and so forth). However, Rev. Proc. 70-24 permits a standard rate of 6 cents per mile in lieu of actual auto expenses. Parking fees and tolls can be added to the standard mileage (Rev. Proc. 70-24 IRB 1970-41, 58).

The IRS recognizes transportation expenses of certain persons accompanying a patient as medical expenses of the patient as, for example, a parent who must accompany a child or a nurse accompanying a patient requiring injections, medications, and so forth.[7]

Meals and Lodging. Meals and lodging while away from home *receiving* medical treatment are not medical expenses except where included as part of a hospital bill.[8]

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[7] "Your Federal Income Tax," IRS Publication 17 (1970 ed.), p. 127.

[8] Regs. Sec. 1.213-1 (e)(1)(iv). For a recent decision to this effect, see *Robert M. Rose*, 52 TC 521 (1969).

However, in a fairly recent case of first impression, a divided Tax Court allowed these deductions en route to obtain medical treatment.[9]

Special Foods

Special foods, even though prescribed by a doctor to control disease, are not deductible where they substitute for regular diets. (See *John R. Newman.*)[10] Such foods qualify as medical expenses, though, if they are not part of a patient's nutritional needs and are taken in addition to his normal diet. An example would be whiskey prescribed for coronary disease (Rev. Rul. 55-261, 1955-1 CB 307).

The Tax Court has allowed deductions for special service charges paid to restaurants for preparation of salt-free meals as well as taxi fares to such restaurants. However, the IRS does not agree with this position. (See *Leo R. Cohn.*)[11]

Compare this case with *Cohn* v. *U. S.*[12] where subsequently, the same taxpayer's health deteriorated to the point that he was unable to travel outside his living quarters for meals. As a result, he had to pay an amount in excess of the cost of usual lodging to obtain accommodations with kitchen facilities so that salt-free meals could be prepared. However, the District Court held that such excess amount was not deductible.

Capital Expenditures

Expenditures otherwise qualifying as medical expenses will not be disqualified merely because they also constitute capital expenditures. Regs. Sec. 1.213-1(e)(1)(iii) establishes the categories and treatment for such capital expenditures as shown in Illustration 3, page 258.

PLANNING SUGGESTION. Determine any increase in property by competent appraisal when substantial capital expenditures are made in accordance with medical advice. This procedure should tend to curb disputes with the Revenue Service.

Appraisal fees incurred to determine property values for income tax purposes are usually deductible as miscellaneous itemized deductions. (See Rev. Rul. 67-461 (1967-2 CB 125) regarding property donated to charity and Rev. Rul. 58-180 (1958-1 CB 153) dealing with casualty losses.)

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[9] *M. C. Montgomery,* 51 TC 410 (1968), aff'd CA-6, 428 F2d 243.

[10] *Newman,* Western DC, Ark. (1968), 68-1 USTC 9411.

[11] *Cohn,* 38 TC 387, nonacq. 1963-2 CB 6.

[12] *Cohn* v. *U.S.*, 240 F. Supp. 786, DC, Ind. (1965).

Category	*Example*	*Treatment*
1. Expenditures relating only to sick person (not related to permanent improvement or betterment of property).	Wheel chair, crutches, or inclinator or air conditioner which is detachable from property and purchased only for such person's use.	Deductible in full (to the extent otherwise allowable)
2. Expenditures for permanent improvement or betterment of property if related directly to medical care.	Elevator installed in residence to prevent heart disease patient from climbing stairs.	Qualifies as medical expense to the extent expenditure exceeds increase in value of related property.

Illustration of Category 2 treatment:

Cost of installing elevator	$1,000
Less increase in value of residence	700
Medical expense portion	$ 300

Special Schools

> . . . While ordinary education is not medical care, the cost of medical care includes the cost of attending a special school for a mentally or physically handicapped individual, if his condition is such that the resources of the institution for alleviating such mental or physical handicap are a principal reason for his presence there. In such a case, the cost of attending such a special school will include the cost of meals and lodging, if supplied, and the cost of ordinary education furnished which is incidental to the special services furnished by the school.
>
> Thus, the cost of medical care includes the cost of attending a special school designed to compensate for or overcome a physical handicap, in order to qualify the individual for future normal education or for normal living, such as a school for the teaching of braille or lip reading. Similarly, the cost of care and supervision, or of treatment and training, of a mentally retarded or physically handicapped individual at an institution is within the meaning of the term "medical care" . . . [Regs. Sec. 1.213-1(e)(1)(v)(a)].

Regular Schools With Special Curricula. In Rev. Rul. 70-285 (1970-23 IRB 11), tuition fees and transportation costs qualified as medical expenses where they were paid by a parent for a mentally retarded child's attendance in a regular school which had a special curriculum for retarded children.

Medical Expenses of Dependents

Deductible medical expenses include amounts paid on behalf of dependents *and* persons who would qualify as such except for failure to meet the gross income test (under Sec. 151(e)) or the joint return test (joint return filed by such person and spouse). (See 302.1.)

This means that only the following tests are required to be met in order to claim deductions for medical expenses paid on behalf of other persons (subject to the limitation of 3 percent of taxpayer's adjusted gross income):

1. Support test (contribution of more than 50 percent of total support).
2. Member of household or prescribed relationship test.
3. Citizenship test.

The support test can also be satisfied through multiple support agreements, as next discussed.

Use of Multiple Support Agreements. The use of multiple support agreements to claim dependency exemptions not otherwise allowable was explained in 302.1. It was also indicated that medical payments for such dependents should be made by the taxpayer obtaining the exemption under such an agreement.

Multiple support agreements can also be used to increase a client's medical deduction even though a dependency exemption cannot thereby be obtained (because the would-be dependent has excessive gross income or has filed a joint return). These agreements may permit the required support test to be met notwithstanding a client's inability to satisfy its general more-than-50-percent requirement.

PLANNING SUGGESTION. Contemplated support contributions, medical payments, and multiple support agreements should be coordinated to produce maximum tax benefits in the form of greatest potential medical deductions. For example, expected support should be contributed as medical expense payments by a taxpayer who will be able to deduct such amounts with the assistance of a multiple support agreement, to maximum advantage.

EXAMPLE. Client's widowed mother is expected to receive support from the following sources:

Client	25%
Brother Abel	15%
Brother Barry	15%
Brother Charles	10%
Total	65%

The balance of mother's support will be furnished by her own gross income of $3,000.

Following past practice, it is anticipated that Charles will pay mother's medical expenses. These payments will be completely wasted as deductions for the following reasons.

1. Charles will be precluded from claiming them on his return since he cannot meet the support test under any circumstances. A multiple support agreement cannot be used in this situation because Charles will fail to contribute the minimum required (i.e., more than 10 percent of total support).

2. Mother cannot claim these expenses relating to her own medical care since she has not paid them. (Medical expenses are deductible only by actual payor and only in the year paid. For a special exception to this rule in the case of payments by a decedent's estate, see 303.3.)

CPA recommends that Charles discontinue such medical payments. In determining who should pay these expenses instead, CPA makes projections of the potential tax benefit to be derived if such payments are made by Client, his mother, or other two brothers. The projections reveal that Client would obtain greatest benefit. Hence, CPA further recommends that (1) Client pay all of mother's medical expenses as part of his support contribution and that (2) brothers Abel and Barry execute a multiple support agreement in favor of Client.

Medicine and Drugs

> The term "medicine and drugs" shall include only items which are legally procured and which are generally accepted as falling within the category of medicine and drugs (whether or not requiring a prescription). Such term shall not include toiletries or similar preparations (such as toothpaste, shaving lotion, shaving cream, etc.) nor shall it include cosmetics (such as face creams, deodorants, hand lotions, etc., or any similar preparation used for ordinary cosmetic purposes) or sundry items. . . [Regs. Sec. 1.213-1(e)(2)].

Items excluded under this definition of medicine and drugs cannot be considered as other medical care.

The IRS views vitamins, iron supplements, and so forth, as medicine or drugs only when prescribed or recommended by a doctor. They are not so considered if taken to preserve general health without medical prescription or recommendation.[13]

[13] "Your Federal Income Tax," IRS Publication 17 (1970 ed.), p. 126.

PLANNING SUGGESTION. In practice, substantiating deductions for medicine and drugs is often a cumbersome chore for clients. For example, cancelled checks are inadequate in view of the great variety of nonmedical merchandise sold by pharmacies.

It may be desirable for clients to establish separate charge accounts where considerable amounts of drugs and medicine and/or other medical supplies are purchased.

303.2 Working With Income Limitations

Planning Technique

Proper timing of medical payments may mitigate effects of income limitations. Also consider advisability of separate returns for married clients.

Except for the limited outright deduction accorded medical insurance premiums (as discussed in 303.1), medical expenses are deductible only to the extent that they exceed 3 percent of adjusted gross income. Medicine and drugs are includible as medical expenses (subject to this 3 percent limitation) only to the extent that they first exceed one percent of adjusted gross income. There are no maximum limitations on the deductibility of medical expenses.

Planning Considerations

Timing of Payments. Since expenses for medical and dental services rendered, as well as for medicine and drugs purchased, are allowable as deductions when paid, a client can determine, to some degree, the year for deducting such expenses by the mere timing of his payments. Of course, he will have more latitude in exercising this discretion in the case of services performed towards the end of a year (where payment can more easily be extended into the following year).

The existence of these one percent and 3 percent limitations strongly compels proper attention to the timing of medical payments. Accordingly, they should be concentrated in a year in which the limitations have already been exceeded as opposed to a year in which such payments would be wasted by these statutory obstacles.

CAUTION. Advance payments for medical services to be performed in a future year are not deductible in any year. See 104.2.

Where significant amounts of medical insurance premiums are involved, it may be worthwhile to arrange for due dates late in December.

The policy's grace period will enable premium payments to be shifted to the subsequent year (and, generally, doubled up with the next premium paid the following December) if advantageous for tax purposes.

NOTE. The income limitations cause the amount of allowable medical deductions to vary inversely with the size of a client's adjusted gross income. This may cause the timing of medical payments, in some situations, to differ from the timing of other itemized deductions. (Also see 301.1 with regard to coordinating the medical deduction in programs involving doubling-up of itemized deductions.)

In view of the many variables involved in these types of circumstances, however, detailed and specific projections will be far more illuminating (and accurate) than any generalized conclusions.

Separate vs. Joint Returns. Separate returns may yield greater medical deductions than joint returns since the separate percentage limitations will be based on smaller adjusted gross incomes. However, because of the progressive nature of our tax rates, this technique will usually reduce the spouses' combined taxes only where their taxable incomes, before any medical deductions, are approximately equal (so that they both would be in the same bracket), as shown in Illustration 4, below.

Illustration 4

	1970		
	Separate Return		*Joint*
	Husband	*Wife*	*Return*
Salary	$50,000	$ –	$ 50,000
Dividends	–	50,000	50,000
Adjusted gross income	50,000	50,000	100,000
Medical payments	2,900	–	2,900
Less 3% of adjusted gross income	1,500	–	3,000
Medical deduction	1,400	–	None
Contributions	4,975	2,975	7,950
Property taxes	–	2,000	2,000
Exemptions	625	625	1,250
Total deductions	7,000	5,600	11,200
Taxable income	$43,000	$44,400	$ 88,800
Tax	$18,410	$19,230	$ 38,460
Total separate taxes			37,640
Tax savings through separate returns			$ 820

303.3 *Expenses Paid After Death*

Planning Technique

Determine whether medical expenses paid by decedent's estate within one year after death should be deducted for income tax or estate tax purposes. Also consider whether decedent's medical expenses should be paid, instead, by surviving spouse.

Although medical expenses are generally deductible only when paid, an exception exists for payments made by a decedent's estate within one year after his death. In such cases, Sec. 213(d) provides that such expenses shall be treated as paid by the decedent at the time the medical services were rendered if a waiver of the right to any estate tax deduction (under Sec. 2053) is filed with the Service. (See Regs. Sec. 1.213-1(d).)

On the other hand, a decedent's medical expenses paid by a surviving spouse are deductible in the year paid.[14]

The general rule also applies to a deceased dependent's medical expenses (i.e., deductible when paid, whether before or after death).[15]

Planning Implications

These rules permit relatively great flexibility in obtaining the most favorable tax benefit for medical deductions in respect of a decedent. By employing the proper procedures, a choice can be made of the most advantageous of several returns in which to claim such deductions. These optional approaches can be summarized as shown in Illustration 5, page 264.

NOTE. A decedent's medical expenses can never be deducted by an estate on its fiduciary income tax return (Form 1041). For further discussion of deductions attributable to decedents and estates, see 403.

304 Employee Expenses and Credits

It has long been held that services performed as an employee constitute a trade or business.[16] Accordingly, expenses attributable to such business are generally deductible for income tax purposes. A

[14] "Your Federal Income Tax," IRS Publication 17 (1970 ed.), p. 128.

[15] *Ibid.*

[16] As representative of the decisions espousing this view, see *J. M. Trent,* CA-2, 291 F2d 669, and *Deputy* v. *DuPont* (concurring opinion of Mr. Justice Frankfurter, 308 US 488).

Illustration 5

	Return Which May Produce Greatest Tax Benefit From Decedent's Medical Deductions	*Effective Tax Rate May Be Affected by*	*To Obtain Such Deductions, Payment Should Be Made by*	*File Waiver of Estate Tax Deduction*
1.	Estate tax return (Form 706)	Marital deduction	Decedent's estate	No
2.	Decedent's income tax return(s) (Form 1040)*	Joint rates	Decedent's estate	Yes
3.	Surviving spouse's income tax return (Form 1040)	Joint rates (for 2 years after year of death if there are dependent children and other conditions of Sec. 2(a) are met)	Surviving spouse	Not applicable

* The decedent's income tax return most frequently involved is his final Form 1040. However, since expenses are deemed to be paid at the time incurred under this alternative treatment, earlier returns may have to be amended or claims for credit or refund filed. In any event, Regs. Sec. 1.213-1(d)(1) disallows such credits or refunds if the statutory period for filing claims (Sec. 6511) has expired.

detailed catalogue of all the various employee expenses that may be allowable as deductions is outside the function of this tax study. Instead, we shall focus upon several planning aspects in this area which are of current practical interest.

304.1 Selected Planning Considerations

Planning Technique

Planning techniques for employees include conserving working capital of certain employees through delayed additional withholding, providing required substantiation of travel and entertainment expenses, and having a working knowledge of basic ground rules which may permit maximum advantage to be taken, to the extent possible, of deductions for expenses attributable to such common activities as travel away from home, travel of wives, commuting, education, and partial business use of home.

Conserving Working Capital of Certain Employees Through Delayed Additional Withholding

In appropriate circumstances, employees who have other sources of income in addition to compensation can take unique advantage of the estimated tax provisions pertaining to the treatment of withheld tax in determining penalties for failure to make timely estimated tax payments. In order to avoid such penalties, it is generally required that payments be made quarterly with respect to tax estimated to be due for non-compensatory income (interest, dividends, etc.). Deficient payments for earlier due dates (e.g., April 15th, June 15th) *cannot* be rectified by subsequent excessive payments (e.g., September 15th, January 15th of the next year).

In contrast, Sec. 6654(e)(2) provides that the total withheld tax shall be deemed to have been paid in equal quarterly installments "unless *the taxpayer* establishes the dates on which all amounts were actually withheld . . . ." (Emphasis supplied.) In this latter case, withholding is applied on an actual basis.

Therefore, Sec. 6654(e)(2) gives taxpayers an option as to whether withholding should be spread evenly throughout the year or applied on an actual basis in determining the fulfillment of estimated tax requirements. The selection of the first option (equal quarterly installments) may permit the quarterly estimated tax requirements to be satisfied *retroactively*.

For example, estimated tax payments attributable to investment income which are required to be made on April 15th and June 15th can instead be satisfied through additional tax withheld in November and December. Such a procedure, of course, permits a client to satisfy his estimated tax requirements as late as possible during the year — thereby enabling maximum utilization of working capital.

EXAMPLE. Client's 1970 income is anticipated as follows:

Salary	$48,000	(payable monthly)
Bonus	$25,000	(payable in December)
Dividends	$52,000	

His total estimated tax requirement for the current year (1970) is $45,000 (current year's rates and exemptions applied to previous year's income).

Of this amount, it is expected that $17,178 will be satisfied through usual withholding procedures, determined as shown in Illustration 6, page 266.

Withheld tax on salary (Tables 4(b), Sec. 3402(a) (1) and (2), IRC)	$12,178*
Withheld tax on bonus (20% flat rate pursuant to Employment Tax. Regs. Sec. 31.3402(g)-1(a)(2)(ii)	5,000
Total expected withheld tax	$17,178

* Rounded to nearest dollar.

Consequently, the following estimated tax computations are submitted for CPA's review:

Total estimated tax required to be paid	$45,000
Less income tax to be withheld during 1970	17,000
Net estimated tax payable	$28,000
Quarterly installment	$ 7,000

However, Client's financial position will compel him to borrow money at 9 percent interest in order to pay these quarterly installments. (Since Client expects to be in the 62 percent bracket (after deductions), the effective interest rate should be 3.42 percent (9 percent multiplied by 38 percent (100 percent less 62 percent). Therefore borrowing would be preferable to incurring penalties at 6 percent interest which are *not* deductible.)

Client requests CPA to suggest ways and means of remedying this undesirable financial situation. CPA advises him to pay only estimated tax installment due January 15, 1971, and to satisfy the remaining estimated tax requirement of $21,000 by additional tax to be withheld in December 1970, as follows:

1. Withhold *additional* tax of $1,000 on December salary.
2. Net bonus of $20,000 should not be paid but, instead, utilized as additional withholding.

In summary, these procedures will permit three $7,000 payments due April, June, and September 15 to be postponed, without penalty, until December.

To accomplish this, CPA suggests that additional withholding should be authorized by written agreements pursuant to Employment Tax Regs. Sec. 31.3402(i)-1.

Such additional withholding must, of course, be predicated upon the availability of sufficient net compensation (after reduction for normal

withholding, and so forth). Where this procedure is utilized, it will have to be geared to large bonuses or else spread among several payroll periods.

In some instances, it may be possible and advisable to spread the total estimated tax requirement, exclusive of any withholding, over all the payroll periods in the year in order to obtain an even amount of periodic withholding which will satisfy the combined estimated tax and regular withheld tax requirements of the Code.

NOTE. As a related matter, do not overlook the additional withholding tax created by excess withholding of F.I.C.A. tax.

Providing Required Substantiation of Travel and Entertainment Expenses

A most comprehensive set of rules is provided by the regulations with regard to the substantiation of deductions for travel, entertainment, and gift expenses. See Regs. Sec. 1.274-5, particularly paragraph (c)(2)(iii) thereof which contains detailed requirements for obtaining documentary evidence, such as receipts for lodging and for other expenditures of $25 or more. These provisions are designed to implement the Congressional intent of insuring "that no deduction is allowed solely on the basis of his own (the taxpayer's) unsupported self-serving testimony. . . ."[17]

In their initial judicial review, these rules have been resoundingly upheld by the courts.[18] In counseling clients as to how to sustain as many T & E deductions as possible, the extreme importance of adhering to these regulations can never be overemphasized.

Standard Mileage Rates. A client's substantiation burden (record-keeping, receipts, and so forth) can be lightened in connection with deductions for business use of his automobile by resort to the following standard mileage rates offered by Rev. Proc. 70-25 (IRB 1970-41, 59):

First 15,000 business miles - 12 cents per mile
Additional business miles - 9 cents per mile

Business parking fees and tolls are not reflected therein and are deductible as separate items. And, beginning in 1970, interest and state and local taxes incurred to purchase the auto are also deductible in addition to the mileage allowance.

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[17] H. Rep. No. 1447, 1962-3 CB 405, 427; S. Rep. No. 1881, 1962-3 CB 707, 741.
[18] See *William F. Sanford,* CA-2, 412 F2d 201, aff'g 50 TC 823.

CAUTION. Substantiation of business mileage is still required. See Section 3.07 of Rev. Proc. 70-25.

Travel Expenses Away From Home

The only business travel expenses allowable are those paid or incurred while away from home (Sec. 162(a)(2)).

The phrase "away from home" has generally been interpreted by the IRS to require a taxpayer to be away from home *overnight* on a temporary as opposed to an indefinite assignment.

For example, in Rev. Rul. 68-663 (1968-2 CB 71), a federal government employee traveled away from his post of duty on official business for a one-day trip, leaving at 9:00 a.m. and returning at 10:00 p.m. Expenses for his noon and evening meals were not deductible since his one-day trip did not require a stop for sleep or rest.[19]

The IRS states that one's home for tax purposes is the "principal place of business, employment, station, or post of duty . . ." regardless of where the family residence is maintained. It also indicates that "usually, an assignment expected to last for a year or more is not temporary. . . ."[20]

However, these positions have been the subject of numerous and often conflicting court decisions.

Travel Expenses of Wives

Regs. Sec. 1.162-2(c) requires a wife's presence on a trip to serve a bona fide business purpose. Her performance of some incidental service, such as occasional typing, does not qualify her expenses as deductions.

The Tax Court has further crystallized these criteria by indicating that the test for deductibility of wives' travel expenses is whether her presence is necessary to the conduct of her husband's business and not merely whether her presence is only helpful.[21]

Under such standards, disallowance of wives' traveling expenses have been generally upheld by the courts. However, there are several decisions in which taxpayers have prevailed. For examples, see *Roy O. Disney*[22] and *P. C. Warwick*.[23] In these cases, the husbands were officers

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[19] The ruling cited the 1967 Supreme Court decision in *Correll*, 389 US 299 (Ct. D. 1917, 1968-1 CB 64) which upheld this sleep or rest rule imposed by the Service.

[20] "Travel, Entertainment, and Gift Expenses," IRS Publication 463 (Oct. 68), p. 3.

[21] *William H. Johnson*, 25 TC Memo 858 (1966).

[22] *Disney*, CA-9, 413 F2d 783, aff'g DC, Calif.

[23] *Warwick*, 236 F. Supp. 761 (DC, Va.).

and sales representatives of the company and were expected to socialize extensively with customers in order to establish close personal and business relationships. It was shown that the wives contributed directly in the success of the sales activities.

Also see *John Charles Thomas*[24] which was favorably cited in Rev. Rul. 55-57 (1955-1 CB 315) for further illustrations of valid business functions performed by a wife.

Commuting Expenses

It is well established that costs of commuting to a place of business or employment are nondeductible personal expenses. (For example, see Regs. Sec. 1.262-1(b)(5).) The Revenue Service applies this rule, with Tax Court approval, where tools and instruments are hauled in an automobile for convenience in commuting to and from places of employment. However, full deductions are allowed by the Service under either of these conditions:

1. The tools, instruments, and so forth, cannot be stored at work site.
2. If a taxpayer works at different locations every day and would not use his auto but for the necessity of transporting tools, instruments, and so forth, that are too bulky or heavy to be carried otherwise.[25]

Contrarily, two Circuit Courts of Appeals (the Second and Seventh) have rejected this stringent primary purpose test in favor of a more liberal allocation-of-costs treatment *whenever* tools, instruments, and so forth, are transported.[26]

NOTE. In the case of construction workers, musicians, salesmen and others who carry tools, instruments, display cases, etc., decisions as to whether protective refund claims should be filed for prior years and deductions claimed on current and future returns can only be made by such taxpayers with the advice of their own tax advisers because of such factors as (1) the client's willingness to dispute the Internal Revenue Service or (2) the overall state of the client's tax situation (including his potential exposure regarding other items of income and deduction), and so forth.

Naturally, reaction to this matter may tend to be different for taxpayers in the Second and Seventh Circuits than for those located elsewhere.

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[24] BTA Memo (1939), CCH, Dec. 10, 622-A.

[25] "Your Federal Income Tax," IRS Publication 17 (1970 ed.), p. 45.

[26] *L. D. Sullivan*, CA-2, 368 F2d 1007, and *J.J. Tyne*, CA-7, 385 F2d 40.

Education Expenses

Deductions are allowable for expenses of education (even though leading to a degree) which is undertaken for either of the following purposes: (a) maintenance or improvement of skills required in performing duties as an employee (or as a self-employed person) or (b) meeting express employer, statutory, or regulatory requirements imposed as a condition to retention of an established employment relationship, status, or rate of compensation.

However, expenses are not deductible if such education also serves any of the following additional purposes: (a) it is required in order to meet minimum educational requirements for qualification in an individual's employment (or other business) or (b) the education will enable qualification for a new trade or business.

NOTE. In the case of an employee, a change of duties does not constitute a new trade or business if the new duties involve the same general type of work as that presently performed. For this purpose, *all* teaching and related duties are considered to involve the same general type of work (Regs. Sec. 1.162-5(b)(3)(i)).

Temporarily Unemployed Teachers. The degree to which these regulations have been liberally interpreted in favor of teachers is illustrated by the 1968 decision of the United States Court of Appeals for the Seventh Circuit in the case of *Mary O. Furner.*[27]

In this case, the appellate court held that amounts spent by a teacher who left her position to pursue a full-time graduate course for one academic year were deductible as educational expenses even though she was not on leave status from the school system and, upon graduation, accepted a teaching position different from her previous job.

However, in Rev. Rul. 68-591 (1968-2 CB 73), the Revenue Service stated that it:

> . . . Will follow the *Furner* decision in cases where the requirements of Sec. 162 of the Code and the regulations thereunder are satisfied, and where the facts are substantially the same as those in the *Furner* case, that is, where a taxpayer, in order to undertake education or training to maintain or improve skills required in his employment or other trade or business, temporarily ceases to engage actively in employment or other trade or business. *Ordinarily, a suspension for a period of a year or less, after which the taxpayer resumes the same employment or trade or business, will be considered temporary.*

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[27] *Furner,* CA-7, 393 F2d 292, rev'g 47 TC 165.

> However, the Service does not agree with any construction of the *Furner* opinion under which an expense could be considered incurred while carrying on a trade or business within the meaning of Sec. 162 of the Code (although in fact such trade or business is not being carried on) merely because (1) the study might be a "normal incident" of carrying on a trade or business and (2) the taxpayer subjectively intends to resume that trade or business at some indefinite future date. [Emphasis supplied.]

Travel and Transportation Expenses. If an individual travels away from home primarily to obtain education, his travel expenses are also deductible under the following conditions: (1) the expenses of the education itself are deductible and (2) the travel expenses satisfy the general rules governing such expenses (see prior discussion). (Regs. Sec. 1.162-5(e).)

In addition, the Revenue Service also permits the deduction of certain local transportation expenses. [28]

Travel Itself As an Educational Activity. Regs. Sec. 1.162-5(d) requires a direct relationship to exist between travel and an employee's duties before travel expenses, *per se*, can qualify as proper deductions.

CAUTION. The approval of a travel program by an employer or its acceptance as fulfillment of requirements for retention of rate of compensation, status, or employment, is not determinative that the required relationship exists between such travel and the duties of the individual in his particular position.

EXAMPLE. A teacher of French, on sabbatical leave, travels to France to improve his knowledge of the French language. The itinerary chosen and the major portion of activities undertaken were to improve skills in using and teaching French. The travel expenses are deductible even though the activities consisted largely of visiting French schools and families, attending French motion pictures, plays, and lectures, and so forth.

No deduction would be allowable for the same trip if taken by an English or mathematics teacher. [29]

Partial Business Use of Home

Use Which Is Appropriate and Helpful to Conduct of Business. The IRS no longer insists that use of a home be required by an employer; in

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[28] "Your Federal Income Tax," IRS Publication 17 (1970 ed.), p. 52.
[29] *Ibid.*

Clarence Peiss (40 TC 78 (1963)), deductions were allowed for expenses allocable to partial use of a university professor's residence to carry on some professional activities such as research and preparation of articles. The Tax Court accepted the following reasons as valid business usage:

> . . . Petitioner testified the work done in his home just could not be done in his office at the school partly because there was not adequate time even in an extended working day and partly because his office space at the school was not separated from the research laboratory which was in constant use by graduate students . . . [40 TC at 83-84].

The Tax Court's allowance of these deductions, despite the apparent absence of any employer requirement for such use of his home, conflicts with the IRS guidelines for determining deductions for partial business use of residences as set forth in Rev. Rul. 62-180 (1962-2 CB 52).

However, the Service has recently abandoned the position expressed in this ruling that such business use be required by announcing its acquiescence in the *Peiss* decision. (See 1968-2 CB 2.)

Peiss was cited with approval in a subsequent Tax Court Memorandum opinion which permitted a commercial artist to claim similar deductions even though his employer did not specifically require that he maintain an art studio in his home.[30]

Allocation of Expenses. Rev. Rul. 62-180 requires that expenses be proportionately allocated to the part of a residence devoted to business purposes. Square footage is suggested as one method of accomplishing this primary allocation.

The ruling further requires a second allocation where a portion of the residence is regularly used for business only part of the time. In such event, this secondary allocation is based upon the following ratio:

$$\frac{\text{Amount of time the area is actually used for business purposes}}{\text{Total time area is available for all uses}}$$

EXAMPLE. Client's home has the following dimensions:

	Square Feet	*Percent to Total*
Den	150	7.5
Total area of residence	2,000	100.0

The den is used as an office two hours a day and is also available for family use. Occupancy expenses (rent, light, and heat) total $3,000.

[30] *Herman E. Bischoff*, 25 TC Memo 538 (1966).

Allocations are required as follows:

Expenses attributable to den (7.5% of $3,000)	$225
Expenses attributable to business use of den (2/24 of $225)	$18.75

NOTE. Under IRS's secondary allocation, all nonbusiness time is treated as personal time regardless of the amount of time the area is actually used for family purposes; thus, so-called "neutral" time affects taxpayers adversely. Nevertheless the IRS's method was followed in a Virginia district court decision.[31]

If family conditions permit, this adverse secondary allocation can be avoided by using a room exclusively for business purposes.

304.2 Effect Upon Adjusted Gross Income, Other Itemized Deductions, and the Use of the Standard Deduction

Planning Technique

Obtaining deductions for certain employee expenses also permits secondary tax benefits to be achieved.

Sec. 62(2) of the Code provides, in essence, that employee expenses are to be claimed as other itemized deductions with the following exceptions:

1. Travel expenses away from home.
2. Transportation expenses.
3. Expenses of outside salesmen.
4. Reimbursed expenses (to the extent the reimbursements are included in gross income. Hence, this deduction has a wash effect.)

These above enumerated expenses are instead deductible from gross income in arriving at adjusted gross income. (Itemized deductions, of course, are deducted from adjusted gross income in computing taxable income.)

Thus, travel and transportation expenses, for example, are especially beneficial because they may have either of the following favorable consequences (besides being deductible themselves):

1. They can be claimed *in addition to* the standard deduction (in contrast to all other employee expenses; i.e., those not described in Sec. 62(2)).

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[31] *Hoggard* (DC Va.), 67-2 USTC ¶9741.

2. Greater medical deductions can be claimed as a result of the decrease in adjusted gross income.

   By the same token, the maximum charitable contribution limitation (20 percent or 50 percent of adjusted gross income)[32] is lowered. However, this may not be a serious matter where the five-year carryover of excess contributions is available (Code Sec. 170(d)(1)). (Charitable contribution limitations and carryovers are further discussed in 401.)

NOTE. Allowable travel and transportation expenses allocable to qualified educational activities are deductible from gross income whereas the actual educational expenses (tuition, books, and so forth) are only deductible from adjusted gross income (except for outside salesmen who can deduct all education expenses from gross income).

305 Self-Employed Expenses

This discussion is concerned with individuals in their nonpersonal capacity as sole proprietors of, or as partners in, a going business. In view of its quasi-personal nature, the question of whether retirement plan expenses should be incurred is dealt with separately from all other deductions and credits pertaining to such businesses.

305.1 Retirement Plan Expenses

Planning Technique

Overall financial advantages and disadvantages should be carefully weighed and incorporation considered before adopting a self-employed retirement plan.

In 204.2, various tax attributes of self-employed retirement plans were compared with corporate plans (i.e., regular qualified plans). This comparison revealed that, in essence, a retirement plan for self-employed persons merely permits deferral of the tax on "employer" contributions to the plan and on earnings derived from contributions.

[32] Technically, these percentages apply to the employee's "contribution base" which is defined by Sec. 170(b)(1)(F) as adjusted gross income computed without regard to any net operating loss carrybacks.

Self-employed plans were found lacking in the following tax benefits available under corporate plans, including Subchapter S corporation plans:

1. Exemption from estate and gift taxes.
2. Capital gain treatment on certain portions of lump sum distributions.
3. The favorable seven-year averaging computation for the remaining lump sum distribution (i.e., the portion not eligible for capital gain treatment) which was described in 203.1. However, self-employed individuals can use a five-year averaging computation to determine their tax on lump sum distributions (if certain conditions are met, as specified in Sec. 72 (n) (1)).

   Nevertheless, the self-employed averaging computation is not as advantageous as the seven-year computation. In addition to the obvious advantage of spreading only one-seventh of this income across the recipient's tax bracket (as opposed to one-fifth for the self-employed), the seven-year computation is also more beneficial than the self-employed mechanism because current compensation ("other than deferred compensation within the meaning of Sec. 404") and the capital-gains portions of the lump sum distribution are not taken into account in calculating the tax attributable to the ordinary income portion of an employee's lump sum distribution.

Furthermore, employer contributions to self-employed plans, unlike corporate plans, are limited to the lesser of $2,500 or 10 percent of earned income for each self-employed individual. However, "principal" shareholder-employees of Subchapter S corporations are currently taxed on employer contributions exceeding similar limitations. (In other words, these employees must include employer contributions in gross income to the extent they exceed the lesser of $2,500 or 10 percent of compensation reportable from the corporation during its taxable year.) (Principal shareholder-employees are defined as officers or employees of a Subchapter S corporation who own more than 5 percent of the outstanding stock on *any* day during the corporation's taxable year, including stock indirectly owned under the *family* attribution rules of Sec. 318(a)(1). Presumably, no other attribution rules apply.)

On the other hand, excess contributions made on behalf of owner-employees under self-employed plans, if not repaid as specified in Sec. 401 (e) (2), will disqualify the plan. (In the case of non-owner-employee self-employed persons, excess contributions are not deductible but will not cause disqualification.) In contrast, excess contributions on behalf of Subchapter S principal shareholder-employees will not automatically

disqualify the plan. (However, the pertinent committee reports[33] state that such contributions are to be regarded as having been made by the corporation for purposes of determining plan qualification. (Isidore Goodman observed recently in this context that deductible contributions must first pass the ordinary and necessary expense tests of Secs. 162 or 212. He pointed out that contributions to a fully funded pension plan are not deductible and may adversely affect its qualification.)[34]

Finally, coverage and vesting requirements for self-employed plans are far more restrictive than those for corporate plans, including Subchapter S corporation plans. For example, self-employed plans must include all full-time employees with at least three years of service (Sec. 401 (d)(3)) and provide for immediate and full vesting of contributions made on their behalf (Sec. 401(d)(2)). All corporate plans can also provide greater benefits in the following additional areas:

1. More liberal provisions for employee contributions and plan distributions.
2. Availability of $5,000 income tax exclusion for lump sum distributions. (See 201.2, Chapter 2.)

Planning Considerations

In deciding whether or not to adopt a self-employed retirement plan, it would seem quite advisable to first answer the more fundamental question of whether or not the business should, and can, be incorporated. Certainly, the advantages of corporate retirement plans provide some rather persuasive arguments in favor of incorporation. Moreover, the climate regarding the validity of professional service corporations is extremely bright in light of Rev. Rul. 70-101 (IRB 1970-9, 13).

In addition, self-imposed barriers to incorporation by professional persons are slowly in the process of disintegration. As one example, the governing Council of the American Institute of Certified Public Accountants has approved a proposed amendment to its Code of Professional Ethics that would permit AICPA members to practice in professional corporation form.[35]

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[33] H. Rep. No. 91-413, Part 1, 8/2/69, p. 171 and S. Rep. No. 91-552, 11/21/69, p. 171.

[34] Goodman's speech (April 21, 1970), "Legislative Changes Affecting Pension and Profit-Sharing Plans," reported in *CCH Pension Plan Guide* 30,335, at 30,338, especially footnote 56 thereof.

[35] *The Journal of Accountancy*, American Institute of Certified Public Accountants (June 1969), p. 9.

Thus, unincorporated businesses, which may desire maximum retirement plan benefits, should give serious consideration to whether incorporation provides the best alternative, particularly from an *overall* financial and tax viewpoint.[36]

If incorporation is not feasible or desirable, self-employed retirement plans might be preferable to no retirement plan at all. This may be especially true where there are no full-time common law employees with at least three years of service or very few such employees, in relation to the self-employed, who are either presently employed or likely to be employed in the future.

Where contributions for such employees will present a more than nominal expense, such factor (after being tax-effected) should be taken into account in arriving at the net benefits inuring to the self-employed person or persons.

Other Expenses and Credits

A discussion of other expenses and credits that may be generated by the operation of an unincorporated business is beyond the scope of this tax study.

306 Investor Expenses, Losses, and Credits

306.1 Investment Interest

Planning Technique

Avoid borrowing substantial funds in order to invest in properties which will not be currently profitable since the resulting interest expense may not be immediately deductible.

A new limitation on the deduction of interest expense will be applicable to taxable years *beginning after December 31, 1971* (e.g., calendar year 1972 and thereafter). Thus, these new rules do not apply to

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[36] For more extensive and competent guidance on the incorporation decision, see the following chapters of Tax Study No. 1 (*Garian*, AICPA): Chapter 2, "Deciding Whether to Incorporate: Federal Income Tax Considerations" and Chapter 3, "Deciding Whether to Incorporate: Considerations Other Than Federal Income Taxes." Also see Peter Elder and Daniel G. Stewart, "Pension Plans Before and After Incorporation," *The Tax Adviser*, Jan. 1970, p. 49, and Arthur F. Shenkin, "The Professional Corporation," *The Tax Adviser*, Feb. 1970, p. 84.

years beginning before 1972 (e.g., 1971). Until this new provision takes effect, however, "excess investment interest" (the excess of investment interest expense over net investment income) will be a tax preference for purposes of the 10 percent minimum tax as discussed in 105.1.

This new limitation applies to interest paid (or accrued) on indebtedness incurred or continued to purchase or carry property held for investment. (Business property under construction is *not* considered investment property for this purpose.)

Such *investment interest* will be deductible in the following layers:

1. The first $25,000 ($12,500 for married persons filing separately) of such expense continues deductible without restriction.
2. Additional interest equal to net investment income (as defined in the technical resume concluding this discussion).
3. An amount equal to the net long-term capital gains (in excess of net short-term capital losses) on investment properties.
4. Fifty percent of any remaining investment interest.

The other 50 percent portion of the remaining investment interest will not be deductible currently. Instead, this disallowed interest can be carried to the succeeding year and is then deductible within the prescribed limitations illustrated in Illustration 7, page 279.

Any interest disallowed under these latter limitations can still be carried to future years. Thus, this carryover can continue throughout a client's existence. However, such carryovers to future years are reduced by any capital gains deduction (50 percent of net long-term gains) allowable in either the present or prior carryover years. This reduction is not made to the initial carryover of disallowed interest actually paid or accrued. It only applies to carryovers subsequently arising from this originating carryover. See Illustration 7.

Carryovers are not available, in any event, to the extent the disallowed interest exceeds taxable income for the year in which the disallowance arises. In other words, carryovers are decreased to the extent the disallowed interest would not have reduced taxable income even if such interest had been originally deductible.

It should be noted that where capital gains are used to increase the deduction for investment interest (see layer (3) above), they are converted into ordinary income for purposes of the alternative capital gains tax and the 50 percent capital gains deduction. However, such gains will also not be considered capital gain tax preferences for purposes of the 10 percent minimum tax.

The deduction of prepaid interest is subject to further restrictions set forth in Rev. Rul. 68-643, as explained in 104.2.

Illustration 7

Deduction of Investment Interest and Carryover of Disallowed Portion

Line	*Facts*	*1972*	*1973*
1.	Investment interest paid	$200,000	$ 15,000
2.	Net investment income	$ 40,000	$ 30,000
3.	Net long-term capital gain on investment properties	$ 10,000	$ 60,000
	1972 Deduction and Carryover to 1973		
4.	Investment interest		$200,000
5.	First deductible layer	$ 25,000	
6.	Net investment income	40,000	
7.	Investment capital gains (line 3)	10,000	
8.	Total of lines 5 through 7	$ 75,000	
9.	Line 4 less line 8	$125,000	
10.	50 percent of line 9		62,500
11.	1972 deduction (line 4 less line 10)		$137,500
12.	Carryover to 1973 (line 4 less line 11, same as line 10)		$ 62,500
	1973 Deduction and Carryover to 1974		
13.	Net investment income		$ 30,000
14.	Additional statutory allowance		25,000
15.	Total of lines 13 and 14		$ 55,000
16.	Investment interest paid	$ 15,000	
17.	Statutory floor	$ 25,000	
18.	Greater of line 16 or 17		25,000
19.	Line 15 less line 18		$ 30,000
20.	Deductible portion of 1972 carryover (50 percent of line 19)		$ 15,000
21.	Remaining 1972 carryover (line 12 less line 20)		$ 47,500
22.	Less — 50 percent of net long-term capital gains (line 3)		30,000
23.	1972 carryover to 1974		$ 17,500
24.	Carryover from 1973 (none, since entire amount on line 16 is deductible in 1973)		0
25.	Total carryover to 1974 (lines 23 and 24)		$ 17,500

Technical Resume

Net investment income is simply investment income less investment expense.

Investment income consists of income, not derived from the conduct of a trade or business, from the following sources: interest, dividends, rents, royalties, short-term capital gains on investment property, and ordinary gains resulting from recapture of depreciation.

NOTE. House Report No. 91-413 (Part 1; 8/2/69; p. 73) states that "rental income is to be considered as trade or business income, unless it is derived from property which is rented under a net lease arrangement. . . . " The effect of this statement, of course, will be to reduce the amount of net investment income against which investment interest will be currently deductible.

The definition of a net lease for minimum tax purposes applies here. (See 105.1.)

"*Investment*" *expenses* also have the same definition as that applicable under the minimum tax. (See 105.1.)

306.2 Other Investor Expenses, Losses, and Credits

Planning Technique

1. Do not overlook the deduction of any expense, reasonable in amount, which bears a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income.

2. Where exempt income is involved, study all facts and circumstances to determine reasonable allocation.

3. Limited conditions for obtaining ordinary losses, in lieu of capital losses, should be availed of, where feasible and desirable.

Deductibility of Investment Expenses

The United States Supreme Court has consistently held that an investor's activities cannot constitute a trade or business.[37] However, by virtue of Sec. 212, expenses for the production of income (otherwise

[37] For a relatively recent interpretation to this effect, see *A.J. Whipple,* 373 US 193, (Ct. D. 1882, 1963-2 CB 641).

known as nontrade or nonbusiness expenses) are allowable as itemized deductions.

NOTE. An exception exists for deductions attributable to property held for the production of rents or royalties which are deductible from gross income instead of from adjusted gross income (Sec. 62(5)). For the generally favorable consequences of such treament, see 304.2.

> The term "income" for the purpose of Sec. 212 *includes not merely income of the taxable year* but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; *and is not confined to recurring income* but applies as well to gains from the disposition of property. For example, if defaulted bonds, the interest from which, if received, would be includible in income, *are purchased with the expectation of realizing capital gain on their resale,* even though no current yield thereon is anticipated, ordinary and necessary expenses thereafter paid or incurred in connection with such bonds are deductible. . . . Expenses paid or incurred in managing, conserving, or maintaining property held for investment may be deductible under Sec. 212 *even though* the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income *and even though* the property is held merely to minimize a loss with respect thereto. [Regs. Sec. 1.212-1(b); emphasis supplied.]

In the context of this discussion, the term "investor" is used in a passive connotation and thus excludes such individuals as dealers and traders in securities.

The following is a broad summary of various kinds of investor expenses and their income tax treatment.

Deductible against ordinary income are the following:

- State and local transfer (stamp) taxes (Sec. 164 (a))
- Investment counsel
- Financial periodicals
- Safe deposit box rentals
- Collection charges
- Allocable portion of residence expenses[38]
- Office rent
- Compensation of secretaries, etc.
- Custodial, agency, or trustee fees
- Ordinary and necessary travel expenses (see 304.1). However, Rev. Rul. 56-511 (1956-2 CB 170) holds that transportation and other

[38] *M.E. Henderson,* 27 TC Memo 109 (1968); also see 304.1, this study.

incidental expenses of attending stockholders' meetings are not sufficiently related to investment activities to warrant deduction under Sec. 212.

- Statistical services

Deductible against capital gains (or additions to capital losses) are commissions on purchase of securities (which increase cost basis) and commissions on sales of securities (which reduce selling prices).[39]

Determine Reasonable Allocation of Expenses To Exempt Income

Under Sec. 265(1), expenses of an investor directly allocable to exempt income, including municipal interest (201.3), are not deductible. Furthermore, a reasonable proportion of expenses indirectly allocable to both exempt and nonexempt income must be allocated to each such category of income "in the light of all facts and circumstances in each case..." (Regs. Sec. 1.265-1 (c)).

Methods of Allocation. In an early Tax Court decision, indirect expenses of an investor were allocated in proportion to the relationship of exempt and nonexempt income to total combined income.[40] See Illustration 8, below.

Illustration 8

Line	*Amount*	*Percent to Total*
1. Exempt income	$ 10,000	10
2. Nonexempt income	90,000	90
3. Total income	$100,000	100
4. Total indirect expenses allocable to both exempt and nonexempt income		$50,000
5. Less nondeductible portion (expenses allocated to exempt income — 10 percent of $50,000)		5,000
6. Allowable deduction		$45,000

[39] Included in this category were federal transfer (documentary stamp) taxes imposed by Chapter 34 (Subtitle D) of the 1954 Code prior to its repeal by the Excise Tax Reduction Act of 1965 (PL 89-44).

[40] *Edward Mallinckrodt, Jr.*, 2 TC 1128 (1943), acq. 1944 CB 18; aff'd on other grounds.

Although *Mallinckrodt* has been followed in subsequent decisions, Rev. Rul. 63-27 (1963-1 CB 57) holds that its income allocation formula is not mandatory. As for other methods of allocation, see *John E. Leslie*[41] where the IRS determined nondeductible interest expense (under Sec. 265(2)) according to the following computation which was roughly based upon the value of exempt and nonexempt assets owned by a stock brokerage firm:

$$\text{Total interest expense} \times \frac{\text{Average monthly value of tax-exempt securities}}{\text{Average monthly value of total assets}}$$

NOTE. This asset formula could be detrimental. See "Caution" below.

PLANNING SUGGESTION. Where a client has indirect expenses allocable to exempt income (whether or not received),[42] a careful study should be made of all pertinent facts and circumstances in order to arrive at an allocation formula which will be reasonable from both the government's *and* client's viewpoint. Such a review should especially include classification of all investor expenses into the following categories:

1. Directly allocable to exempt income (not deductible).
2. Indirectly allocable to both exempt and nonexempt income (subject to allocation by formula).
3. Directly allocable to nonexempt income (*completely deductible* as itemized deductions, *if* otherwise allowable).

CAUTION. The asset formula above may penalize a client since it does not permit *any* deductions to be allocated to tax-exempt securities in order to recognize their partial production of taxable income in the form of capital gains upon disposition. *Thus, an income formula would be more advantageous where capital gains on otherwise tax-exempt securities can be included as nonexempt income in determining the allocation ratio.* In *Whittemore*, the Eighth Circuit Court of Appeals adopted this approach as to capital gains on municipal bonds in rejecting the government's advocacy of a similar asset formula.[43]

NOTE. A detailed allocation statement must be submitted with a taxpayer's return and include a recitation that each deduction claimed in the return is in no way attributable to exempt income (Regs. Sec. 1.265-1(d)(1)).

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[41] *Leslie*, CA-2, 413 F2d 636, rev'g 50 TC 11 (1968), cert. denied.
[42] Regs. Sec. 1.265-1(b)(1).
[43] *Clinton L. Whittemore*, CA-8, 383 F2d 824 (1967).

No allocation is required of state income taxes to municipal interest income since taxes are deductible as such under Sec. 164 and are not considered investor expenses allowable under Sec. 212. However, taxes allocable to other classes of exempt income must be allocated.[44]

Obtain Ordinary Losses Under Limited Conditions — Where Feasible and Desirable

Losses from sales or exchanges of capital assets are subject to the relatively unfavorable treatment previously described in 203.10 of this tax study.

In addition to losses arising from actual sales or exchanges, the Internal Revenue Code places losses stemming from the following events in the same comparatively undesirable capital loss category:

1. Worthlessness of securities which are capital assets (Sec. 165(g)). (Regs. Sec. 1.165-5(c) requires that such securities be *wholly* worthless in order for any loss to be recognized.) Such losses are treated as resulting from hypothetical sales or exchanges on the last day of the taxable year.
2. Worthlessness of nonbusiness debts which are treated as short-term capital losses (Sec. 166(d)). (Regs. Sec. 1.166-5(a)(2) requires such debts to be *totally* worthless before such losses can be recognized.)

NOTE. Under the Supreme Court's *Whipple* decision (cited earlier) investors as such are precluded from designating funds advanced by them as business debts. Hence, they cannot claim ordinary deductions if and when such advances become totally worthless but must resign themselves to capital loss treatment upon such eventuality.

PLANNING SUGGESTION. As discussed at the conclusion of 203.10, there are two statutory provisions which convert capital losses into ordinary losses under limited circumstances, as follows:

1. Losses on small business stock (Sec. 1244).
2. Losses on small business investment company stock (Sec. 1242).

Investments in these media might be considered if (a) the tax (Code, regulations, and so forth) requirements can be met and (b) these stocks would otherwise be attractive from an investment (nontax) viewpoint.

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[44] Rev. Rul. 61-86, 1961-1 CB 41. Also see Sec. 265(1) for the precise terminology responsible for these distinctions.

307 Other Deductions

This chapter cannot conclude without some random thoughts regarding several planning techniques pertaining to selected miscellaneous deductions.

307.1 Accounting and Legal Fees

Planning Technique

Charges for professional services should be carefully allocated and itemized as applicable to deductible, capital, or personal functions.

Accounting and legal services performed for individuals would be deductible where they relate to the following activities:

1. The conduct of a trade or business (including the rendition of services as an employee as described in 304.1).
2. Nonbusiness activities, defined by Sec. 212(1) and (2) as (a) the production or collection of income or (b) the management, conservation, or maintenance of property held for the production of income.
3. Services "in connection with the *determination*, collection, or refund of *any* tax" (Sec. 212 (3), emphasis supplied.)

NOTE: This definition is not restricted to income taxes, of course, but includes *all* other taxes as well (such as estate, gift, or excise taxes, and so forth).

On the other hand, outright current deductions are not available for fees paid for services which constitute capital expenditures. Expenses for services which are personal *in nature*, of course, are never deductible.

Some examples of professional services and their tax treatment follow:

1. *Deductible activity.* Record-keeping regarding rent and royalty income.[45]
2. *Capital expenditures.* Defending or perfecting title to property. (Under Regulation 1.212-1 (k), these costs are added to the basis of the property.
3. *Personal services.* Legal expenses generated by a separation or divorce.[46]

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[45] *M. Frost,* 1 TC Memo 849.

[46] *Gilmore,* 372 US 39.

Illustrative Situations in Which Allocation Is Advisable

As can be seen from the illustrative situations presented below, professional services may frequently cut across deductible and non-deductible lines by involving a variety of activities such as:

- Functions relating to the production of income or income-producing property.
- Tax advice, preparation of tax returns, pursuing disputes with taxing authorities.
- Acquisition of property.
- Services regarding personal or family relationships.

In these cases, the ability to allocate, itemize, and substantiate the portion of a fee applicable to each of these various services will enable at least part of a fee to be salvaged as a deduction. In the absence of such breakdowns, *no* deduction at all may be allowed.[47]

Legal Services Regarding Defense of Title and Collection of Income. According to Regs. Sec. 1.212-1(k), "Attorney's fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents."

Accounting Fees for Obtaining a Private Tax Ruling and Determining the Basis of Stock. In a 1963 case of first impression, a U. S. district court (Missouri)[48] was concerned with a shareholder's income tax treatment of an invoice from an accounting firm for the following services:

Research and consultation regarding tax aspects and problems of proposed exchange of stock. Preparation of an "application for ruling" and conferences with IRS officials regarding this matter	$7,500
Determination of tax basis of stock involved in such tax-free reorganization	1,000
Total fee (payable by two shareholders)	$8,500

The Court held that all services pertaining to the exchange of stock, including the procuring of the IRS ruling, were deductible under Sec. 212 (3). However, the $1,000 charge was not deductible because:

[47] For a recent example of such a dire consequence, see the reviewed Tax Court decision in *G. L. Schultz*, 50 TC 688 (1968).
[48] *Basil L. Kaufmann*, 227 F. Supp. 807.

> . . . There was no controversy at that time as to the tax base of the new stock, and the mere fact that the new owners desired that such a determination be made while the accountants were investigating the situation generally, would not justify the deduction of the amount paid for that service. The base was computed for the information of the taxpayers or for some possible future use, and not for the purpose of determining any tax. . . .[49]

QUERY. Would this cost be an addition to the basis of said stock?

Tax Advice in Connection With Divorce and Separation Proceedings. Fees allocable to advice as to the tax consequences flowing from an alimony and property settlement in a divorce action were fully deductible, *even though such advice would also be of future use.*[50]

NOTE. Only expenses of the taxpayer himself are deductible. Consequently, a husband cannot deduct fees for tax advice rendered to his (former) wife.[51]

Estate Planning. Estate planning services usually consist of one or more of the following elements: tax advice, investment matters, and dispositive arrangements.

Generally, deductions should be claimed for services rendered relative to the first two elements while expenses involving the last element are not deductible. Consequently, estate planning fees should be specifically allocated among these categories and appropriately described when invoicing clients. (See 406.2, Chapter 4, regarding the role of certified public accountants and attorneys in estate planning.)

Following is a brief technical resume regarding the deductibility of the basic elements of estate planning services.

Tax Advice: Sec. 212 (3) authorizes deductions for expenses paid in connection with the *determination* of any tax. In turn, Regs. Sec. 1.212-1(l) specifies that expenses paid by a taxpayer *for tax counsel* are deductible.

Since tax advice, or counsel, in estate planning involves the determination of estate, gift and income taxes, fees for such services would seem to be deductible under Sec. 212 (3) and the regulation thereunder.

Although there does not appear to be any judicial decision *directly* in

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[49] For a contrary decision, see *W. K. Carpenter* (Ct. Cls.), 338 F2d 366.

[50] See *Carpenter* (footnote 49), following *Davis* (152 Ct. Cls. 805), 287 F2d 168 (aff'd and rev'd on *other* grounds by the Supreme Court.)

[51] *U.S.* v. *Davis*, 370 US 65 at p. 74.

point, the *Carpenter*[52] and *Kaufmann*[53] cases furnish favorable precedent.

Investment Matters: Sec. 212 (2) allows deductions for expenses paid for the *conservation* of property held for the production of income. Regs. Sec. 1.212-1 (g) specifically includes investment counsel in this category.

Thus, the Tax Court made the following statement in *Nancy Reynolds Bagley*:[54]

> . . . We think it equally clear that the $5,000 fee paid for advice and services with respect to the plans submitted by the Robinson brothers, a firm of estate planners, is deductible. The plan finally adopted effected a substantial rearrangement and reinvestment of petitioner's entire estate of income-producing properties. . . .

For further discussion of investment expenses, see 306.

Dispositive Arrangements: It has long been established that such expenditures as legal fees paid in connection with the preparation[55] or construction[56] of wills are nondeductible personal expenses.[57]

Tax Indemnification Agreement Upon Sale of Business

An individual sold his wholly owned corporate business to another company and agreed to indemnify the purchaser for any past tax owed by his corporation, retaining the right to contest any assessed deficiency. The buyer liquidated the corporation and transferred the assets to itself.

The seller could not deduct attorneys' fees and other legal expenses incurred in contesting tax deficiencies asserted against the purchasing company as transferee of the business assets since he was not liable for the deficiency either personally or as a transferee.[58]

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[52] See footnote 49.

[53] See footnote 48.

[54] *Bagley*, 8 TC 130 (1947), acq. 1947-1 CB 1.

[55] *Helen S. Pennell*, 4 BTA 1039 (1926).

[56] *Cornelius Vanderbilt, Jr.*, 16 TC Memo 1081 (1957).

[57] See Mertens, *Law of Federal Income Taxation*, Sec. 25.18; for further background, see M. E. Marmer, "Professional Fees: When Are They Deductible for Estate Planning Work," *The Journal of Taxation* (Nov. 1967), p. 300.

[58] *Southern Arizona Bank and Trust Co., Exrs., Est. of George Martin*, Ct. Cls., 386 F2d 1002.

307.2 Alimony and Support Payments

Planning Technique

Parties to a divorce can control income tax consequences of payments resulting therefrom. Generally, payor-spouse (husband) should arrange for all such payments to be deductible by him and taxable to payee even though some additional payment may be necessary.

The Code permits spouses contemplating divorce to determine which of them shall bear the tax burden with respect to alimony and support payments. Sec. 71 sets forth certain conditions under which such payments will, or will not, be includible in the recipient's gross income. Usually, these conditions are such that their compliance or noncompliance can be controlled by mutual consent of the parties involved.

Deductions are allowed the payor under Sec. 215 to the extent income is includible by the payee under Sec. 71.

Payments to support minor children are excludible from income (and not deductible) if fixed in amount by decree, instrument, or agreement.[59]

Only periodic alimony payments are deductible. Installment payments of a principal sum (an amount definitely stated or which can be definitely fixed) qualify as periodic alimony payments if payable over more than ten years. Payments for ten years or less are not deductible unless they are subject to any of the following contingencies: death of either spouse, remarriage of wife, or change in economic status of either spouse (Regs. Sec. 1.71-1 (d)(3)).

Planning Implications

Where a husband is in a higher tax bracket than his (former) wife, it will be mutually advantageous to follow these steps:

1. Arrange for *all* payments, including child support, to qualify as deductions for the husband (and taxable to the wife).
2. Negotiate the division of the resulting overall tax savings among the spouses. This savings will be the amount by which the reduction in the husband's taxes (caused by these deductions) exceeds the increase in the wife's taxes (attributable to this income).

There are various ways of implementing this objective. For example, the decree, agreement, and so forth, should not allocate any specific

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[59] Sec. 71(b). Also see the Supreme Court's decision in *J. Lester*, 366 US 299.

amounts as child support payments. Other means of achieving deductibility of payments to wife include:

1. Providing for installment payments of a principal sum to be paid for a period exceeding ten years pursuant to Sec. 71 (c) (2).
2. If wife insists upon full payment within ten-year period, make such payments subject to any of the contingencies previously mentioned which can be negotiated to the satisfaction of the wife.

307.3 Loss on Sale of Residence

Planning Technique

Nondeductible loss on sale of personal residence can be converted into deductible loss, within limits, if property is rented prior to sale.

As indicated in Chapter 2, losses sustained on sales or exchanges of personal residences are normally not deductible pursuant to Regs. Sec. 1.262-1 (b) (4). Nevertheless, Regs. Sec. 1.165-9 (b) (1) reads as follows:

> If property purchased or constructed by the taxpayer for use as his personal residence is, prior to its sale, rented or otherwise appropriated to income-producing purposes and is used for such purposes up to the time of its sale, a loss sustained on the sale of the property shall be allowed as a deduction under Sec. 165 (a).

The loss is determined by the standard computation, as follows:

Basis of property — amount realized from sale = loss

However, the basis of property converted from personal to income-producing or business purposes is the *lesser* of the following amounts: (a) fair market value at time of conversion or (b) adjusted basis for loss (under usual rules) at time of conversion, without reference to such fair market value.

Whichever amount is appropriate must, of course, be reduced by depreciation allowed or allowable after the property has been converted to income-producing purposes (Regs. Sec. 1.165-9 (b) (2)).

PLANNING SUGGESTION. It is advisable to ascertain fair market value (upon conversion) through competent appraisals in order to determine allowable depreciation and any subsequent loss. Presumably, such appraisal costs are deductible. (See similar discussion in 303.1 regarding appraisals in connection with capital expenditures that may qualify as medical deductions.)

Ordinary vs. Capital Loss. The Tax Court has held that the renting of a single residence constitutes a trade or business.[60] It might be noted that there are judicial decisions to the contrary.[61]

However, in view of the IRS' *acquiescence* in the *Hazard* decision, there should not be any dispute as to treating losses on converted residences as incurred in a trade or business. Therefore, such losses should be eligible for the favorable, noncapital loss provisions of Sec. 1231. (See 203.4, Chapter 2.)

Degree of Activity Necessary to Achieve Business Conversion. Generally, the preponderance of the decided cases support the criteria enunciated in Regs. Sec. 1.165-9(b)(1) that, prior to sale, personal use must be completely terminated and the residence actually rented in order to achieve the desired conversion into business (or income-producing) property.

Mere listing with a broker for sale or rental (whether or not on an exclusive basis) has been considered inadequate for this purpose.[62]

PLANNING SUGGESTION. Where a residence must be sold because of employment-connected relocation, and its cost exceeds current fair market value, any realized capital loss would still not be deductible.[63] In such a situation, consideration should be given to selling the home to the employer who, in effect, reimburses the employee for the prospective loss.

However, this reimbursement (excess of selling price over fair market value) will constitute taxable income to the employee.[64]

Reimbursement of moving expenses is further discussed in 307.5.

307.4 Depreciation and Maintenance Expenses Regarding Converted Residence

Planning Technique

Depreciation and maintenance expenses are deductible after residence is abandoned and merely listed for rent (or for rent

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[60] *L. Hazard,* 7 TC 372, acq. 1946-2 CB 3.

[61] For example, see *I. H. Grier,* CA-2, 218 F2d 603, (aff'g DC decision.)

[62] See *Morgan,* CA-5, 76 F2d 390, cert. denied, 296 US 601, which has been followed in several subsequent cases, including some of recent vintage. For some isolated exceptions where listing sufficed, see *Jay Burns,* 21 TC 857 (1954), acq. 1954-2 CB 3 (rem'd on another issue by CA-5) and *Est. of Heine,* 10 TC Memo 738 (1951).

[63] H. Rep. No. 91-413, Part 2, 8/4/69, p. 51.

[64] For examples, see *Bradley,* CA-4, 324 F2d 610; *Kobacker,* 37 TC 882; and *Ritter* (Ct. Cls.), 393 F2d 823.

and sale). Actual renting of the residence is not required.

Recent decision would also allow deductions where property is listed only for sale if certain conditions are met.

Depreciation and maintenance expenses are deductible, of course, only after a residence has been converted to business (or income-producing) use. However, the test for determining whether such conversion has occurred for this purpose is significantly less stringent than it is for purposes of claiming losses upon disposition (see 307.3).

To deduct depreciation and maintenance expenses after a personal residence has been abandoned, only mere listing for rent is required.[65]

The Tax Court recently indicated[66] that these deductions would be allowable where an abandoned residence is listed for *sale alone* and the owner is seeking (a) a profit over his cost and (b) a profit representing post-conversion appreciation in value.

307.5 Moving Expenses

Planning Technique

Certain moving expenses of unreimbursed employees and self-employed individuals can be partially recouped through income tax deductions.

Since reimbursement for all moving expenses are includible in gross income, qualifying the expenses for deduction will provide an offset against this otherwise taxable income.

Illustration 9, below, summarizes the income tax treatment accorded moving expenses.

Illustration 9

	Direct Expenses	*Indirect Expenses*
Reimbursed expenses:		
Reimbursements	T	T
Expenses paid or incurred	D	LD
Unreimbursed expenses paid or incurred	D	LD

T - Includible in gross income.
D - Deductible if certain conditions are met.
LD - Limited deduction if certain conditions are met.

[65] See, for example, *Mary L. Robinson*, 2 TC 305 (1943), acq. 1944 CB 23 (withdrawing prior nonacq. in 1943 CB 38). Also see *Frost* (DC, Colo.) where, under special circumstances, such deductions were allowed even though there was a long delay in renting and the property was never advertised.

[66] *Newcombe*, 54 TC 1298 (1970).

In order for moving expenses (direct and indirect) to qualify as deductions, they must meet a 50-mile minimum distance requirement (Sec. 217 (c)(1)), and a 39-week minimum employment requirement in the case of employees or a 78-week test in the case of self-employed individuals (Sec. 217(c)(2)). (See technical resume.)

NOTE. Moving expense deductions are deductible *from gross income* in arriving at adjusted gross income (Sec. 62 (8)). See 304.2 for the significance of this treatment.

Self-Employed Persons. Self-employed persons can deduct moving expenses to the same extent as employees. However, eligibility is conditioned, in part, upon a 78-week test (at new place of employment) as opposed to only the 39-week test applicable to employees. This additional requirement was imposed because self-employed relocation was more likely to be voluntary than employee relocation.[67]

Dollar Limitations on Moving Expenses

Direct Expenses. The following expenses are considered direct expenses and are deductible in full providing the taxpayer meets the time and distance requirements.

1. Moving of household goods and personal effects. (See detailed description in Regs. Sec. 1.217-1 (b)(3).)
2. Transportation costs of employee and family.
3. Meals and lodging in transit.

Indirect Expenses. The limited deductions allowable under Sec. 217 (b)(3) for three categories of so-called indirect moving expenses (whose composition is more fully covered in the technical resume) may be explained and depicted as shown in Illustration 10, below.

Illustration 10

Category of Expense	*Maximum Amount Deductible*
1. Pre-move house-hunting trips	$ 600
2. Temporary living expenses at new job site	700
3. Limit on deduction for both (1) and (2)	$1,000
4. Reasonable expenses of selling, purchasing, or leasing a residence	1,800
Maximum deduction	$2,500

[67] See p. 39 of the Summary of H. R. 13270 (Tax Reform Act of 1969), dated Nov. 18, 1969, prepared for the Senate Finance Committee.

The maximum deductions are not increased if a husband and wife both obtain new employment in the same general area. However, the maximum deductions are reduced by 50 percent for a married taxpayer filing a separate return. To the extent that the amounts incurred with respect to the acquisition or disposition of residences are not deductible as moving expenses, they are treated as capital expenditures which either decrease the net sale price of the old residence or increase the tax basis of the new one.

PLANNING SUGGESTION: Generally, it will be advisable to claim selling expenses as moving expense deductions, to the extent permitted under the law, rather than offset them against the selling price. (It is not clear whether the selling price could instead be reduced in those rare instances where it would be more advantageous. In other words, such a choice may not be possible for moving expenses which are allowable as deductions.)

Reimbursements

All direct as well as indirect reimbursements for moving expenses must be included in gross income as compensation for services (pursuant to Sec. 82), with deductions for such expenses allowable in accordance with Sec. 217. Expenses paid by the employer to a mover, lessor of a temporary residence, and so forth, are considered indirect reimbursements.

Consequently, Sec. 82 can cause increased tax liability if offsetting expenses cannot qualify for deduction under Sec. 217.

Sec. 3401 (a)(15) provides that moving expense reimbursements are not subject to withholding to the extent it is reasonable to believe that offsetting deductions will be available.

Technical Resume

Pre-Move House-Hunting Trips. Under Sec. 217(b)(1)(C), such expenses include transportation, meals and lodging for a taxpayer and members of his household paid for the principal purpose of searching for a new residence, subject to the following conditions: (1) the taxpayer has obtained new employment before beginning the trip and (2) he makes a round trip between his former residence and the general area of his new principal place of employment.

Temporary Living Expenses at New Job Site. Under Sec. 217 (b)(1)(D), such expenses consist of meals and lodging incurred by a

taxpayer and his household members in the vicinity of a new job location while looking for, or waiting to move into, a permanent residence. However, only those expenses incurred within any 30 consecutive days after obtaining employment are deductible.[68]

Expenses of Disposing of and Acquiring Residences.[69] The deduction for expenses of selling or exchanging a former residence is confined to those items which would be allowed as offsets against the selling price in determining the gain realized. Selling expenses include sales commissions and related legal fees, title costs, and escrow fees. "Fixing-up" expenses and any realized capital losses cannot be claimed as moving expenses. Double tax benefits are denied by Sec. 217(e); thus, any selling expenses which are deductible as moving expenses cannot also be used to reduce the gain realized (if any).

In order for expenses of purchasing a new residence to be deductible, the new residence must be located in the general area of the new principal place of employment. Purchasing expenses are confined to those items which would be added to either the adjusted basis of the new residence or the cost of a loan. For example, such expenses include legal, appraisal and escrow fees, title costs, and loan placement charges (i.e., "points") which do not represent interest or prepaid interest. ("Points" which are essentially interest expenses are deductible as such pursuant to Rev. Rul. 69-582. See 104.2, Chapter 1.)

The Senate Report[70] states that neither prorated real estate taxes nor the actual purchase price are considered purchasing expenses. Since double benefits are denied under Sec. 217 (e), deductible purchasing expenses must be excluded from the residence's tax basis.

The expenses of settling a lease are also deductible as moving expenses. The House Report[71] declares that these expenses consist of those items incident to settling an unexpired lease on a former residence, including payments to secure release from the lease as well as legal fees, commissions, and other similar expenses incurred to obtain an assignee or sublessee.

The expenses of acquiring a lease on a new residence may be

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[68] H. Rep. No. 91-413, Part 2, 8/4/69, p. 50.

[69] Sec. 217(b)(1)(E) and Sec. 217(b)(2). H. Rep. No. 91-413, Part 1, 8/2/69, p. 76 and Part 2, 8/4/69, p. 51. For this purpose a residence is property owned or leased by the taxpayer, his spouse, or the couple jointly and includes a house, an apartment, a cooperative or condominium dwelling unit, or other similar dwelling.

[70] S. Rep. No. 91-552, 11/21/69, p. 109.

[71] H. Rep. No. 91-413, Part 2, 8/4/69, p. 51.

deducted. These expenses include fees and commissions incident to obtaining a lease, sublease, or assignment of an interest in property used by the taxpayer as his new residence in the general location of his new principal place of employment. According to the Senate Report, rent or prepaid rent and security deposits are not includible as lease acquisition expenses.

Mileage Test. The new place of work must be at least 50 miles further from the old residence than the old place of work. The Conference Committee Report[72] indicates that the distance used between these two points will be the shortest of the more commonly traveled routes between them rather than the actual distance.

Nevertheless, this requirement has been viewed as excessive. Testimony presented by the AICPA's federal taxation division to the Senate Finance Committee indicated that an employee formerly commuting 20 miles to his old employment may not qualify for the deduction unless the new employment is 70 miles from his former residence. This is not realistic even in our largest metropolitan areas.

Time Test. In order for any moving expenses to be deductible, an employee must be employed full time in the general location of his new principal place of work for at least 39 weeks during the 12 months immediately following his arrival at such location. Appropriate procedures are provided if this test is not satisfied when the return for the year is due, if it is then still possible for the test to be subsequently satisfied.

As previously mentioned, the same test applies to self-employed persons except that 78-week period is substituted for the 39-week period applicable to employees.

Sec. 217(d)(1)(A) waives this time test if it cannot be satisified because of death or disability. Such test is also waived if an *employee* obtains full-time employment and could reasonably have been expected to meet the test but is either (a) involuntarily separated from the employer's service, except for willful misconduct, or (b) transferred for the employer's benefit.

Effective Dates. This discussion reflects 1969 Tax Reform Act provisions and applies to taxable years beginning after 1969 (i.e., calendar year 1970 and thereafter) with the following exceptions:

1. Certain reimbursed expenses. Reimbursed expenses are not deductible if the reimbursement was received in a taxable year beginning

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[72] H. Rep. No. 91-782, 12/21/69, p. 301.

before January 1, 1970 and was not included in gross income (under prior law).

2. Certain moves before January 1, 1971. At the taxpayer's election, prior law can be applied to moving expenses paid or incurred before January 1, 1971, pursuant to a notice received from an employer on or before December 19, 1969.

307.6 Consuming Expiring Carryovers

Planning Technique

Wasting net operating loss, investment credit, or contribution carryovers can be curtailed by shifting income or deductions and stepping up the basis of property.

For background on this subject, see prior discussion in 104.2 and 201.4.

Further Lifetime Advanced Planning
For Income, Estate, and Gift Tax Purposes

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Chapter 4

Further Lifetime Advanced Planning for Income, Estate, and Gift Tax Purposes

The pervading theme of this chapter is the further enrichment of individuals through overall reduction of income, estate, or gift taxes, or advantageous financial transactions which may be accomplished, generally, by extraordinary measures or achieved in nonroutine situations. In many instances, the techniques discussed cut across tax "lines" and, accordingly, stress coordinated planning efforts.

401 Charitable Contributions

The modern day debate regarding the use of our tax structure as a means of attaining social objectives is certainly not grounded upon purely contemporary thought. In fact, such concepts may have originated with the passage of the Revenue Act of 1917 which, for the first time, permitted deductions in computing taxable income for essentially personal gifts for "religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children or animals. . . ." [1]

Without intending in any way to disparage the extremely worthy humanitarian goals served by such legislation, which has been continued in expanded form as part of every subsequent income tax statute as well as later estate and gift tax enactments, there are a variety of ways and means of effectuating these gifts whose tax consequences warrant prudent consideration.

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[1] H. Rep. (Conf.) No. 172 (65th Cong., 1st sess.) 1939-1 CB (Part 2), 72.

401.1 Lifetime vs. Testamentary Gifts

Planning Technique

Lifetime gifts can provide income tax as well as estate tax savings. Where such gifts are incomplete for estate tax purposes, additional estate tax savings may be possible through increased marital deduction (if otherwise available).

Lifetime gifts as opposed to testamentary gifts can generate current income tax deductions and, of course, accelerate the financial benefit obtained by the charity. On the negative side, the donor must make an irrevocable decision which will permanently remove property from his dominion and enjoyment.

Both lifetime and testamentary gifts enable property to be excluded from the donor's taxable estate. Naturally, any unconsumed income tax savings resulting from lifetime gifts would be subject to estate tax upon the donor's death.

Effect of Charitable Gifts Upon Estate Tax Marital Deduction

The estate tax marital deduction, in general, is discussed in 406. However, the interrelationship between charitable gifts and the estate tax marital deduction might be noted here.

The maximum marital deduction cannot exceed 50 percent of the adjusted gross estate which is the gross estate reduced only by funeral expenses, administration expenses (403.2), and debts. The deduction for charitable bequests, which is allowable in computing the taxable estate, does not enter into the calculation of the adjusted gross estate and, therefore, does not affect the maximum marital deduction. In other words, the maximum marital deduction is not reduced by charitable bequests.

On the other hand, this deduction is reduced by diminution of the gross estate and conversely, is increased by additions thereto. Thus, a lifetime charitable contribution will reduce the maximum marital deduction because it will have depleted the gross estate. However, if such contributions can be made in such a manner that they will still be complete for income tax purposes but yet be considered incomplete for estate tax purposes, they will have the following advantageous effects:

1. Current income tax deductions will continue to be available.
2. The contribution will be added back to the gross estate, increasing the base for computing the maximum marital deduction.

3. The same contribution is deductible in determining the taxable estate, exactly offsetting the addition to the gross estate.
4. The net effect is a reduction of the taxable estate equal to 50 percent of the charitable contribution, added back to the gross estate in those situations where the maximum marital deduction is available and desired.

EXAMPLE. Client's gross assets total $1,600,000. He wishes to contribute $500,000 to charity during his lifetime and also obtain the maximum marital deduction for bequests to his wife upon his death. His taxable estate would be computed as shown in Illustration 1, below.

Illustration 1

Gross assets	$1,600,000
Less lifetime charitable contributions	500,000
Gross estate	1,100,000
Less debts	100,000
Adjusted gross estate	1,000,000
Less:	
Maximum marital deduction	500,000
Charitable bequest	—
Exemption	60,000
Total	560,000
Taxable estate	$ 440,000

PLANNING SUGGESTION. Make charitable contributions with certain strings attached or under such other conditions that they must be added back to the gross estate. This procedure will achieve estate tax savings as shown in Illustration 2, below.

Illustration 2

Gross estate (Illustration 1)	$1,100,000
Add charitable gifts considered incomplete for estate tax purposes	500,000
Gross estate revised	1,600,000
Less debts	100,000
Adjusted gross estate revised	1,500,000
Less:	
Marital deduction	750,000
Charitable bequests	500,000
Exemption	60,000
Total	1,310,000
Taxable estate revised	$ 190,000

NOTE. The taxable estate has been decreased by $250,000 which is 50 percent of the lifetime charitable contributions added back to the gross estate.

Planning Technique

Estate taxes can be reduced (at the death of the first spouse) in cases where the maximum marital deduction is available if the gross estate is increased by assets which have been given or bequeathed to charitable organizations.

For example, it may be advisable, if the maximum marital deduction is obtainable, to agree with a revenue agent who proposes a higher value for corporate stock if a sufficient amount of the stock has been bequeathed to charity.

In addition, the estate tax sections of the Internal Revenue Code *require* certain assets to be included in the gross estate *even though they may have been transferred by the decedent before his death.* See the discussion of ineffective gifts in 202.2.

NOTE. Since there is *no* complete correlation between these estate tax sections and the income tax sections, such pre-death transfers may usually be deductible for income tax purposes.[2]

It might be reiterated that this planning technique depends upon the availability of the marital deduction and becomes academic if a client is not survived by his spouse (or is survived by a spouse to whom bequests will not be made).

(There is also no advantage to increasing the marital deduction if bequests to a spouse would be eligible for estate tax credit in her estate (under Sec. 2013). However, this credit only applies if the spouse dies within ten years after, or two years before, her husband's death. It is also reduced by the following scale:

Credit Reduction	*Year of Spouse's Death Subsequent to Donor's Death*
20%	3rd or 4th
40%	5th or 6th
60%	7th or 8th
80%	9th or 10th

[2]The following estate tax provisions could be used to add charitable gifts to the gross estate: Secs. 2035 (transactions in contemplation of death); 2036 (transfers with retained life estate); 2038 (revocable transfers); 2040 (joint interests); and 2042 (proceeds of life insurance).

Thus, this credit has limited application and cannot be relied upon, in any event, for planning purposes.)

Revocable Transfers

A revocable transfer is a gift, usually in trust, that is considered incomplete for estate tax purposes. However, because of the difference in the applicable standards, a revocable transfer may be considered complete for income tax purposes.

For example, Sec. 674 (b) (4) provides that a grantor is *not* considered to own any portion of a trust — *for income tax purposes* — merely because he has the power to determine the beneficial enjoyment of its charitable beneficiaries. However, Sec. 2038 provides that the gross estate includes the value of any interest in property transferred by the decedent if the enjoyment of the interest was subject, at the time of death, to any change through the exercise of a power by the decedent to alter, amend, revoke, or terminate.

Several cases have held that a transfer had to be added back to the decedent's estate because he reserved the power to change the ultimate beneficiaries or to vary the shares distributable.

Regs. Sec. 1.170-1(e) deals with charitable transfers subject to a condition or power. This regulation disallows a charitable deduction if the condition or power would prevent the charity from enjoying the transferred property. If all of the beneficiaries of a trust are charities, the donor's power to change their individual interests would not appear to jeopardize his income tax deduction since all of the property, in any event, has been given to charity.

Therefore, revocable transfers to charity could be used to obtain the following advantages:

- A current income tax deduction for the full value of the property transferred.
- An additional estate tax deduction due to a greater marital deduction (equal to 50 percent of the property's estate tax valuation).

EXAMPLE. In 1970, Client creates a trust with the following provisions:

1. Client reserves the power to accumulate or distribute income. He also reserves the power to distribute principal.
2. Any income that is not accumulated must be distributed to the community fund. Principal can only be distributed to the county hospital. At Client's death, any undistributed income and principal is to be distributed to the state college.

At the same time, Client transfers $100,000 in cash to the trust and deducts this amount on his 1970 income tax return (subject to the limitation of *20 percent* of adjusted gross income).

NOTE. Contributions to the trust, in this example, would *not* qualify for the 50 percent limitation and the five-year carryover since a substantial part of its support would not normally be received through direct or indirect contributions from the general public.

Client dies in 1975. The value of the trust's assets is included in his estate because of the powers which he had reserved, as shown in Illustration 3, below.

Illustration 3

Computation of Taxable Income

Trust (market value of investments in 1975)		$ 150,000
Other assets		950,000
Gross estate		1,100,000
Less debts		100,000
Adjusted gross estate		1,000,000
Less:		
Maximum marital deduction	$500,000	
Charitable bequest	150,000	
Exemption	60,000	710,000
Taxable estate		$ 290,000

If Client had made an outright contribution in 1970, his taxable estate would be increased by $75,000, as follows:

Gross estate		$950,000
Less debts		100,000
Adjusted gross estate		850,000
Less:		
Maximum marital deduction	$425,000	
Exemption	60,000	485,000
Taxable estate		$365,000

NOTE. In a case before the Fifth Circuit Court of Appeals, the donee had disposed of some of the original subject matter of revocable lifetime transfers. This fact did not prevent the inclusion in the donor's estate of more than the amount of the original property than is still retained by the donee. (Presumably, *all* of the original property was included in the estate.)[3]

[3] *L. H. Howard, Exr.*, 125 F2d 986.

Transfers With Retained Life Estate

Sec. 2036 of the Code requires all gifts to be added back to the donor's gross estate if he has retained a life estate in the property during his lifetime. Therefore, the retention of a life estate in a gift to charity will increase the maximum martial deduction allowable as discussed above. However, various requirements must be met in order to obtain income, estate, and gift tax deductions for a gift of a remainder interest to charity. (See 401.3.)

Joint Interests

Sec. 2040 requires the gross estate to "include the value of all property to the extent of the interest therein held as joint tenants by the decedent and any other person. . . . " Therefore, it may be possible to use this section as follows.

EXAMPLE. In 1970, Client gives a university a 50 percent interest, as joint tenant, in certain investment securities. He can deduct the value of this 50 percent interest on his 1970 income tax return. At his death, 100 percent of the property's value, at that time, is included in his gross estate with the resulting increase in the maximum marital deduction allowable. The entire value of the property would then be deductible as follows:

1. 50 percent portion representing the interest given to the university in 1970.
2. 50 percent portion representing the balance of the property that automatically passes to the university, as surviving joint tenant, upon Client's death.

Transactions in Contemplation of Death

The Code (Sec. 2035) presumes that all gifts made three years prior to death are deemed to have been made in contemplation of death, unless the contrary is shown. Therefore, the estate tax could be reduced by taking into account the contributions shown on the decedent's income tax returns that were made during the three-year period prior to death.

NOTE. If the benefits of Sec. 2035 are desired, it would be advisable for the donor to leave evidence, such as a written statement, of his intent that charitable contributions were made in contemplation of death. However, this procedure may not be advisable if noncharitable gifts were also made during this period.

Use of Life Insurance

Outright Transfers. Outright transfers of life insurance policies to charities, with retention of certain limited incidents of ownership by the donor (within the purview of Sec. 2042), may be another means of achieving lifetime income tax deductions and greater estate tax marital deductions.[4]

Life Insurance Charitable Trusts. To illustrate the income and estate tax effects of life insurance charitable trusts, assume that a client transfers a policy on his life to an irrevocable trust requiring proceeds to be paid to charity. He is named as trustee with these reserved powers:

1. To designate and change particular charitable recipients and their proportionate shares.
2. To surrender policy.
3. To reinvest proceeds. (Presumably, indenture would require proceeds either to be paid to charity, or applied for the benefit thereof.)
4. To accumulate or distribute income and corpus.

Income Tax Effects: The transfer of the policy to the trust and the client's later payments of premiums would seem to qualify for income tax charitable deductions, despite his reservation of powers.[5]

Estate Tax Effects: The client's reserved powers should cause inclusion of the trust in his gross estate, upon any one of the following three theories:

1. Retention of an incident of ownership over the policy.[6]
2. Retention of the power to alter, amend, or terminate.[7]
3. Retention of the right for his life to designate who shall possess or enjoy the income or corpus.[8]

CAUTION. The *Winthrop* opinion[9] casts some doubt on this procedure, as follows: ". . . there appears to be no authority under either gift or estate tax law as to the effect of a retained power to allocate among a

[4] For further discussion, see Philip J. Goldberg, "Funding a Charitable Program with Life Insurance," *Trusts & Estates* (Sept. 1960), p. 788.
[5] *John Danz*, 18 TC 454 (1952), acq. 1952-2 CB 1; *H. H. Bowman*, 16 BTA 1157 (1929); *cf. Winthrop* v. *Meisels*, CA-2, 281 F2d 694.
[6] Regs. Sec. 20.2042-1 (c).
[7] Sec. 2038; *Lober*, 346 US 335.
[8] Sec. 2036; *Struthers* v. *Kelm*, CA-8, 218 F2d 810.
[9] See footnote 5.

class of charitable beneficiaries. . . ." It goes on to approve the government's analogy from income tax Sec. 674 (b) (4), which for includibility purposes does draw a distinction between the power to allocate among charitable and noncharitable beneficiaries. However, the income tax statute expressly draws this distinction while the estate tax statute does not. Any extension of this distinction to the estate tax statute would seem to be without statutory authority.

Further Comment. Life insurance creates a large gross and adjusted gross estate, at relatively little cost, where the insured dies before his life expectancy and it is customarily financed out of current income. [10]

401.2 Outright Gifts

Planning Technique

Charitable gifts can be made outright or can consist of limited interests in property, such as gifts of income or remainder interests. Outright gifts should reflect consideration of such factors as (1) appreciation versus decline-in-value of potential gift property, (2) varying consequences of giving capital assets versus ordinary income assets, and (3) bargain sales to recover donor's cost.

The optimum type of charitable contribution for an individual client depends, of course, upon all the particular facts and circumstances involved.

Gifts of limited interest are discussed in 401.3.

Appreciated vs. Declined-in-Value Property

A contribution of appreciated property enables the client to financially benefit from the appreciation in value without having to pay any tax (usually at capital gain rates) on such increment. This admirable result is caused by the following authorized treatment:

1. The full fair market value of donated property is taken into account in determining the amount of deductible charitable contributions.
2. A gift of property, whether charitable or otherwise, is not a taxable event giving rise to recognized gain or loss.

[10] For additional information, see R. B. Fraser, "Charitable Giving as an Element in Planning Lifetime and Testamentary Giving," 19 NYU Proc. 751 (1961), at p. 793.

By the same token, property which has declined in value should not, itself, be contributed to charity. Instead, such property should first be sold in order to recognize the loss sustained (usually a capital loss) for income tax purposes. The cash proceeds realized from such a sale can then be contributed to charity. This latter procedure does not diminish the amount of the charitable contribution deduction since the cash donated will equal the property's fair market value.

Reduction of Contribution Deduction in Certain Cases

Ordinary Income Property Contributed to Any Charity. The fair market value of ordinary income property contributed to any charity, whether a public charity or a private foundation, is reduced by 100 percent of any appreciation (i.e., unrealized or potential ordinary gain). Consequently, a donor can only deduct the cost or other basis of such donated ordinary income property which includes such assets as the following:

1. Short-term capital assets.
2. Inventory.
3. Works of art created by the donor.
4. Letters, memoranda, etc., prepared by the donor or for the donor (see Sec. 1221 (3)).
5. Sec. 306 stock (briefly described in 203.5).

Where contributed property would produce both ordinary and capital gain if sold instead, the contribution deduction is reduced by only the ordinary income portion of the hypothetical gain. However, further reduction may be required for the capital gain element in the case of certain tangible personal property or for gifts to certain private foundations (as more fully explained later in this discussion). Such mixed results (ordinary and capital gain) are caused by various statutory recapture provisions and pertain to such property as (1) depreciable personal and real property (discussed in 203.7) and (2) farm property (see 502).

Capital Gain Property Contributed to Certain Private Foundations. The fair market value of capital assets contributed to private foundations, except those subsequently noted, is reduced by 50 percent of the potential long-term capital gain — as shown in Illustration 4, page 311.

This reduction is comparable to recognizing the appreciation as a long-term capital gain (without the benefit of the maximum alternative tax rates (see introduction to 203, Chapter 2)). However, no such

Illustration 4

Line		
	Facts	
1.	Fair market value	$1,000
2.	Cost	100
3.	Potential gain	$ 900
	Amount of Deductible Contribution	
4.	Fair market value (line 1)	$1,000
5.	Less — reduction (line 3 multiplied by 50%)	450
6.	Amount of deductible contribution (subject to over-all limitations)	$ 550

reduction is required for appreciated capital assets donated to the following three types of private foundations:

- "Distributing" foundations.
- Operating foundations.
- "Community" foundations.

Each of these particular foundations is defined in the technical resume concluding this discussion.

On the other hand, a contribution deduction for certain kinds of capital gain property is reduced, regardless of the type of donee involved, under the circumstances next described.

Certain Capital Gain Property Contributed to Any Charity. The fair market value of capital assets in the form of tangible personal property (such as paintings, art objects, and books not produced by the donor) is reduced by 50 percent of the potential gain where such property is contributed to any charity (public or private) if the property's use is unrelated to the donee's exempt purpose or function. Conversely, no reduction is required if the property's use is related to the donee's exempt purpose or function.

This treatment will, apparently, affect contributions which the charity resells, as shown in Illustration 5, p. 312.

Evaluation and Summary. The full fair market value of appreciated capital gain property can be deducted, without any recognition of income, if contributed to public charities or "qualifying" private foundations (see technical resume, page 315). This favorable treatment applies to intangible property (e.g., securities), real property (land), and tangible personal property used by the donee in a manner related to its exempt purpose.

Illustration 5

Type of Property	*Donee*	*Donee's Use*	*Reduced Contributions Deduction*
Painting (not created by donor)	Museum	Display	No
	Hospital	Resale	Yes
	University	Educational program such as an art appreciation course	No
		Display outside a museum, etc.	Possibly yes

Note: Based upon Congressional Record, 12/23/69, p. H13038.

On the other hand, only 50 percent of the appreciation (plus cost or other basis) can be deducted for:

1. Any capital asset given to "nonqualifying" private foundations.
2. Tangible personal capital gain property used by any donee in an unrelated manner.

Finally, no appreciation can be deducted to the extent it would yield ordinary income (if the contributed property was sold instead). This unfavorable treatment applies to all ordinary income property (or to the ordinary income element in capital gain property) regardless of the type of donee involved (public charity or private foundation) or the nature of the donee's use of the property (related or unrelated to its exempt purpose).

Of course, any deductions obtained from contributions of appreciated property are also subject to overall limitations (based upon adjusted gross income) which are considered in 401.4.

Bargain Sales to Recover Donor's Cost

A bargain sale at cost is a variation of the contribution-in-kind technique just discussed. Such bargain sales permit a client to recoup his investment in donated property. However, the basis of the property must be allocated to the portion deemed sold and the portion deemed contributed, based upon the fair market value of each portion. Therefore, a bargain sale of appreciated property cannot be made without recognizing gain.

A contribution deduction is still obtainable for the part of the property given to charity. In this case, of course, the deduction is based upon the property's appreciation only — not its entire fair market value. This deduction is also subject to the same reduction applicable to outright gifts of appreciated property in the circumstances previously specified.

In Illustration 6, below, the contribution taken into account is $4,000, which is equal to the property's appreciation.

Illustration 6

Facts

Taxpayer sells land to a public school.

Fair market value			$10,000
Cost			$ 6,000

Treatment	*Portion Sold*	*Portion Given*	*Total*
Value	$6,000	$4,000	$10,000
Cost	3,600 (60%)	2,400 (40%)	6,000
Long-term capital gain*	$2,400		

* Such gain also constitutes a tax preference. See 105.1.

If, instead, the property is sold to a nonoperating or nondistributing private foundation, the contribution deduction would be reduced by $800, which is 50 percent of the $1,600 hypothetical gain ($4,000 less $2,400) allocated to the portion given.

This allocation only applies if a contribution deduction results from a bargain sale (Sec. 1011(b)). Thus, a bargain sale of ordinary income property (e.g., short-term capital assets) will not precipitate any gain since it also will not produce any deductions. For example, stock purchased for $10,000 and sold two months later for the same price, when its fair market value is $15,000 will not generate any gain or deductions.

PLANNING SUGGESTION. (1) A bargain sale avoids capital gains tax on the portion of property deemed contributed to charity. (2) Avoid bulk bargain sales of capital assets with different tax bases. Instead, sell high-basis property and only contribute low-basis property.[11]

[11] See Leonard A. Rapoport, "Charitable Contributions Under the Tax Reform Act of 1969," *The Tax Adviser* (March 1970), p. 162.

EXAMPLE. Assume Client owns two lots of stock, each worth $50,000. However, lot X cost $10,000 while lot Y cost $50,000. Client wishes to sell both lots for his $60,000 cost to a public charity.

Unless future regulations permit actual cost to be assigned to each lot, Client will have a long-term capital gain of $24,000, computed as follows:

	Portion Sold	*Portion Given*	*Total*
Value	$60,000	$40,000	$100,000
Cost	36,000	24,000	60,000
Gain	$24,000		

On the other hand, if each lot is sold separately for its own cost, a gain of only $8,000 is recognized as follows:

Lot X:

	Portion Sold	*Portion Given*	*Total*
Value	$10,000	$40,000	$50,000
Cost	2,000	8,000	10,000
Gain	$ 8,000		

Lot Y: No gain is recognized since $50,000 cost equals fair market value.

Planning Considerations

Declined-in-Value Property. Declined-in-value property should not be given to charity since no tax benefit will be obtained from the unrealized loss (the excess of cost or other basis over the deductible fair market value). Instead, such property should be sold to incur a recognizable loss (see 402) and the proceeds (approximating the property's fair market value) contributed to charity.

Investment Credit Recapture. Under Regs. Sec. 1.47-2(a)(1), a gift is included among those premature dispositions of depreciable property that can give rise to investment credit recapture. (See 202.2.)

Determination of Value for Gift and Estate Tax Purposes. Gifts of closely held corporate stock may cause such stock to be valued by the IRS upon examination (or by the courts upon dispute). Such official determinations may be of precedental value for gift and estate tax purposes as well as for estate planning. (For further discussion, see 201.6.)

Technical Resume

As explained earlier, deductions for contributions of appreciated capital gain property to private foundations are reduced unless the foundation falls within any of the following three categories:

"Distributing" Foundations. A foundation which distributes, within 2 1/2 months after the end of the year in which contributions are received, an amount out of its corpus equal to 100 percent of such contributions to public charities or private operating foundations (see below). However, the donor must obtain sufficient evidence of such distributions from the foundation (Sec. 170(b)(1)(E)(ii)).

Operating Foundations. A foundation which spends substantially all (at least 85 percent) of its income directly for the active conduct of its activities representing the purpose or function for which it is organized and operated and which also meets *any one* of the following tests.

Asset Alternative Test: Substantially more than one-half (at least 65 percent) of the foundation's assets must be devoted directly to the activities for which it is organized and operated or to functionally related businesses.

This alternative test is intended to apply particularly to museums and such organizations as Colonial Williamsburg, Jackson Hole (Wyoming), and Callaway Gardens (Pine Mountain, Georgia).[12]

Endowment Alternative Test: The foundation's endowment (plus any other assets not devoted directly to the active conduct of the activities for which it is organized), based upon a 4 percent rate of return, is no more than adequate to meet its current operating expenses. (This 4 percent rate will vary with any changes made by IRS in the 6 percent minimum payout requirement necessary to avoid the 15 percent excise tax for failure to distribute income, which is imposed upon certain private foundations by the 1969 Tax Reform Act. However, the endowment rate of return will always be two-thirds of the minimum payout requirement rate.)

This alternative test is intended to apply to foundations which actively conduct charitable activities, as distinguished from merely making grants, where their personal services are so great in relation to charitable assets that the cost of those services cannot be met out of small

[12] S. Rep. No. 91-552, 11/21/69, p. 61; explaining Sec. 4942(j)(3).

endowments. Examples of such foundations include research organizations, Sleepy Hollow Restoration, and Longwood Gardens.[13]

Support Alternative Test: All of the following conditions must be met:

- Substantially all support (at least 85 percent), except gross investment income, is received from the general public and from five or more exempt organizations, which are not related private foundations (as defined in Sec. 4946(a)(1)(H)).
- Not more than 25 percent of such support is received from any one of these exempt organizations.
- Not more than one-half of the foundation's total support is derived from gross investment income.

This support alternative test is intended to focus primarily upon special-purpose foundations, such as learned societies, library associations, and organizations which have developed an expertise in certain substantive areas and which provide for the independent granting of funds and direction of research in those specialized substantive areas.[14]

"Community" Foundations. A foundation which pools all contributions into a common fund but permits the donor to designate the ultimate recipients from among public charities. However, all income from the common fund must be distributed to these recipients within 2 1/2 months after the end of the year in which it was realized; and all corpus attributable to any donor's contribution must be likewise distributed not later than one year after the donor's death, or one year after the death of the donor's surviving spouse if she has the right to designate corpus recipients.[15]

401.3 Gifts of Partial or Limited Interest

Planning Technique

Under prescribed conditions, contribution deductions can be obtained even though the donor has not relinquished all interest in the gift property.

Where a client does not wish to surrender all rights and benefits emanating from his property, he may find gifts of either partial or

[13] See footnote 12.
[14] *Ibid.*
[15] Sec. 170(b)(1)(E)(iii).

limited interests desirable — depending upon his overall economic and tax situation.

Gifts of Partial Interest

No deductions are generally allowable if less than an entire interest in property is given to charity without the use of a trust. A gift of the right to use property, such as the free use of space, is considered to be such a nondeductible gift of a partial property interest. [16]

However, no income (e.g., rent) is imputed for the value of such rights. [17]

On the other hand, there are significant exceptions to this forbidden deduction which make some gifts of partial interest attractive where a trust is not feasible or desirable. Thus, gifts of the following types of partial interests should be considered since the charity's interest will be deductible:

1. Remainder interests in personal residences or farms.
2. Outright gifts of undivided interests.

Another exception exists for gifts of partial interest which would have been deductible if made in trust. (See succeeding discussion.) Since annual payments to beneficiaries are required for both remainder and income interest charitable trusts, this exception appears relevant only for gifts of assets which will be sufficiently income-producing or liquid to meet these requirements.

In valuing gifts of remainder interests in residences or farms, the following rules must be observed:

1. Straight-line depreciation (and cost depletion) is taken into account.
2. The value of the gift is discounted at a rate of 6 percent per annum. However, the IRS can prescribe a different rate (based upon changed economic conditions).

Gifts of Limited Interest

Gifts of limited interest consist of either a remainder or an income interest and are usually made in trust. Each of these two types of limited interests have tax and financial advantages and disadvantages.

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[16] Sec. 170(f)(3)(A).

[17] H. Rep. No. 91-413, Part 1, 8/2/69, p. 58.

Remainder Interests

A charitable gift of a remainder interest in property permits the donor to obtain the following benefits:

1. Immediate income tax deduction for the present value of the remainder interest.
2. Continued income, use, or other enjoyment of the property throughout any future period he selects — including his entire lifetime.
3. Removal of the property from his taxable estate without incurring gift tax.
4. Further reduction of taxable estate where maximum marital deduction is available (as more fully described in 401.1).

Sec. 170(a)(3) generally prevents immediate deductions for gifts of remainder (future) interests in tangible personal property such as works of art and automobiles. However, remainder interests in intangible personal property (e.g., securities) or real property (e.g., personal residence) are eligible for current charitable contribution deductions.

PLANNING SUGGESTION. Gifts of remainder interests in non-income-producing properties, such as a residence, may be more advisable, financially, than gifts of remainder interests in liquid assets — such as securities. If a choice exists between such types of property, it appears more prudent to retain complete ownership of liquid assets in the event of unforeseen personal needs.

Statutory Requirements. Deductions are allowable for charitable gifts of remainder interests in trust (with noncharitable income beneficiaries) *only* if the trust is:

- A charitable remainder annuity trust.
- A charitable remainder unitrust.
- A pooled income fund.

These different types of trusts are further described in the technical resume concluding this discussion.

Effective Dates and Transitional Rules. These requirements were imposed by the 1969 Tax Reform Act and apply, for income and gift tax purposes, to transfers in trust and contributions made after July 31, 1969. For estate tax purposes, they generally apply in the case of decedents dying after 1969 except for certain pre-10/10/69 arrangements which cannot be modified to take the new rules into account. [18]

[18] Act Sec. 201(g)(4)(B) and (C).

Accordingly, wills should be revised in appropriate situations in light of the 1969 legislation.

Valuation of Remainder Interest — Annuity Trusts and Unitrusts. The remainder interest is computed on the basis that 5 percent of the net fair market value of the assets (or stated amount, if greater) will be distributed annually to the income beneficiary. [19]

EXAMPLE. Assume a donor makes a completed gift of $100,000 to a trust which provides for a $5,000 annuity to *A* for life with the remainder to charity. Using a 3 1/2 percent discount rate, the present value of the income interest is valued by determining *A*'s life expectancy and discounting the annual payments by 3 1/2 percent. This amount, when subtracted from the total value of the gift, would indicate the present value of the charitable remainder. [20]

If *A* had a life expectancy of 25 years, the present value of his annuity interest would be approximately $82,400. [21] The present value of the charity's remainder interest would be $17,600 ($100,000 less $82,400).

A charitable remainder in a 5 percent unitrust would have the same value in view of the statutory presumption (Sec. 664 (e)) that $5,000 will be distributed annually to the income beneficiary.

Effect of New Actuarial Tables: Amendments to the estate and gift tax regulations were recently adopted which would revise the actuarial tables previously used to calculate deductions for gifts of limited interest to charities.[22] As mentioned in 202.2, these revised tables reflect a 6 percent interest factor.

Assuming that these actuarial tables, as revised, will continue to be applicable in valuing limited interest gifts, the value of an annuity interest will generally be decreased, thereby increasing the deduction for a contribution to a charitable remainder annuity trust. Charitable remainder unitrusts and pooled income funds (see below) are not directly affected by these tables. However, the IRS may prescribe a 6 percent interest factor (rather than 3 1/2 percent) for computing the annual increment in unitrust value which would generally increase the charitable contributions deduction.

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[19] Sec. 664(e).

[20] H. Rep. No. 91-413, Part 1, 8/2/69, p. 59.

[21] Table II, Col. 2, Estate Tax Regs. Sec. 20.2031-7(f), prior to amendment.

[22] See pre-1969 Regs. Sec. 1.170-1(d)(1).

Valuation of Remainder Interest — Pooled Income Funds. In determining the charitable contributions deduction, the income interest, which is subtracted from the total fair market value of the property to arrive at the remainder interest, is computed on the basis of the highest rate of return earned by the fund for any of its three immediately preceding years. If not in existence for such three prior years, a 6 percent rate is presumed unless otherwise specified by the IRS (Sec. 642 (c) (5)).

The valuation of pooled income fund remainder interests is described, in greater detail, in Prop. Regs. Sec. 1.642 (c)-6.

Selecting Valuation and Earnings Rates: These different valuation rates offer a donor flexibility in determining the amount of his contribution deduction which, of course, will vary inversely with the amount of income to be received by him. This choice is especially pronounced in the case of pooled income funds, in existence for at least three years, where a great variety of *actual* earnings rates is available for selection.

On the other hand, an income interest in a fund less than three years old must be valued at the presumed rate, which is presently 6 percent. However, this can be advantageous if the actual earnings rate is higher since greater income can be obtained without diminishing the contributions deduction. However, a relatively new fund may present increased investment risk.

CAUTION. If the facts and circumstances indicate that the highest yearly rate of return has been manipulated in order to obtain an excessive charitable contributions deduction, the proposed regulations (Sec. 1.642 (c)-6 (b) (2)) state that such a rate cannot be used. Instead, the presumed rate (e.g., 6 percent) is substituted.

QUERY. Suppose a fund which has yielded 3 1/2 percent for the past three years is currently converted into properties earning 7 percent. Would a donor be able to use the 3 1/2 percent rate to value his contribution deduction notwithstanding the higher current yield?

If a $100,000 contribution with a 25-year retained life interest is assumed, the difference in deductions would be as shown in Illustration 7, page 321.

Low earnings rates, which may be available for contributions to certain pooled income funds, might be desirable for some high-bracket clients who would be primarily interested in maximizing their charitable contributions deduction. For example, compare the $42,315 deduction shown above with a deduction of $36,100 if, instead, the $100,000 was contributed to a 5 percent (minimum) charitable remainder annuity trust

Earnings Rate Used	*Charitable Contributions Deduction*
3 1/2%	$42,315*
7%	$18,425†

*Source: Estate Tax Regs. Sec. 20.2031-7(f) (prior to amendment), Table II, col. 4.
†Source: C. D. Hodgman, comp., *Handbook of Chemistry and Physics* (8th ed.), p. 293 (mathematical tables).

or unitrust with the same 25-year term for the noncharitable income interest. This latter deduction (i.e., $36,100) is less even though it reflects the higher value provided by using the new 6 percent interest (or discount) factor as shown in Illustration 8, below.

Illustration 8

Line	
1. Annual distribution to income beneficiary (5% of $100,000)	$ 5,000
2. Present value of $5,000 annuity for 25 years*	$63,917
3. Present value of remainder interest ($100,000 less $63,917)	$36,083
4. Line 3 rounded	$36,100

*Source: Regs. Sec. 20.2031-10(f), Table B, col. 2.

Of course there are other tax as well as economic (e.g., investment) considerations to be weighed in comparing the merits of these types of trusts as donees of a charitable remainder interest. Such further comparison is beyond the scope of this tax study.

Income Interests

Charitable gifts of income interests have the following economic characteristics:

1. The donor is deprived of income for the period specified by the gift.
2. At the conclusion of this period, the underlying property can revert to the donor or to remaindermen selected by him.

However, for income tax purposes, no deduction is allowable unless the trust income is taxable to the donor (Sec. 170(f)(2)(B)). Thus, the only income tax advantage gained by such a gift is a shifting of income by obtaining a deduction prior to the taxation of the corresponding income (as it is reported by the trust). Of course, this advantage can be

further enhanced if the deduction is obtained in a high bracket year and is recaptured in lower bracket years (such as those during retirement).

On the other hand, a donor would apparently have to retain certain powers or interests, such as a reversionary interest, in order to be taxed on the trust's income (which is required to obtain the income tax deduction). Such retention would prevent removal of the remainder interest from the donor's gross estate.

If such powers or interests are released to reduce future estate tax, the charitable contributions deduction will be recaptured for income tax purposes. Of course, where not detrimental from an estate tax viewpoint, the retention of substantial reversionary interests — without jeopardizing the income tax deduction — can be an additional benefit for the donor.

However, no income tax deduction will be allowable if the reversionary interest cannot reasonably be expected to take effect until ten years after the gift is made since, under these circumstances, the trust's income will not be taxed to the donor. [23]

Although the deduction requirements of Sec. 170(f)(2)(B) will not be met, the donor will obviously be relieved of paying tax on income generated by the gift property. Thus, a short-term trust (more than ten years duration) enables a client to completely exclude such income from his own tax bracket. This exclusion is a particularly effective technique for bypassing the overall limitations, based on adjusted gross income, which govern charitable contribution deductions; including the 20 percent limitation generally applicable for gifts to private foundations. These limitations are further explored in 401.4.

Tax would also be eliminated on the income reportable by the trust to the extent the income is expended for charitable purposes since a trust is allowed an unlimited deduction for such payments. Moreover, unlike other taxpayers, a trust (or estate) can also deduct payments to foreign charities. [24]

Short-term trusts are also discussed in 202.3.

Effect of New Actuarial Tables. The new tables considered earlier in connection with charitable remainder trusts will, of course, have an opposite effect on charitable gifts of income interests. That is, the value of the charitable income interest will generally be decreased, commensurate with the increased value of the noncharitable remainder

[23] See Sec. 673 (a).

[24] See Sec. 642 (c)(1).

interest — assuming these tables continue applicable in valuing charitable gifts of limited interests. A similar reduction would result for the value of an income interest in a "unitrust" if the Service prescribes a 6 percent interest factor rather than a 3 1/2 percent factor.

Statutory Requirements. The statutory requirements regarding contribution deductions for income interests given to charities in trust are summarized as follows:

	Income Tax Deduction	*Estate and Gift Tax Deductions*
Trust income taxable to donor	Required	Not required
The income interest is either a:	Required	Required
(1) Guaranteed annuity, or (2) Fixed percentage of fair market value of trust property (determined annually), distributed annually, as specified in indenture.		

CAUTION. Additional deductions are not allowable to the grantor or any other person (e.g., the trust itself) for any contributions made by the trust with respect to the income interest (Sec. 170(f)(2)(C)). Presumably, this disallowance to the trust will persist even if it is subsequently taxed on the income instead of the donor (in the event his ownership powers or interests are relinquished). This result is especially detrimental since, in addition, the donor would be required to recapture his own prior deduction.

NOTE. There is no minimum percentage distribution requirement for such split-interest charitable income trusts (Sec. 170(f)(2)(B)). In contrast, compare the 5 percent minimum distributions required for charitable remainder annuity trusts and unitrusts (as described in the succeeding technical resume).

On the other hand, the noncharitable beneficiary of a pooled income fund must receive income distributions based upon the fund's current rate of return. (See technical resume.)

No deduction is allowable for contributions to split-interest charitable income trusts unless the trust instrument prohibits "self-dealing" (as

defined in Sec. 4941), "taxable expenditures" (as defined in Sec. 4945), excess business holdings (Sec. 4943), and improper investments (Sec. 4944).[25] However, these last two restrictions do not apply if the value of the charitable income interest does not exceed 60 percent of the total fair market value of the trust's property.

Charitable remainder trusts are subject to similar restrictions. (See technical resume.)

Recapture of "Excess" Deductions. When donor is no longer taxable on trust income, income may be recognized under the following prescribed computation:

Contribution deduction previously allowed	$10,000
Less — discounted value of trust income previously taxed to donor (discounted to date of contribution)	9,000
Imputed income	$ 1,000

Effective Dates and Transitional Rules. The same dates and rules apply as in the case of charitable remainder trusts discussed earlier.

Technical Resume

Charitable Remainder Trusts. Charitable remainder annuity trusts and unitrusts (as defined in Sec. 664) are described as follows.

Annuity Trusts: A charitable remainder annuity trust must specify in dollar terms the amount of the income beneficiary's annuity, which must be paid at least annually. This amount cannot be less than 5 percent of the *initial* fair market value of all corpus.

Unitrust: A charitable remainder unitrust must specify a fixed percentage, not less than 5 percent of the net fair market value of the trust's assets, as an annual payment to the income beneficiary. Such value must be determined annually. However, the trust indenture may provide for actual trust income, determined under local law, to be paid to the income beneficiary when less than the stated payout. This flexibility of payment, not available to annuity trusts, cannot be discretionary with the trustee.[26]

The indenture can also provide that any deficiencies in income distributions (i.e., where the trust income was less than the stated

[25] See Secs. 508 (d)(2)(A) and 4947 (a)(2).

[26] H. Rep. (Conf.) Rep. No. 91-782, 12/21/69, p. 296.

amount payable to the income beneficiary) can be made up in a future year when the trust income exceeds the stated amount due the income beneficiary.

Common Characteristics: The income interest in either an annuity trust or a unitrust can be for a term of years (not exceeding 20 years) or for the life of the income beneficiary (who, if an individual, must be alive when the trust is created). Multiple income beneficiaries are permitted.

The 20-year limitation on term trusts appears required by a literal reading of Secs. 664 (d) (1) (A) and (2)(A). However, House Report No. 91-413 stated [27] that "the income interest . . . may be for *a* term of years or for the life of the income beneficiary . . . . " Senate Report No. 91-552 declared [28] that "the committee has *modified* the House provision to make it clear *an annuity trust or a unitrust may have more than one noncharitable income beneficiary, if the interest of each such beneficiary either is for a term of years which does not exceed 20 years or is for the life of the beneficiary. . . .*"

House (Conference) Report No. 91-782[29] is silent on this point. Future regulations may clarify Congressional intent as to whether a trust with only one noncharitable income beneficiary can have a term exceeding 20 years.

All annuity trusts or unitrusts must have at least one income beneficiary who is a noncharitable person (such as an individual or a noncharitable trust). The remainderman of any such trust must be *a* charitable organization.[30] It is uncertain whether multiple charitable remaindermen are permissible. Hopefully, this question will be clarified by future regulations.

Neither type of trust can distribute amounts other than the stated annuity or unitrust percentage to noncharitable beneficiaries. Thus, the charitable remainder interest, whether consisting of accumulated income or corpus, cannot be subject to a power of invasion — even if limited by an ascertainable standard or other contingency. On the other hand, such accumulated income, or corpus gains, are not generally taxed since these trusts are exempt from income taxes except for the unrelated business income tax (Sec. 664 (c)).

Finally, distributions to the income beneficiaries are treated as

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[27] Part 1, 8/2/69; emphasis supplied.

[28] 11/21/69, p. 59; p. 90; emphasis supplied.

[29] 12/21/69, pp. 295-296.

[30] Secs. 664(d)(1)(C) and (2)(C).

consisting of the following layers: current and accumulated ordinary income, current and accumulated capital gains, current and accumulated exempt income, and corpus.

This contrasts with the treatment of income beneficiaries of non-charitable trusts where distributions are deemed to consist of only proportionate amounts of ordinary income, capital gain, exempt income, and corpus. (See Sec. 662 (b).) In comparison, the taxation of ordinary income and capital gains to income beneficiaries of charitable remainder trusts is accelerated while nontaxable distributions are deferred.

Pooled Income Funds. Pooled income funds are trusts which must meet all of the following conditions:

1. The fund is a transferee of property in which an irrevocable remainder interest is given to a public charity[31] and the income interest is retained for the *life* of one or more beneficiaries then living.
2. The fund cannot have investments in tax-exempt securities.
3. Neither the donor nor income beneficiary can be a trustee.
4. The fund must be maintained by the charitable remainderman (but not necessarily as trustee).
5. The life tenant must receive an amount of income each year based upon the fund's rate of return for the year.
6. The property transferred to the fund must be commingled with property similarly received from other donors.
7. The fund only contains property received under the above conditions.

Comparison With Other Charitable Remainder Trusts. While pooled income funds are not exempt from income tax, as are the annuity trusts and unitrusts previously described in this resume, they are allowed an unlimited deduction for any amount of gross income attributable to long-term capital gains which is permanently set aside for charitable purposes (Sec. 642(c)(3)). In addition, under Sec. 661(a), a fund can also deduct the distributions to its income beneficiary which, in effect, consist of its current ordinary income. (See condition (5) above.) Therefore, such funds should usually have little or no taxable income.

It might also be noted that no deduction is allowable for contributions to any type of charitable remainder trust unless the trust instrument prohibits self-dealing (as defined in Sec. 4941) and taxable expenditures (defined in Sec. 4945). (See Secs. 508(d)(2)(A) and 4947(a)(2).)

[31] As defined in Sec. 642(c)(5)(A).

However, these trusts are not subject to restrictions on excess business holdings and improper investments. (Sec. 4947 (b)(3)(B).)

As previously indicated, charitable income trusts are subject to similar restrictions.

On the other hand, unlike charitable remainder annuity trusts or unitrusts, pooled income funds are subject to the following restrictions:

- Investments in tax-exempt securities are not permitted (see condition (2) above).
- A term for years is prohibited (see condition (1) requiring *life* interests).
- Only individuals, apparently, can be income beneficiaries (as implied by condition (1), which is based upon Sec. 642 (c)(5)(A)).

However, under all three varieties of trusts, the donor himself can be an income beneficiary.

401.4 Working With Income Limitations

Planning Technique

Knowledge of various limitation and carryover rules will generally maximize tax benefits obtained through charitable contributions. Particular techniques include (1) avoiding private charity contributions where excess public charity contributions exist, (2) advantageous election of 50 percent limitation for contributions of certain appreciated property, and (3) avoiding gifts "for the use of" charity if 50 percent limitation and/or carryovers are necessary to obtain deductions.

In addition, maximum limitations can be bypassed through short-term trusts (of more than 10 years duration) as indicated in the discussion of gifts of income interests in 401.3.

Income Limitations

Charitable contributions made by individuals after 1969 are subject to the following limitations, based upon a "contribution base" (adjusted gross income without regard to any net operating loss carryback):

Public Charities. The limitation upon contributions to public charities are subject to income limitations (based upon the "contribution base") which differ with the type of property as categorized below:

1. Nonappreciated property, such as cash — 50 percent.
2. Appreciated ordinary income property — 50 percent. However, as

indicated in 401.2, no deduction is allowable for the portion of the property's fair market value which represents untaxed ordinary income.

3. Appreciated capital gain property — 30 percent.

This lower limitation applies even though the appreciation is nominal (e.g., one percent of the property's total value). However, the 50 percent limitation can apply if an election is made to reduce the contribution by 50 percent (apparently) of the appreciation. (Some uncertainty exists as to whether 50 percent or 100 percent must be used for this reduction.) The type of property subject to the 30 percent limitation, as well as the effect of electing the 50 percent limitation, are considered at greater length later.

For these purposes, private foundations classified as "distributing," "operating," or "community" foundations (see the technical resume in 401.2) are considered public charities.

Private Charities.[32] The income limitation on contributions to private charities is 20 percent, which is subject to a ceiling, illustrated as follows.

EXAMPLE. Client's 1970 contribution base is $100,000. He has given securities worth $40,000 to his state university and is contemplating a $20,000 cash gift to his private foundation (which will not be a distributing foundation, and so forth).

His CPA advises him that the cash gift should be reduced to $10,000 in view of the following ceiling:

50 percent of contributions base	$50,000
Less — contributions to 50 percent charities (including carryovers)*	40,000
Ceiling	$10,000

*30 percent limitation regarding appreciated capital gain property ignored. (See Sec. 170(b)(1)(B)(ii).)

CAUTION. If the $20,000 gift is nevertheless made, the $10,000 portion in excess of the ceiling is obviously not currently deductible. Moreover, it also could *not* be carried to any other year. (See succeeding discussion of contribution carryovers.)

Application of Various Limitations. Sec. 170(b)(1)(D)(i) requires contributions subject to the 30 percent limitation to "be taken into account after all other charitable contributions." On the other hand,

[32] To reiterate: private charities are private foundations other than distributing, operating, or community foundations.

contributions of appreciated capital gain property to public charities, *without* regard to the 30 percent limitation (but subject to the 50 percent limitation), are taken into account in determining the maximum deduction for private (20 percent) charities. (See example above.) Therefore, these various income limitations would appear to be taken into account in the following sequence: 50 percent, 30 percent, 20 percent.

Carryover of Excess Contributions

Public Charities. Contributions to public charities (including distributing, operating, or community foundations) exceeding the prescribed 50 percent or 30 percent limitations can be carried over for five succeeding years. (See example in the technical resume concluding this discussion.) A special rule applies to reduce such carryovers if the excess contributions also increase net operating loss carryovers to future years.

All pre-1970 contributions to public charities were subject to a 30 percent limitation. Excess contributions continue to be eligible for a five-year carryover. Presumably, the 50 percent limitation will apply in any post-1969 year to which these contributions may be carried.

Private Charities. Contributions to nondistributing (and so forth) private foundations in excess of the 20 percent limitation cannot be carried to any other year. Moreover, these contributions are ignored, and therefore wasted, in computing the carryover of 50 percent and 30 percent contributions to later years.

EXAMPLE. Client (without professional advice) makes cash gifts in 1970 to the following donees:

Community fund	$75,000
Private foundation (nondistributing, etc.)	30,000
Total cash gifts	$105,000

If his contributions base is $100,000, his 1970 deduction will be $50,000. The carryover to 1971 is computed as follows:

Contributions to 50 percent charities	$75,000
Less — 50 percent of contributions base	50,000
Carryover	$25,000

No part of the $30,000 contribution is deductible since it exceeds the ceiling (zero) on the 20 percent limitation. This contribution is also not considered in the above determination of the carryover (and, hence, does not increase it).

PLANNING SUGGESTION. Client would have been well advised not to make such a contribution in 1970.

In addition, contributions to such private foundations in future years are likewise ignored in determining the subsequent absorption of a contribution carryover. Therefore, such private foundation contributions should also not be made in years to which prior contributions can be carried.

Types of Appreciated Assets Subject to 30 Percent Limitation

The 30 percent limitation described earlier in this discussion applies to contributions of the following types of appreciated property:

1. Long-term capital gain property (i.e., which would give rise to long-term capital gain if sold instead) such as stocks or bonds.
2. Sec. 1231 property (generally depreciable property or land used in a business, as set forth in 203.4).

In addition, this limitation may also apply to the bargain element (i.e., the portion of property deemed given) in a bargain sale (see 401.2) of such capital gain or Sec. 1231 property.

On the other hand, the 30 percent limitation is not applicable to contributions or bargain sales of capital assets or Sec. 1231 property to private charities (nondistributing, etc., private foundations) since the lower 20 percent limitation is operative. Furthermore, it does not apply to tangible personal property used by the donee in a manner unrelated to its exempt purpose or function. However, in this case, either the 50 percent or 20 percent limitation will apply, depending upon whether the donee is a public or private charity. (See Secs. 170(b)(1)(D)(i) and (e)(1)(B).)

Of course, ordinary income properties, including short-term capital assets, are not subject to the 30 percent limitation since their appreciation is not deductible. Here, too, either a 50 percent or 20 percent limitation will be applicable, depending upon the nature of the donee. (See 401.2 for a further description of ordinary income property and its treatment.)

When Should 50 Percent Limitation Be Elected for Contributions of Appreciated Capital Assets

As was indicated at the beginning of this discussion, a 50 percent limitation could be substituted for the 30 percent limitation otherwise applicable to charitable gifts of appreciated capital assets. (Both limitations, of course, are based upon the contributions base (i.e., adjusted

gross income exclusive of any net operating loss carrybacks).) However, this higher limitation applies only if an election is made to reduce such contributions by 50 percent (presumably) of the appreciation.

Since this election causes a permanent loss of contribution deductions (equal to 50 percent of the untaxed capital gain), it should *not* be made if:

1. The excess contribution (i.e., the portion of the full fair market value exceeding the 30 percent limitation) can be recovered within the succeeding five-year carryover period.
2. The donor's tax brackets are fairly equal during the year of the gift and throughout the carryover period.

On the other hand, this election can be advantageous if future tax brackets are expected to decline, such as in retirement situations.

EXAMPLE. Client contributes a capital asset to a 50 percent charity in 1970, with the following characteristics:

Fair market value	$100,000
Basis	-0-

Other contributions of appreciated capital assets during the year have absorbed the 30 percent limitation. Consequently, this particular contribution would not be currently deductible.

Client anticipates retirement at the end of 1970. Therefore, his projected tax brackets are 70 percent for 1970 and 25 percent for 1971.

Tax Benefit Without *Election:*

1970 None

1971 $25,000 (25 percent of $100,000). Of course, part of this $100,000 amount will likely be carried to several subsequent years because of the 30 percent limitation applied to Client's *lower* post-1970 income. Hence, realization of all tax benefits flowing from this contribution may be even further postponed.

Tax Benefit With *Election:*

1970 $35,000 (70 percent of $50,000). This $50,000 deduction is derived by reducing the fair market value of $100,000 by 50 percent of the appreciation (which is also $100,000).

Under these particular facts, an additional $10,000 tax benefit is provided by the election (assuming that the $50,000 reduced contribution is entirely deductible in 1970 under the 50 percent limitation).

Moreover, the election permitted faster enjoyment of the tax benefits produced by the contribution.

Technical Resume

EXAMPLE: *Application of 50 percent and 30 percent limitations.* During 1970, Client's only contributions are securities (worth $60,000) and cash ($40,000). Both gifts were made to public charities. Client's contribution base is $100,000 and he does not elect the 50 percent limitation for the securities.

Client will have a $50,000 current deduction and a $50,000 carryover, computed as shown in Illustration 9, below.

Illustration 9

Line			
1.	Contributions base		$100,000
2.	50 percent of line 1		$ 50,000
3.	Less — deduction for cash contribution		40,000
4.	Remaining 50 percent limitation		$ 10,000
5.	Total fair market value of securities	$60,000	
6.	Less — 30 percent of line 1	30,000	
7.	Unused contribution	$30,000	
8.	Balance of contribution applied against 50 percent limitation (line 6)		$ 30,000
9.	Less — amount deductible (line 4)		10,000
10.	Additional unused contribution		$ 20,000
11.	Total current deduction (lines 3 and 9)		$ 50,000
12.	Total carryover (lines 7 and 10)		$ 50,000

NOTE. House Report No. 91-413[33] states that a carryover arising under these facts must be added to future contributions of appreciated property for purposes of applying the 30 percent limitation in such subsequent year.

Eligibility of Charitable Gifts of Limited Interest for Higher Income Limitations. To qualify for deduction, subject to the 20 percent limitation, a contribution must be "to" or "for the use of" a charity. Eligibility for the higher 50 percent limitation is confined to gifts only "*to*" charity. (For pre-1970 years, a 30 percent limitation applied in lieu of the 50 percent limit.)

[33] Part 2, 8/4/69, p. 33.

Pre-1969 Prop. Regs. Sec. 1.170-2(b)(1) treated remainder interests as gifts "for the use of" charity rather than as gifts "to" charity. However, this provision was deleted from the final pre-1969 regulations which would appear to qualify remainder interests for the 50 percent limitation.[34]

In contrast, this same proposed regulation recognized a gift of an income interest as eligible for the 50 percent limitation. This provision was also deleted when it was finalized. However, an adverse inference appears unwarranted since an income interest can be presently enjoyed and, therefore, can be viewed as a gift *to* charity. Nevertheless, the IRS has reportedly held, in at least two private rulings, that gifts of income interests were ineligible for the former 30 percent limitation.

House Report No. 91-413 also states[35] that contributions of appreciated capital gain property, which do not exceed the 30 percent limitation (presently applicable to such contributions), are deductible to the extent that they, plus other contributions, do not exceed the general 50 percent or 20 percent limitations. Thus, contributions of appreciated property "for the use of" a public charity which are within the 30 percent limitation would still not qualify for the 50 percent limitation and, therefore, would only be deductible to the extent permitted by the 20 percent limitation. In addition, any resulting nondeductible contributions appear ineligible for carryover to subsequent years.

Gifts of limited interest are more extensively considered in 401.3.

401.5 Substantiation Requirements

Planning Technique

Deductions for noncash contributions exceeding $200 may avoid needless controversy through familiarity and compliance with detailed substantiation requirements.

Regs. Sec. 1.170-1(a)(3) requires detailed supporting information to be submitted with a tax return in which a deduction is claimed for a noncash contribution exceeding $200. Such information must include the fair market value of the property and the method utilized in its determination. Also, if the valuation was determined by appraisal, a copy of the signed report of the appraiser "should" be submitted.

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[34] For a comparatively recent Tax Court opinion to this effect, see *Alice Tully*, 48 TC 235 (1967).

[35] Part 2, 8/4/69, p. 32.

Comprehensive appraisal guidelines, for this purpose, are set forth in Rev. Proc. 66-49.[36]

Conformity with these substantiation requirements may be especially advisable when the contribution consists of unique property such as real estate, art objects, literary manuscripts, antiques, and so forth.[37]

402 Handling Appreciated and Declined-in-Value Properties Prior to Death

Planning Technique

Where possible and feasible, appreciated property should not be sold prior to death in order to permit otherwise taxable gains to be eliminated by stepped-up basis. Conversely, declined-in-value property should be sold to recognize losses otherwise eliminated by stepped-down basis acquired at death.

As indicated in 201.6, appreciation in the value of property completely escapes income tax upon the owner's death since the new owner's basis will generally be equal to the value placed upon such property for estate tax purposes. In turn, the estate tax value is the fair market value at date of death or at the alternate valuation date (e.g., one year later). Consequently, the operation of these provisions also means that declines in property values will also escape income tax recognition, in the form of capital (or ordinary) losses, as a result of death.

Planning Implications

To the extent that planning in situations involving death is feasible, the following tax rules of thumb should be considered.

Do sell property which has declined in value prior to death in order to recognize the inherent loss. (See 203.10, regarding effects of capital losses.)

Do not sell property which has appreciated in value prior to death in order to allow such appreciation to escape income taxation.

NOTE. These rules of thumb are based solely on income tax considerations and do not reflect such nontax factors as whether sales are or are

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[36] 1966-2 CB 1257.

[37] Valuation of art objects and antiques, in particular, has been recently exposed to fairly extensive litigation.

not advisable from an investment viewpoint or whether they are necessitated by personal exigencies.

403 Deductions, Credit, and Carryovers Attributable To Decedents, Estates, and Trusts

As the result of the termination of a life or a fiduciary relationship, property is usually transferred to successor owners. Certain deductions, credit, and carryovers attributable to the decedent or terminated fiduciary entity can also be similarly transferred.

In the case of deductions for administration expenses which arise after death, a choice must be made as to whether they shall be utilized for income tax or estate tax purposes.

This section will be devoted to a review of these tax attributes and various planning techniques designed to achieve their maximum tax benefit.

403.1 Deductions and Credit in Respect of Decedents

Planning Technique

Do not overlook the double *deductions, and so forth, available for those debts of the decedent, which are deductible for estate tax purposes, and also deductible for income tax purposes when paid.*

Expenses which have accrued at the date of a decedent's death are deductible for estate tax purposes under Sec. 2053(a) (3) as claims against the estate. In addition, Sec. 691(b) also permits the following categories of such accrued expenses to be deducted for income tax purposes when they are paid (if not properly allowable to the decedent):

Type of Expense	*Described in Code Section*
Business	162
Nonbusiness	212
Interest	163
Taxes	164

Ordinarily, these income tax deductions are allowed to the estate. However, if the estate is not liable for such payment, the deduction is allowed to the person who, by reason of the decedent's death, acquires

an interest in the decedent's property subject to such obligation.

Similar treatment is provided for foreign tax credits (granted by Sec. 33) in the case of accrued foreign income taxes.

Furthermore, periodic alimony payments were deductible, when paid by an estate for income tax purposes (as distributions to a beneficiary under Code Sec. 661). In addition, the commuted value of such payments was deductible for estate tax purposes as a claim against the estate (pursuant to Sec. 2053(a)(3)).[38]

Planning Considerations

Percentage Depletion. If the decedent had claimed percentage depletion, a similar income tax deduction is allowable only to the person receiving the income upon which the depletion is computed. There is no comparable deduction if the decedent had claimed cost depletion since any depletion deduction to which he was entitled at death would be allowable in computing his final taxable income (Regs. Sec. 1.691(b)-1(b)).

OBSERVATION. This percentage depletion deduction in respect of a decedent does not appear to give rise to a double deduction since it, presumably, is not deductible for estate tax purposes.

Medical Expenses. As was stated earlier, in 303.3, accrued medical expenses are deductible *only* for income tax *or* estate tax purposes. Moreover, they can never be claimed against the taxable income of an estate. (Regs. Sec. 1.642(g)-2.)

Double Benefits Only for Designated Items. Double benefits are not possible for any other deductions or credits since only those items designated by Sec. 691(b), as described above, can be availed of for income tax purposes. For example, Rev. Rul. 54-207 (1954-1 CB 147) precludes a capital loss carryover from a decedent to his estate (under 1939 Code provisions essentially the same as their current counterparts).

403.2 Estate Administration Expenses

Planning Technique

Determine whether administration expenses allocable to non-exempt income should be deducted for either income tax or

[38] Rev. Rul. 67-304, 1967-2 CB 224.

estate tax purposes. This comparison should include consideration of residual beneficiaries' income tax brackets.

Unlike deductions in respect of a decedent (see 403.1), administration expenses of an estate and casualty or theft losses occurring during administration cannot generate double deductions since Sec. 642(g) requires that they shall only be allowable for either income tax or estate tax purposes. Consequently, the effective rate of each tax should be compared and the most advantageous alternative selected (i.e., deductions claimed against tax with the highest rate).

Factors Influencing Effective Tax Rates. The effective rate applicable to administration expenses claimed for estate tax purposes is cut in half where the maximum marital deduction is also claimed. (This latter deduction is briefly discussed in 406.)

As will be explained in 403.3, payment of administration expenses may be timed so as to allow their deduction on the income tax returns of the residual beneficiaries. Therefore the following income tax rates should be considered: (1) fiduciary (at "separate return" rates) and (2) residual beneficiaries (at single, *joint, or head of household* rates).

Type of Expenses Involved. Administration expenses include executor's commissions; legal, accounting, and appraisal fees; court costs; surrogates' fees; clerical assistance, and so forth (Estate Tax Regs. Sec. 20.2053-3).

Furthermore, interest, business expenses, and other items not accrued at the date of death are also included in this category, where they would be allowable as estate tax deductions only as administration expenses (under Sec. 2053(a)(2)). (See Regs. Sec. 1.642(g)-2.)

Planning Pointers

Expenses Allocable to Exempt Income. Estate tax deductions should be claimed for administration expenses which are not deductible for income tax purposes because they are allocable to exempt income.[39]

NOTE. Such income tax allocations are required by Sec. 265 (discussed in 306.2).

Selling Expenses. In a reviewed 1966 Tax Court decision,[40] affirmed by the Sixth Circuit Court of Appeals in 1968, expenses of selling

[39] Rev. Rul. 59-32, 1959-1 CB 245, clarified on another ground by Rev. Rul. 63-27.

[40] *Est. of Viola E. Bray*, CA-6, 396 F2d 452, aff'g 46 TC 577; nonacq. IRB 1970-30, 7.

securities were not considered to be "deductions" for income tax purposes even though they are allowed as "reductions" (offsets against selling price) in determining gain or loss. Hence, *such expenses are deductible for both income and estate tax purposes.*

NOTE. Sales expenses are classified as administration expenses for estate tax purposes by Regs. Sec. 20.2053-3(d)(2) which was cited by the Tax Court in *Bray*.[41]

Sec. 303 Redemptions. As more fully considered in 203.5, Chapter 2, administration expenses can be included in determining the amount of a Sec. 303 redemption even though they are actually deducted for income tax purposes.

Procedural Aspects

Estate tax deductions allowable for administration expenses, or casualty or theft losses, are not allowed as income tax deductions unless a statement is filed which indicates that (1) such items have not been allowed as estate tax deductions and (2) the taxpayer has waived all rights to the allowance of such estate tax deductions.

This statement must be filed, in duplicate, with the income tax return in which such deductions are claimed or with the pertinent district director for association with a previously filed return if the statute of limitations has not expired.

Income tax deductions are not precluded by claiming estate tax deductions so long as the estate tax deduction is not finally allowed and the required statement is filed. On the other hand, filing such a statement will permanently prevent any estate tax deductions for the particular expenses involved. (Regs. Sec. 1.642(g)-1.)

Portions of an expense can be split between the two taxes (Regs. Sec. 1.642(g)-2).

403.3 Excess Deductions and Unused Loss Carryovers Available to Beneficiaries Upon Termination of Estate or Trust

Planning Technique

Excess deductions and unused loss carryovers are available to residual beneficiaries upon termination of estates or trusts. Therefore, proper timing of fiduciary deductions, to the extent

[41] See footnote 40.

possible, can control their maximum tax utilization by shifting them to the taxpayer (fiduciary or beneficiary) in the higher bracket. Estate administration expenses are particularly susceptible to this technique.

Excess Deductions. The excess of deductions over gross income of a fiduciary (estate or trust) for its terminal year is allowed as a deduction to the beneficiaries succeeding to the fiduciary's property. (Deductions for the personal exemption and charitable contributions are excluded for this purpose.)

These excess deductions are allowable to a beneficiary *only* in the *one* taxable year in which (or with which) the estate or trust terminates. If the beneficiary has insufficient net taxable income to absorb all such excess deductions, the unused balance cannot be carried to any other taxable year.

This deduction is not allowed in computing adjusted gross income but can only be claimed in arriving at taxable income. Thus, it cannot be claimed together with the standard deduction (Regs. Sec. 1.642(h)-2).

Unused Loss Carryovers. Somewhat similar treatment is provided for the transfer of net operating loss carryovers and capital loss carryovers which would be allowable to the fiduciary in subsequent years, but for its termination. For purposes of counting the five-year carryover period applicable to net operating losses, the last year of the fiduciary (whether or not a short period) and first year of the beneficiary to which the loss is carried are each considered as separate years. Of course, capital loss carryovers transferred to either individuals or other fiduciaries can be carried forward indefinitely (as described in 203.10).

Generally, these carryovers retain their character in the hands of the beneficiary; consequently, they are deductible in determining adjusted gross income (Regs. Sec. 1.642(h)-1).

NOTE. Unabsorbed net operating loss carryovers which expire in the fiduciary's final year are considered excess deductions (see above) (Regs. Sec. 1.642(h)-2(b)). Duplicate deductions arising from the interaction of these provisions is prevented by the aforementioned regulations. In addition, rules for allocating these items among several beneficiaries are also provided (Regs. Sec. 1.642(h)-4).

Planning Considerations

Beneficiaries of Estates. Where the income tax bracket(s) of a beneficiary (or beneficiaries) is higher than either the estate's income tax

or estate tax bracket, it is possible to shift such estate deductions as administration expenses to the beneficiary by exercising coordinated control over (1) the year in which the estate should be terminated and (2) the time such expenses are paid.

Furthermore, these deductions can also be shifted to higher bracket beneficiaries by postponing payment until the estate has been terminated (see Regs. Sec. 1.641(b)-3(d)). Naturally, this can be done only to the extent permitted by creditors and other financial conditions (see 104.2).

EXAMPLE. Client is sole executor and beneficiary of the estate of his cousin who died July 17, 1970. The estate's annual gross income is expected to be $18,000 ($1,500 received each month), in the 42 percent bracket. The taxable estate, for estate tax purposes, before deducting any administration expenses, is $600,000 which is in the 31 percent bracket. Client's own annual taxable income for 1970 through 1972 will be $100,000, in the 60 percent bracket (joint rates).

Projected administration expenses are:

Legal and accounting fees	$30,000
Executor's commission	25,000
Miscellaneous	5,000
Total	$60,000

Also, interest payable at the decedent's death amounted to $10,000.

In view of the various prevailing tax rates, the following steps are taken:

1. A June 30th taxable year is selected to provide greater period for estate's income to be taxed at its lower bracket.
2. The administration of an estate cannot be unduly prolonged (Regs. Sec. 1.641(b)-3 (a)). Therefore, the estate is terminated on July 31, 1972.
3. All administration expenses and accrued interest are paid during the estate's last taxable year which begins July 1, 1972 and ends July 31, 1972.
4. These payments are claimed as deductions on the final Fiduciary Income Tax Return (Form 1041) which also contains the estate tax waiver required by Code Sec. 642 (g) with regard to the administration expenses.
5. The estate's excess deductions of $68,500 ($70,000 less $1,500 July gross income) is claimed by Client as an itemized deduction on his 1972 return.

NOTE. Client's 1972 gross income will include his $25,000 executor's commission so that his taxable income will only be reduced by the net amount of $43,500 (68,500 less $25,000) as a result of the estate's termination.

The effect of claiming these commissions as income tax deductions on the executor/beneficiary's return is to:

1. Offset their inclusion in the executor's gross income.
2. Subject them to estate tax (by foregoing their deduction on the Estate Tax Return (Form 706)). However, this is most appropriate under these facts since the commissions would otherwise be exposed to the executor's higher income tax rates.

PLANNING SUGGESTION. Where the executors and beneficiaries are not identical, the same tax effect can be accomplished by timely and effective waiver of the right to receive executor commissions. See Rev. Rul. 66-167 (1966-1 CB 20) which prescribes conditions under which such waivers are recognized. This ruling also holds that commissions waived in this manner will not constitute a gift. Also see *George M. Breidert*,[42] where a waiver was effective even though the somewhat compelling facts did not satisfy all the conditions set forth in Rev. Rul. 66-167 and pertinent prior rulings.

Beneficiaries of Trusts. The tax privileges extended to estate beneficiaries regarding excess deductions and loss carryovers are equally applicable to trust beneficiaries (Code Sec. 642(h)). However, planning opportunities are much more restricted since terminating a trust usually lacks even the relatively moderate degree of discretion exercisable in the case of estates. (The duration of a trust is either fixed by its indenture or else depends upon the longevity of its life tenants.) Thus, the termination of a trust in the year in which its beneficiary expects to be in a high bracket cannot be nearly as precisely planned as it might be for an estate.

Nevertheless, some comparatively modest tax leverage may be obtained if expenditures are effectively timed during the final two (or possibly three) years of a fixed term trust. Knowledge of its terminal date and a comparison of anticipated tax brackets of fiduciary and remaindermen will indicate the most advantageous utilization of these deductions. Whether these plans can be implemented depends, of course, upon the cooperation of creditors and other financial factors. (See 104.2.)

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[42] *Breidert*, 50 TC 844 (1966), acq. 1969-1 CB 20.

404 Satisfying Estate Tax Liability With Par Value Of Certain U.S. Bonds Acquired at Discount

Planning Technique

Certain Treasury bonds can be redeemed at par value in payment of estate taxes. Acquiring these bonds at a discount assures a net (after-tax) financial gain if used for this purpose.

United States Treasury bonds of certain issues which were owned by the decedent at the time of his death or which were treated as part of his gross estate may be redeemed at par plus accrued interest in payment of the estate tax (Estate Tax Regs. Sec. 20. 6151-1 (c)). Whether bonds of particular issue may be redeemed for this purpose will depend on the terms of the offering circulars cited on the face of the bonds.[43]

Bonds acceptable as estate tax payments have recently been selling at attractive discounts approximating 30 percent. However, the gross economic gain realized upon redemption of the bonds must be reduced by the increased estate tax attributable to their inclusion in the decedent's gross estate at par value instead of the lower value based upon selling price. Of course, this estate tax valuation results in a stepped-up basis which eliminates any taxable gain for income tax purposes.[44]

CAUTION. Par value valuation applies to all Treasury bonds owned which *may* be used for estate tax payments, *regardless of whether or not they are actually so utilized.*[45] Therefore, failure to use such bonds as estate tax payments can be financially unfortunate unless there are expectations for future market value to exceed par value.

404.1 Use of Powers-of-Attorney or Revocable Trust

Planning Technique

To insure adequate supply of acceptable Treasury bonds in case of incapacity prior to death, powers of attorney should be

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[43] A current list of eligible issues may be obtained from any Federal Reserve bank or branch, or from the Bureau of Public Debt (Washington, D.C.).

[44] The valuation of these bonds for estate tax purposes is prescribed by Rev. Rul. 156 (1953-2 CB 253). For judicial decisions to the same effect, see *Charles H. Candler, Jr.*, CA-5, 303 F2d 439, aff'g DC, and *Seattle-First National Bank (Est. of H. V. Laucks)*, DC (63-1 USTC ¶12,137). Also see *Est. of H. H. Peyton*, 21 TC Memo 1111 (1962), aff'd on another issue by CA-8.

[45] *Bankers Trust Company*, CA-2, 284 F2d 537 (rev'g DC), cert. denied, 366 US 903.

executed in advance to authorize purchases by designated agents. The same result can also be reached through bond purchases by trustee of an existing revocable trust.

Powers of Attorney. There are no provisions preventing the application of this technique even though bonds are purchased in contemplation of death. Therefore, their purchase may be most advisable when death is imminent.

In view of the possibility of incapacity prior to death, it may be practical to execute powers of attorney in advance of such possible occurrence. Such powers would authorize designated persons in close personal and/or business relationship with a client to make these purchases in the event of his disability. This procedure should provide a safeguard against a supply of bonds insufficient to extinguish estate tax liability that could otherwise be caused by human frailty.

In crucial situations, where, for instance, substantial estates or the precarious health of clients is involved, it has been suggested that agents (i.e., banks, trust companies, and so forth) located in the Hawaiian Islands be included in a power of attorney in order to furnish maximum time (because of zone differences) within which bonds might be purchased in case of emergency.

Revocable Trusts. As mentioned at the outset of 404, this payment privilege applies not only to bonds owned directly by the decedent but is also available for bonds which are otherwise includible in his gross estate. Thus, for example, bonds owned by a revocable trust would likewise qualify.

Consequently, powers of attorney would not be needed where the same purpose can be accomplished through bond purchases by the trustee of such a trust. In some instances, it may be desirable for the trust agreement to contain specific instructions to this effect.

404.2 Sustaining Capital Losses Through Sales and Repurchases in Declining Bond Market

Planning Technique

In a declining bond market, consider sales and repurchases of Treasury bonds in order to recognize capital losses and also maintain position regarding future estate tax payment. To prevent disallowance of losses, replacement bonds must not be "substantially identical" to those sold.

If a client has purchased U. S. Treasury bonds acceptable for estate tax payment and the bond market declines, the following steps may be advantageous:

1. Sell declined-in-value bonds in order to sustain capital losses (see 203.10 for the effect of such losses).
2. Purchase other Treasury bonds which are acceptable in payment of estate taxes so as to preserve the economic benefit afforded by these securities when eventually used for such payment (as described earlier).

Avoid Repurchase of Substantially Identical Bonds

A deduction is not allowed, generally, for loss from sale of bonds (or other securities) if, within either 30 days before or after such sale (i.e., within a 61 day period), substantially identical property is reacquired (Sec. 1091).

"Substantially identical" is not defined in either the Code or regulations. However, some elaboration has been provided by several revenue rulings. For example, Rev. Rul. 60-195 (1960-1 CB 300) stated that:

> Generally bonds are not "substantially identical" if they are substantially different in any material feature, or because of differences in several material features considered together. Rev. Rul. 58-211, 1958-1, p. 530. Securities are substantially identical when the par value, interest yield, unit price and the security behind the obligation are the same. *Hanlin, Executor v. Commissioner*, 108 F2d 429.
>
> In the present case, there is a substantial difference in interest rates. . . . Interest rates are considered to be a material feature. . . .

Accordingly, the ruling held that 3.45 percent bonds were not substantially identical to 4.5 percent bonds.

Rev. Rul. 58-211 vividly illustrates the obstacle presented by the wash sales provisions of Sec. 1091 in a situation specifically dealing with the sale and repurchase of Treasury bonds acceptable in payment of estate taxes.

As indicated above, there is no disallowance of a wash sale loss where substantially identical property is acquired either 30 days prior to the sale or 30 days subsequent thereto. However, it does not appear prudent for a client to rely on this exception since death could occur during this 61-day period, at a time when he would have to be devoid of this particular bond investment.

405 Effect of Gifts Included in Gross Estate

405.1 Simultaneous Estate Tax Credit and Deduction (or Gross Asset Reduction) for Gift Tax

Planning Technique

Gifts which are ineffective for estate tax purposes can, nevertheless, achieve incidental tax savings.

The merits and requirements of a sound gift program were described in 202.2, including consideration of certain gifts which would not be deemed effective for estate tax purposes.

Despite the failure of such ineffective gifts to achieve their primary estate tax savings goal, they may still produce incidental savings because of the following remaining favorable consequences:

1. The reversal of the gift itself also results in reversal of the tax thereon in the form of a credit against the estate tax (pursuant to Sec. 2012 of the Code).
2. The gift tax previously paid or presently payable will, respectively, either directly reduce the gross estate or provide additional deductions therefrom by way of increased indebtedness. In any event, the taxable estate is reduced by gift tax attributable to gifts subjected to estate taxation.

In essence, ineffective gifts are treated as though they were never made for both gift and estate tax purposes except for the recognition given to the reality of the actual gift tax payment or liability. It is this recognition, reflected in the estate tax return, which gives rise to incidental estate tax savings.

In other words, the net tax effect of this treatment allows a deduction for the estate tax itself, in an amount equal to the superseded gift tax, in determining the estate tax due and payable. Needless to say, such a deduction is not possible otherwise.

Naturally, this net tax savings will be decreased by the adverse monetary factor arising from loss of the use of money expropriated for gift tax payments. Consequently, ineffective gifts made closest to death may, interestingly enough, produce the greatest overall savings since their monetary impact (that is, interest factor) will be the least detrimental.

405.2 Deathbed Gifts

Planning Technique

Where feasible, gifts in contemplation of imminent *death should be made to obtain incidental estate tax savings.*

The savings described in 405.1 can be maximized by making gifts when death is most imminent. However, it must be strongly stressed that courses of action dictated by pure tax and other economic motives are greatly influenced by such "human" considerations as:

1. The physical, mental, and emotional state of the client.
2. The attitude of his immediate family.
3. The closeness of the CPA, attorney, and/or other advisors to the client personally as well as intimate knowledge of his overall tax and financial situation.

406 Marital Deductions

Federal income, estate, and gift tax consequences are frequently affected by property rights prescribed by the laws of our 50 states which, in turn, are categorized as (1) common law states and (2) community property law states.

Since these two legal systems are dissimilar in significant aspects, they can produce diverse federal tax effects, depending upon which state jurisprudence governs the federal taxpayer's affairs. In order to equalize federal tax treatment for all taxpayers, regardless of residence, the Code contains the following mechanisms:

1. Joint income tax returns, which allow common law taxpayers to split taxable income among married couples on a par with community property residents.
2. The estate tax marital deduction, which permits comparable estate-splitting.
3. Gift-splitting (discussed in 407 below) and the gift tax marital deduction, both of which serve the same purpose with regard to the gift tax.

Briefly, an estate tax marital deduction is allowable for the value of qualifying property interests passing to a surviving spouse, limited to a maximum deduction of 50 percent of the adjusted gross estate.

The gift tax marital deduction generally corresponds to its estate tax counterpart. As one significant exception, however, it should be noted

that it is based upon only 50 percent of qualifying gifts to a spouse, with no maximum limitation.

Discussion of the complex definitions and many other technical ramifications pertaining to both types of marital deduction is beyond the scope of this tax study.

406.1 Advisability of Maximum Deductions

Planning Technique

Marital deductions permit substantial amounts of property to be transferred to a spouse at reduced gift taxes and without any estate tax. However, these transfers may produce additional future gift or estate taxes unless they are consumed (or spouse remarries and effects similar transfers). Therefore, married couples should be treated as one unit, generally, for transfer tax purposes in order to equalize their combined *estates.*

Progressive rates are characteristic of both estate and gift taxes. Moreover, each spouse is treated as a separate taxpayer for estate and gift tax purposes. Consequently, marital deductions should be used to shift property between spouses so that maximum advantage can be taken of the lower brackets available to *both* husband and wife. This means that the estate of neither spouse can be viewed in a vacuum. To the contrary, their aggregate holdings must be considered in order to avoid, from a tax viewpoint, costly concentrations of wealth resulting from unnecessary gifts and bequests.

Therefore, the mission of the marital deduction, as a bracket equalizer, becomes obvious. Its desired role can, perhaps, best be seen through the deliberately extreme examples shown in Illustration 10, page 348.

Factors Affecting Use of Marital Deduction

Monetary Considerations. A deduction of only $10,000 was used in Example 2 (Illustration 10, page 348) in order to demonstrate bracket equalization. However, sound estate planning must also consider the marital deduction's second function of tax postponement. Thus, the maximum deduction could, nevertheless, be advantageous in Example (2) if the investment yield on the estate tax postponed at husband's death is more than the additional estate tax resulting from higher brackets at the wife's death.

Naturally, the ultimate investment yield on this tax postponement will depend upon the surviving spouse's longevity. Hence, the CPA must

Maximum Deduction

	Example 1 (advisable)		*Example 2 (possibly not advisable)* *		*Example 3 (not advisable)*	
Line	*Husband*	*Wife*	*Husband*	*Wife*	*Husband*	*Wife*
1 Gross assets	$120,000	$ –	$120,000	$100,000	$120,000	$300,000
2 Transfer from spouse	–	60,000	–	10,000	–	–
3 Gross estate	120,000	60,000	120,000	110,000	120,000	300,000
4 Marital deduction (maximum of 50 percent of line 3, *where advisable*)	60,000	–	10,000	–		–
5 Exemption	60,000	60,000	60,000	60,000	60,000	60,000
6 Subtotal of lines 4 and 5	120,000	60,000	70,000	60,000	60,000	60,000
7 Taxable estate (line 3 less line 6)	$ –	$ –	$ 50,000	$ 50,000	$ 60,000	$240,000

* See discussion regarding monetary considerations on page 347.

make custom-tailored projections of these factors where family wealth is already somewhat evenly divided between husband and wife.

NOTE. The estate tax marital deduction cannot be waived if subsequently undesirable. See Rev. Rul. 59-123 (1959-1 CB 248) where a more favorable credit for prior transfers (Sec. 2013) was precluded by the authorized (and mandatory) marital deduction.

Gifts. For simplicity, the preceding discussion has ignored gifts as another means of transferring property to the wife. As more fully explained in 202.2, such transfers can be made at relatively low, or no, tax cost.

Where gifts to a spouse are desirable, it will be advantageous, for gift tax purposes, to always qualify for the maximum marital deduction since it could have an approximately 50 percent reduction on gift taxes otherwise payable. However, qualification may not always be possible because income tax, estate tax, or nontax objectives may conflict with the gift tax marital deduction requirements (briefly discussed in 406.2).

In practice, accordingly, effective estate planning must coordinate the advisability of the maximum estate tax marital deduction with the desirability of a sound gift program.

Other Factors Affecting Use of Marital Deduction. The extent to which a maximum, partial, or no marital deduction should be utilized is also affected by a variety of other tax, business-financial, and personal factors. Since extended discussion of this subject is beyond the scope of this study, only a brief sketch of several major considerations is presented.

Effect of Marital Deduction Upon Surviving Spouse's Estate: To avoid an undue and costly "pile-up" of property in the surviving spouse's estate, projections should be made of (a) other sources of wealth which may flow to the spouse as well as (b) property which otherwise may be owned by the spouse at her death.

Since transfers to the spouse under marital deduction bequests, and so forth, will, in effect, be subjected to her highest estate tax brackets, it may not be advisable, generally, to "over-fund" the surviving spouse's estate. This, in turn, requires an evaluation of the spouse's probable consumption, over her life expectancy, of property which she may acquire from the decedent or from other sources, as well as property presently owned.

Consequently, the ages of both spouses are significant since they can

affect the amount of property consumed and thus influence marital deduction provisions.

Dissipation of a married couple's wealth, obviously, is also affected by the number and ages of their children. This factor also leads to consideration of the extent to which the surviving spouse's estate tax burden can also be eased by her own gift program. (See 202.2.)

On the other hand, the spouse may desire maximum lifetime enjoyment of her property even to the detriment of her heirs — particularly where they may be strangers or charities. For example, a spouse may attempt to maximize her estate in order to obtain more income even though estate taxes at her death would thereby be increased.

A further ramification of this problem is the extent to which generation-skipping transfers[46] should be utilized to provide income for the surviving spouse, while avoiding estate tax upon the death of one or more succeeding generations of beneficiaries.

Other Taxes: Obviously, the effect, if any, of a marital deduction upon state death taxes must be considered (comparably to the consideration to be given to the impact of a gift program upon state gift taxes, if any).

In addition, the surviving spouse's existing income tax bracket would also affect the amount of income-producing property to be transferred to her. It would be inadvisable to transfer property whose income would only be substantially consumed by income taxes.

Nature of Property: In view of the tax postponement achieved through the marital deduction, its maximum utilization may be desired if the decedent's estate is not sufficiently liquid to satisfy the estate tax otherwise due. This factor may be especially acute where the estate consists of family business interests whose retention is paramount. The maximum marital deduction would be helpful in mitigating undesirable liquidation of these interests after the decedent's death, even though increased taxes might be precipitated upon his spouse's death.

Personal Considerations: Other factors to be considered in the use of the marital deduction involve the decedent's wishes regarding the extent to which he may desire to place absolute control over the investment and ultimate disposition of his property in the hands (and judgment) of his spouse, taking into account the possibility of remarriage.

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[46] See discussion of estate taxes of future generations, 201.2, this study, in connection with life insurance protection.

PLANNING SUGGESTION. Where estate planning results in reliance upon a future marital deduction, it may be advisable to obtain insurance on the spouse's life as a hedge against her prior death and loss of the anticipated deduction.

Also to be considered in this context are the provisions of Sec. 2056 (b) (3) which do not disqualify a marital deduction which is subject to the spouse's survival under conditions specified therein. Thus, a marital deduction will not be disallowed because it could have been terminated upon the spouse's death (1) within six months after the decedent's death or (2) if it resulted from a common disaster which also caused the decedent's death. (However, the deduction will be disallowed if such contingency does, in fact, occur.)

These provisions enable a client, under limited conditions, to advantageously bypass his spouse's estate in the event of her early death without jeopardizing his marital deduction if such event does not actually occur.

406.2 Obtaining Maximum Deductions

Planning Technique

Maximum estate tax marital deductions, where advisable, should be authorized by wills carefully drawn to conform with Internal Revenue Code requirements and Supreme Court interpretations. In most situations, it will usually be advisable to also comply with Treasury regulations[47] *and IRS rulings — unless potential tax savings make controversy worthwhile.*

Similar compliance should prevail in qualifying gifts for the marital deduction.

Estate Tax Marital Deduction

The maximum marital deduction is most effectively and precisely achieved through formula clauses embodied in wills. Needless to say, the drafting of wills is a legal matter which should never be attempted, on behalf of a client, by anyone other than a qualified attorney. However, in order for a client's interests to best be served, estate planning is customarily conducted as a team effort, involving such advisors as the client's attorney, certified public accountant, insurance agent, and trust officer. Obviously, such planning cannot be complete without consid-

[47] Unless invalidated by Supreme Court.

ering the manner of achieving the maximum marital deduction, which is the largest single estate tax deduction — assuming, of course, that such deduction is advantageous (see 406.1).

Broadly stated, maximum marital deduction clauses contain either a pecuniary or fractional formula for determining distributions to the surviving spouse or to a trust for her benefit (i.e., a marital trust).

The selection of either formula involves a host of significant considerations, including:

1. The client's wishes as to whether or not his spouse shall share in appreciation or depreciation of property during the estate's administration.
2. Whether or not estate assets can be easily valued or feasibly divided.
3. Income tax as well as estate tax consequences of the formula contemplated in response to the foregoing.

Pecuniary vs. Fractional Bequests. Under a pecuniary formula providing for the maximum marital deduction, 50 percent of the adjusted gross estate is bequeathed to the surviving spouse, either outright or in trust. Such bequests become fixed and definite amounts, once the value of the adjusted gross estate is finally determined. Consequently, gain or loss is recognized for inccome tax purposes when pecuniary bequests are satisfied with assets which have appreciated or depreciated in comparison with their bases (estate tax values).[48]

To avoid overfunding of the surviving spouse's estate, pecuniary formula clauses prescribe appropriate adjustments for nonprobate and other property passing to the spouse.

A fractional formula, providing for the maximum marital deduction, is based upon the following fraction:

$$\frac{\text{M less N}}{\text{Value of residuary estate}}$$

M= Maximum marital deduction finally allowable in determining estate tax.

N = Value of all other property, included in gross estate, which passes, or is passed to, surviving spouse under other provisions of will or otherwise; and which qualifies for marital deduction.

Consequently, a fractional formula, unlike its pecuniary counterpart, automatically permits the marital bequest to share in appreciation and depreciation in the value of the estate. However, utilization of this

[48] See, for example, Rev. Rul. 56-270, 1956-1 CB 325, as clarified by Rev.Rul. 60-87, 1960-1 CB 286.

approach depends upon the extent to which the estate's assets can be feasibly divided.

IRS Requirements Regarding Pecuniary Marital Bequests. Rev. Proc. 64-19[49] sets forth certain conditions for pecuniary bequests[50] to qualify for the marital deduction which might also precipitate capital gains. Although it has been suggested that distributions under Rev. Proc. 64-19 are not within the capital gains scope of Rev. Rul. 56-270,[51] the Revenue Service has yet to issue a ruling directly in point.

Rev. Proc. 64-19 is designed to prevent the estate tax avoidance otherwise possible if pecuniary marital bequests, whether outright or in trust, can be distributed at estate tax values. Such a procedure would permit these bequests to be satisfied with property which has declined in value after the decedent's death. Consequently, the surviving spouse would have been able to receive property whose value would be less than the corresponding amount allowed as a deduction in the decedent's estate. This, of course, would have enabled such property, to the extent of its shrinkage in value during the estate's administration, to escape transfer taxes in the hands of *both* spouses.

However, similar savings of perhaps greater magnitude appear possible if marital trusts are established in such a manner that appreciation of principal would not be taxed at the surviving spouse's death. See the discussion of marital trusts following.

In view of the many conditions, considerations, and ramifications surrounding the use of marital deduction formulae, further detailed discussion must be beyond the scope of our "broad-brush" study.

Planning Pointers Regarding Marital Trusts

Marital trusts must meet the following criteria (established by Sec. 2056 (b) (5)):

1. The surviving spouse must be entitled to its income for life, payable at least annually.
2. She must have power, exercisable alone and in all events, to appoint the principal either to herself or to her estate.

[49] 1964-1 CB (Part 1), 682.

[50] Rev. Proc. 64-19, by its own terms (see Sec. 4.01 (1) thereof), does not apply to fractional bequests.

[51] See, for example, Mark B. Edwards, "Which Marital Deduction Formula Clause Is Best for Your Client," *The Journal of Taxation* (Oct. 1967), p. 232, which also indicates that these capital gains can be diminished by (1) funding the marital bequest as soon as possible (after decedent's death) and/or (2) careful selection of funding assets.

In addition, no power can exist for any other person to appoint principal to anyone except the surviving spouse.

These criteria apply either to an entire interest in property, or to a specific portion thereof, for which the marital deduction is sought. The Code merely mentions "specific portion" without any elaboration, although Regs. Sec. 20.2056 (b)-(5) (c) requires the surviving spouse's rights over income and principal to constitute a fractional or percentile share so that it will share in any appreciation or depreciation experienced by the entire property interest (to which it relates).

This regulation was invalidated by a 1967 Supreme Court decision[52] which held that a partial interest could, nevertheless, qualify for the marital deduction even though the spouse's income rights are stated in fixed dollars or in terms of income from a stated amount of corpus.

The Court's dissenting opinion indicated that under this rationale, a partial interest would qualify for the marital deduction where rights to both principal and income are limited to fixed amounts. In such event substantial tax savings may be possible as illustrated in this excerpt from said minority opinion:

> . . . Assume a trust estate of $200,000, with the widow receiving the right to the income from $100,000 of its corpus and a power of appointment over that $100,000, and the children of the testator receiving income from the balance of the corpus during the widow's life, their remainders to vest when she dies. Now suppose that when the widow dies the trust corpus has doubled in value to $400,000. The wife's power of appointment over $100,000 applies only to make $100,000 taxable to her estate [Sec. 2041 of the 1954 Code]. *The remaining $300,000 passes tax free to the children.* Contrast the situation in a community property state. The wife's 50 percent interest in the community property places $200,000 of the expanded assets in her estate and taxable as such; only $200,000, therefore, passes directly to the children. Thus, the Court's interpretation of "specific portion" affords common law estates a significant tax advantage that community property dispositions cannot obtain. . . . [Emphasis supplied.]

NOTE. Comparable savings are possible through inter vivos gifts since Gift Tax Regs. Sec. 25.2523(e)-1 (c) contains the identical definition of "specific portion" which, presumably, is likewise invalid.

Use of "Estate Trusts" to Accumulate Income for High Bracket Spouse. Rev. Rul. 68-554 (1968-2 CB, 412) holds that an "estate trust" qualifies for the marital deduction where the corpus and any accumu-

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[52] *Northeastern Pennsylvania National Bank and Trust Co.*, 387 US 213.

lated income is to be paid to the estate of the surviving spouse even though the spouse may not receive any of the trust income during her lifetime.

The unlimited throwback rules (Secs. 665-669) would apparently apply to the distribution of such accumulated income to the spouse's estate. However, additional taxes appear unlikely since the estate did not exist while the income was earned by the estate trust and, therefore, would usually have no other income. Consequently, the estate's taxable income for the throwback years should be less (under the exact method of computation permitted by Sec. 668 (b)) than the taxable income of the estate trust because the estate qualifies for a $600 exemption, in contrast to the $100 exemption allowable to the estate trust.

On the other hand, no refunds are possible (under Sec. 6401 (b)) since the surviving spouse's estate was not "in being" during the throwback period — as required by Sec. 667 (b).

In any event, the throwback rules do not prevent utilization of an estate trust as a means of bypassing the high income tax brackets of a surviving spouse.

Gift Tax Marital Deduction

The greatest barrier to obtaining the gift tax marital deduction is the "nondeductible terminal interest", which is extensively defined in the Gift Tax Regulations promulgated under Sec. 2523.

407 Splitting Gift by Married Couples To Third Parties

As mentioned in 406, this type of gift-splitting is another measure designed to achieve federal tax parity between residents of common law and community property states. A technical discussion of this provision (contained in Sec. 2513) is beyond the scope of this tax study. Instead, emphasis shall be placed upon planning considerations flowing from the elective nature of this privilege.

407.1 Providing for Post-Mortem Consent

Planning Technique

Executors should be specifically instructed by will to consent to gift-splitting if advantageous for surviving spouse.

Post-Mortem Consent to Gift-Splitting

The executor or administrator of a deceased spouse *may* signify the consent required (by Sec. 2513(a)(2)) in order to obtain gift-splitting.[53]

Where gifts for the year of death have only been made by the decedent, his executor may usually be impelled to consent in order to reduce any gift tax payable. (The executor's fiduciary duty will require such action if overall estate liabilities would be minimized. (See 407.2 for the effect of such gifts included in the decedent's gross estate.)

If the shoe is on the other foot and it is the surviving spouse who has made the sole gifts for the year of death, the reverse situation may prevail. The executor's duty, in general, may preclude such consent since it may cause gift tax to be payable by the estate even though more than offset by savings to the surviving spouse.

PLANNING SUGGESTION. To provide certainty with regard to the gift-splitting election, the wills of both a client *and* his spouse should require their executors to signify the necessary consent whenever beneficial to their *combined* interests.

EXAMPLE. Client's wife dies in November, 1970 without ever making any gifts. Her will is silent regarding gift-splitting consent.

Client had given their only child $100,000 in March, 1970. No other gifts have been made. Wife's executor refuses to consent since estate liabilities would be increased. Accordingly, Client is compelled to pay a gift tax of approximately $8,600.

If wife's will had required such consent, the net savings would be as follows:

Gift taxes payable:	
Husband	$ 952.50
Estate	952.50
Total	1,905.00
Less tax otherwise payable by husband	8,600.00
Net savings	$6,695.00

Under Rev. Rul. 70-600 (IRB 1970-48, 12), the gift tax paid by the wife's estate would not be deductible for estate tax purposes since her executor's post-mortem consent does not, retroactively, create an enforceable obligation at the date of her death.

[53] See Gift Tax Regs. Sec. 25.2513-2 (c).

407.2 Post-Mortem Consent Not Always Advisable

Planning Technique

Surviving spouse should not consent if no resulting benefit is gained by estate.

A surviving spouse should avoid post-mortem consent where it cannot produce any benefit for the decedent's estate because (1) the decedent's $30,000 lifetime exemption was not consumed or (2) his gifts are includible in his gross estate, under the contemplation of death provisions, and so forth, and the gift tax allowed as both an estate tax credit and deduction.

In this latter event, it actually will be advantageous for the decedent's gift tax to be as high as possible. (See 405.)

The surviving spouse's consent in these situations will be unfortunate since it will have the following adverse consequences: (1) application of her own lifetime exemption will be wasted[54] and/or (2) her gift tax brackets for future gifts will be increased.

NOTE. Double taxation is not imposed, however, for split gifts subjected to estate tax because credit is allowed for the gift tax paid by the surviving spouse as well as by the decedent (Estate Tax Regs. Sec. 20.2012-1(e)).

408 Maintaining Adequate Substantiation Regarding Jointly Held Property

Planning Technique

Proper records should be maintained, prior to death, regarding the financing of certain jointly owned property to avoid unnecessary double estate taxation.

Sec. 2040 requires the total value of all jointly held property, except tenancies in common,[55] to be included in the gross estate of a co-owner regardless of his legal share of ownership. However, such values need not be included to the extent attributable to consideration in money or money's worth furnished by the surviving owners.

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[54] *R. H. Ingalls*, CA-4, 336 F2d 874, aff'g 40 TC 751, and *Keturah English, Exr.*, 284 F. Supp. 256 (DC, Fla.)

[55] Estate Tax Regs. Sec. 20.2040-1(b).

In other words, "the entire value of jointly held property is included . . . *unless the executor submits facts sufficient to show that property was not acquired entirely with consideration furnished by the decedent. . . .*"[56]

EXAMPLE. Messrs. Careless and Complacent own property jointly which they acquired in 1934 at a total cost of $20,000. Careless believes they each contributed half the purchase price but this fact can no longer be substantiated.

Careless dies in 1970, when the property is worth $100,000. Since Complacent's consideration cannot be sufficiently shown, the entire value is included in Careless's gross estate.

Complacent succeeds to full ownership of the property, which he retains until his death in 1981. At that time, its entire value will again be subjected to estate tax.

PLANNING SUGGESTION. Co-owners of property held in joint tenancy or in tenancy by the entirety (applicable to married couples) will be very well advised to maintain adequate records and sufficient corroboration in order to meet the substantiation requirements of Regs. Sec. 20.2040-1 (a). Availability of such data should prevent estate taxation of more than the decedent's financially proportionate share of ownership.

As a practical matter, it is certainly also advisable to maintain such information with regard to tenancies in common in order to avoid gift and estate tax treatment, inconsistent with actual facts, which may be asserted by taxing authorities.

409 Electing Gift Treatment for Creation of Certain Joint Tenancies

Planning Technique

Use Sec. 2515 (c) election only where future gift tax savings can be expected in excess of any present financial costs.

A tenancy by the entirety in real property is essentially a joint tenancy between husband and wife with the right of survivorship. (The term "tenancy by the entirety" includes a joint tenancy between husband and wife in real property with right of survivorship, or a tenancy which accords to the spouses rights equivalent thereto, regardless of the term

[56] Regs. Sec. 20.2040-1 (a); emphasis supplied.

by which such a tenancy is described in local property law).[57] During calendar years prior to 1955, the contribution made by a husband or wife in the creation of a tenancy by the entirety constituted a gift to the extent that the consideration furnished by either spouse exceeded the value of the rights retained by that spouse.

Sec. 2515 (a) provides that the contribution made by either or both spouses in the creation of such a tenancy during the calendar year 1955, or any calendar year thereafter, *is not deemed a gift* by either spouse, regardless of the proportion of the total consideration furnished by either spouse unless the donor spouse elects under Sec. 2515 (c) to treat such transaction as a gift in the calendar year in which the transaction is effected. This treatment applies only to tenancies created in real property.

However, there is a gift upon termination of such tenancy, except through death, if the proceeds received are not commensurate with the value of a recipient's property interest acquired through purchase or recognized gift (including a Sec. 2515 (c) gift).

Advisability of Election

Income Tax Effect. Income from property held in joint ownership is generally taxable to each co-owner in proportion to the income that each is entitled to receive under applicable local law. The usual rule in most states is that such income inures equally to each co-owner (Massachusetts and North Carolina being among the exceptions).

Thus, neither the general rule of Sec. 2515 (a) nor the election granted under Sec. 2515 (c) would have any income tax effect upon income-producing realty jointly held by married couples. (In addition, the division of income from such property, for income tax purposes, would be negated by filing joint returns.)

Estate Tax Effect. Likewise, none of the provisions contained in Sec. 2515 have *any effect* for estate tax purposes in view of Sec. 2040 which requires inclusion in a co-owner's estate to be based upon his proportionate contributions towards the cost of such jointly held property.

NOTE. Gift tax paid because of the election, if any, would be credited against the estate tax. See Sec. 2012.

[57] See Gift Tax Regs. Sec. 25.2515-1(b) for circumstances creating tenancies by the entirety.

Gift Tax Effect. A Sec. 2515 (c) election would be advantageous only if:

1. The resulting gift will be less than the gift reportable when the tenancy is terminated because (a) a subsequent sale of the property is anticipated at *appreciated* values and (b) the proceeds will be divided equally among the spouses.
2. Such gift tax savings exceed any financial costs arising from immediate gift tax payments. (See 104.2 for discussion of monetary factors, i.e., interest expense, loss of investment yield, and so forth.)

Any desired election should be made in accordance with the requirements of Regs. Sec. 25.2515-2(a).

EXAMPLE. Husband furnishes the entire $100,000 purchase price for a rental property which will be held in joint tenancy (including right of survivorship) with his wife.

If a subsequent sale is anticipated for $150,000, to be equally divided among the co-owners, an election would be advisable (ignoring monetary factors) since reportable gifts can be reduced by $25,000, as follows:

	Election	*No Election*
Reportable gifts to wife:		
Upon acquisition of property	$50,000	$ None
At later sale	$ None	$75,000

CAUTION. There is no advantage in making an election if the expected selling price may approximate the purchase price. *On the other hand, a substantial decline in value would render an election distinctly disadvantageous.*

410 Possible Deduction for Depreciation (Amortization) Of Gift Tax Applicable to Gift of Income Interest in Limited Term Trust

Planning Technique

In appropriate circumstances, it might be desirable for income beneficiaries to claim depreciation (amortization) deductions for gift tax attributable to the gift of their income interest.

In accordance with the IRS's Experimental Revenue Rulings Program, the committee on federal taxation of the American Institute of Certified Public Accountants submitted in April 1967, the matter of such gift tax

amortization as a suggested subject for a revenue ruling. This suggestion was accompanied by an analysis which read, in part, as follows:

> Sec. 1015 (d) provides that the basis of "the property" in the hands of the donee shall be the donor's basis "increased (but not above the fair market value of the property at the time of the gift) by the amount of the gift tax paid with respect to such gift. . . ."
>
> This section contemplates that the stepped-up basis in the property shall inure to the benefit of the donee. In a ten-year short-term (Clifford type) trust the donee only receives the right to receive the income for the trust term. The trust principal reverts back to the settlor on termination of the trust. There is obviously no justification for increasing the basis of the principal by the gift tax paid, since the subject of the gift was the right to receive the income. Therefore, the income beneficiary of the trust should be permitted to amortize the gift tax basis adjustment against trust income equitably over the life of the trust. . . .

CAUTION. Within a month thereafter, the Service indicated that it would not rule on this matter since it could find no legal basis to do so.

Nevertheless, authority for this position might be found in the following:

1. Regs. Sec. 1.167(a)-3 which allows depreciation deductions for intangible assets.
2. Mertens, *Law of Federal Income Taxation*, which states[58] that depreciation or amortization of the purchase price of an outstanding life estate is allowable over the life expectancy of the measuring life (e.g., life of income beneficiary).
3. Virginia District Court decision in *Thomas A. Grant*[59] where a life income beneficiary was allowed to deduct, over her life expectancy, an amount paid to a trustee for purposes of satisfying debt previously assumed by the trust, *even though* the debt was originally incurred by an estate to pay estate taxes.

NOTE. In the case of accumulation trusts, this depreciation would still appear allowable to the income beneficiary even though the income is currently taxed to the trust.

Deductions are not allowable for depreciation or amortization with respect to the value of the income interest itself since Regs. Sec. 1.273-1 states, in pertinent part, that a holder of a life or terminable interest, acquired by gift, cannot "set up the value of the expected future

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[58] See 23.63(a), which cites *May T. Hrobon* (41 TC 476 (1964)). Taxpayer's appeal to CA-6 dismissed pursuant to stipulation.

[59] 202 F. Supp. 608 (1962).

payments as corpus or principal and claim deduction for shrinkage or exhaustion thereof due to the passage of time. . . . "

The manner in which this deduction might be claimed in the beneficiary income tax return is shown in Illustration 11, below.

Illustration 11

Depreciation of basis (pursuant to Sec. 1015(d)(1)(A) of the 1954 Code) for intangible property, held for the production of income, consisting of taxpayer's interest as trust income beneficiary as follows:

Total basis of taxpayer's interest	$12,100
Term	121 months
Monthly depreciation	$ 100
Annual depreciation	$ 1,200

Note: Deductions for depreciation allowable under Sec. 167 to an income beneficiary of property held in trust are deductible *for* determining adjusted gross income. (See Sec. 62(6); Regs. Sec. 1.62-1 (c)(9).)

PLANNING SUGGESTION. It should be emphasized that this deduction has not been directly subjected to judicial review. Since the Revenue Service's national office has declined to rule on this point, challenges might be quite likely upon examination (which could, possibly, be precipitated by claiming such deductions).

Thus, a decision to claim this deduction should be made by the client after due consideration of professional advice, which should include an evaluation of the risks and consequences, if any, of an IRS audit.

The benefits to be derived, in general, from the effective use of trusts are discussed in 202.3.

Further Planning

Other lifetime planning such as private annuities and powers of appointment, as well as extended consideration of post-mortem matters,[60] is beyond the scope of this tax study.

[60] See, for example, Bernard Barnett, "After-Death Estate Planning," *The Tax Adviser* (Jan., Feb., Mar. 1970).

Other Tax Shelters

CHAPTER 5

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Chapter 5

Other Tax Shelters

There are certain forms of investment that seem to have achieved some sort of modern day notoriety as shields against the ravages of our taxing scheme. Foremost among these shelters in our nuclear age, and not necessarily in order of popularity (or effectiveness), are real property and farm operations — both of which will be discussed in this chapter.

501 Real Property

Planning Technique

Investments in real property can be used to generate ordinary income deductions that can exceed the cash invested, provide ordinary income deductions for costs incurred which may eventually be recouped at capital gain rates, obtain income taxed at favorable capital gain rates, and achieve tax-free build-up of equity through nontaxable exchanges.

Planning Considerations

Depreciation Deductions. It is possible to obtain depreciation deductions in excess of a client's cash investment since depreciable basis includes indebtedness to which property is subject as well as such cash investment. General monetary conditions permitting, a high percentage of the purchase price of real property can usually be financed with borrowed funds.

One hundred fifty percent declining-balance depreciation is also available for new or constructed properties. A change to the straight-line method during a later year in the asset's life may be desirable — after giving effect to estimated salvage value, if any — in order to obtain

maximum deductions. Such a change can be made under Rev. Proc. 67-40 (1967-2 CB 674) within 90 days of the beginning of the year for which the change is sought.[1]

Using separate lives for a building's components (i.e., walls, floors, wiring) may cause even greater deductions. Under Rev. Rul. 66-111 (1966-1 CB 46), the use of component lives is likewise restricted to new or constructed property.

Deductions for Carrying Charges. Taxes, interest, and other carrying charges can be deducted against ordinary income even though (1) the real estate is in a nonproductive stage; e.g., buildings under construction or land which is idle or vacant; and/or (2) the income eventually realized is subject to capital gain rates.

Capital Gain Opportunities. The capital gain opportunities inherent in real property were previously discussed in 203.6.

It should be noted that the process of distilling capital gains through accelerated depreciation has been largely vitiated by the recapture provisions of Sec. 1250 (discussed at 203.7). However, as previously mentioned, Sec. 1250 recapture is somewhat less pervasive than Sec. 1245 recapture (relating to personal property, and so forth). Thus, the ordinary deduction (depreciation, and so forth) — capital gain ambit may have some vitality where real estate is involved.

Tax-Free Exchanges. In 204.11, the benefits of trading real properties in nontaxable exchanges, including three-party transactions, were described.

Tax on Disposition Can Exceed Cash Realized. The benefit of claiming depreciation deductions in excess of cash investment can "come home to roost" when the property is sold and outstanding indebtedness is assumed by the buyer. Such assumptions are treated as additional proceeds of sale which generate gain not reflected by cash receipts. This gain can be taxed as ordinary income to the extent required by the depreciation recapture provisions. (See, for example, the discussion of Sec. 1250 at 203.7.)

EXAMPLE. On January 1, 1970, Sharpo acquires a building for $20,000 cash and an $80,000 mortgage, at 8 percent interest payable monthly

[1]See the initial discussion of Sec. 1250 property in 203.7, herein.

over 25 years. If, after making mortgage payments of $17,800,[2] he sells the building on January 1, 1981 for $5,000 cash with the buyer assuming the unpaid mortgage, his income tax return will reflect the figures shown in Illustration 1, below.

Illustration 1

Line			
	Proceeds of sale		
1.	Cash		$ 5,000
2.	Assumption of mortgage		62,200
3.	Total proceeds		$67,200
	Basis of building		
4.	Original cost	$100,000	
5.	Less accumulated depreciation	49,400*	
6.	Basis		50,600
7.	Total gain		$16,600
8.	Less — additional depreciation recaptured as ordinary income ($49,400 less $44,000 straight-line depreciation)		5,400
9	Long-term capital (or Sec. 1231) gain		$11,200
10.	Tax on line 8 (50%)†		$ 2,700
11.	Tax on line 9 (at 25%)		2,800
12.	Total tax		$ 5,500

*Computed under 150 percent declining-balance method, useful life of 25 years (rounded to nearest hundred dollars).

†Assumed ordinary income tax rate.

In this case, the tax will exceed the cash realized by $500. However, depreciation deductions have exceeded cash investment by $11,600 ($49,400 less $37,800 ($20,000 plus $17,800)). Consequently, Sharpo's *overall* cash flow from this investment must reflect the tax savings attributable to these depreciation deductions (which, in turn, depends upon his ordinary income tax rates throughout the 1970 to 1981 holding period). On the other hand, this overall cash flow will be diminished by Sharpo's net (after-tax) interest payments on the mortgage.

[2] Derived from "Monthly Payment Loan Schedules" (10th ed.) Financial Publishing Company, Boston, p. 8%-49. Rounded to nearest hundred dollars.

Planning Technique

Certain investments in farming operations may allow ultimate realization of residual value to be taxed at favorable capital gain rates while permitting associated costs, in varying degrees, to be deducted against ordinary income.

There are various types of investments that a client can make in the field of agriculture which will achieve, to a greater or lesser extent, the epitome of protection from ordinary income tax rates. Among those shelters in popular vogue today are livestock, Christmas trees and other tree farms, and fruit orchards.

Hobby vs. Business Operation

Individuals (and Subchapter S corporations) cannot deduct losses arising from activities not engaged in for profit (to the extent attributable to business deductions) (Sec. 183 (a)). However, an activity will be presumed to be engaged in for profit, unless rebutted by the IRS, if it is profitable for at least two years during the five-year period ending with the current taxable year. (A seven-year period is substituted for an activity which, in major part, consists of breeding, training, showing, or racing horses.) (Sec. 183 (d).) These provisions are intended to prevent the reduction of taxable income by losses sustained in a hobby or other economically unprofitable activity.

Obviously, this statutory presumption is beneficial where its minimum two-year profit requirement can be met. On the other hand, the Revenue Service might draw adverse inferences if this requirement is not fulfilled. Therefore, it seems prudent, from an income tax standpoint, to avoid investments which are economically unprofitable. In other words, tax shelters cannot be obtained by deducting operating losses of farms which are essentially owned for personal or recreational purposes or which only produce a "tax profit" (in the absence of the actual profits required during a five-year or seven-year period).

It might be noted, for purposes of the presumption, the five-year or seven-year measuring period must consist of consecutive taxable years. However, the profit requirement can be met, apparently, for *any* two years (not necessarily consecutive) during this measuring period. In determining such profits, all deductions attributable to the activity, other than net operating loss *carryovers*, are taken into account.[3]

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[3] S. Rep. No. 91-552, 11/21/69, p. 105.

If an activity is not engaged in for profit, deductions are still allowable for non-business deductions such as interest, property taxes, the long-term capital gains deduction, and so forth. In addition, business deductions (or deductions for production of income) are also allowable to the extent of any gross income derived from the activity after reduction for non-business deductions (interest, taxes, and so forth) (Sec. 183 (b)). The business, and other, deductions which are allowed first (but after interest, taxes, and so forth) are those involving basis adjustments, such as depreciation.[4]

502.1 Livestock

Capital Gain — Ordinary Deduction Shelter

Investments in animals held for draft, breeding, dairy, or sporting purposes qualify for the extremely favorable Sec. 1231 treatment described in 203.4 (net gains taxed at capital gain rates while net losses deductible against ordinary income). However, Sec. 1231 (b) (3) requires such animals (which do not include poultry) to be held for the following periods in order to be eligible for this benefit:

1. Cattle and horses — 24 months.
2. Other livestock — 12 months.

These holding periods apply to livestock acquired after 1969.[5] Animals owned prior to 1970 are generally subject to only a 12-month holding period except where held for sporting purposes. In this latter case, the required holding period must only exceed six months.

CAUTION. The underlying Congressional Committee reports[6] both indicate that merely satisfying the holding period requirements:

> . . . Should not, in itself, be considered to conclusively demonstrate that the animals were held for breeding purposes (or any of the other specified purposes). Thus, even though a taxpayer holds livestock for the necessary period, he should not, merely because of that fact, be treated as having held the animal for one of the specified purposes. This determination should be made on the basis of all the facts and circumstances which indicate the purpose for which the animal was held. . . .

[4] *Ibid.*, p. 104.

[5] Sec. 212(b)(2), 1969 Tax Reform Act.

[6] H. Rep. No. 91-413, Part 1, 8/2/69, p. 70; S. Rep. No. 91-552, 11/21/69, p. 101.

Raised vs. Purchased Animals. The cost of raising livestock can be currently deducted against ordinary income since farmers can use the cash method of accounting and, therefore, are not required to inventory their herds. On the other hand, amounts expended to purchase livestock held for draft, breeding, or dairy purposes must be capitalized by cash basis farmers. In this case, only depreciation allowed or allowable can be charged against ordinary income with the unrecovered cost applied against the sales proceeds in reduction of the Sec. 1231 gain.[7] Moreover, this Sec. 1231 gain will be converted into ordinary income to the extent such depreciation is allowed or allowable for periods after December 31, 1969.[8]

Minimum Tax on Tax Preferences. Any net Sec. 1231 gains taxed as long-term capital gains will also constitute tax preferences which may be subject to the 10 percent minimum tax. (See 105.1.)

Timing Control

The cash basis provides great flexibility with regard to the timing of deductions (assuming favorable monetary conditions as discussed in 104.2). Purchases of feed can be particularly effective in this respect since they can be deducted when payment is made even though the feed will actually be consumed in subsequent years. However, such payments must be absolute and nonrefundable, under binding contracts.[9] Mere deposits, refundable upon request, do not give rise to current deductions.[10]

Where an absentee livestock operation is involved, which may be the usual case for the typical farm tax shelter, another pitfall to avoid is advance payments for feed which also include services to be performed by the managers of the cattle raising operation. The portion of the payment allocable to such future services will be viewed as a deposit and not allowable as a current deduction.

EXAMPLE. A dentist conducted a cattle business at a loss. The cattle were actually fed in commercial feedyards by professional feeders. On December 21, 1959, the dentist paid $25,000 for feed to be consumed in 1960. This payment also included the services of the professional feeders.

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[7] See Regs. Secs. 1.61-4(a) and 1.162-12.

[8] Sec. 1245 (a)(2)(C).

[9] *John Ernst,* 32 TC 181 (1959), acq. 1959-2 CB 4.

[10] *Shippy,* CA-8 (1962), 308 F2d 743, aff'g 199 F. Supp. 842 (West. D., So. Dak.).

The current market price for feed and services was applied against this advance payment as feed was consumed.

Another prepayment was made at the end of 1960. In 1961, the dentist changed feeders and received a $26,000 refund for unconsumed feed.

The IRS, sustained by the Tax Court and the Ninth Circuit Court of Appeals, allowed these payments as deductions only in the years they were actually used to defray the cost of feed and services rendered. The Courts distinguished this case from the *Ernst* decision (footnote 9) on the following grounds: (1) refunds for unconsumed feed were received and (2) the price of feed included the cost of valuable services to be performed in the future.[11]

Recapture of Certain Farm Operating Losses

Individuals (and other taxpayers) who sustain farm net losses in taxable years beginning after 1969 must establish and maintain an excess deductions account (EDA). The purpose of this account is to measure the amount of gain arising on the sale or other disposition of farm recapture property, *including livestock*, which must be treated as ordinary income instead of capital gain. This particular type of ordinary income recapture, authorized by Sec. 1251, applies to the extent of the balance in the EDA at the end of the year in which the disposition occurs.

Sec. 1251 makes no effort to match the recaptured gain with the farm loss which measures the amount of such recapture. All post-1969 farm net losses form the recapture yardstick which can be applied upon the disposition of any type of farm recapture property. Moreover, multiple farming businesses are consolidated for Sec. 1251 purposes (Sec. 1251 (e) (4) (B)). Thus, a farm net loss attributable to crop expenses can be recaptured upon the disposition of livestock, and losses from a previously abandoned tree farm can be recaptured upon the sale of unharvested crops. On the other hand, income from crop sales can offset expenses of raising breeding livestock, which will permit greater capital gain recognition when such livestock are sold.

NOTE. Farm recapture property, farm net loss, farm net income, and nonfarm adjusted gross income are defined later.

Additions to EDA. Additions to this account are required for any year beginning after 1969 in which a farm net loss is sustained, in an amount equal to such loss. However, in the case of individuals and certain

[11] *Tim W. Lillie*, CA-9, 370 F2d 562, aff'g 45 TC 54.

Subchapter S corporations,[12] additions are only required if nonfarm adjusted gross income for the year exceeds $50,000 *and* to the extent the farm net loss for such year exceeds $25,000.

These dollar limitations are halved for married couples filing separately unless the farmer's spouse does not have any nonfarm adjusted gross income for the year (Sec. 1251(b)(2)(C)).

There is no statutory indication as to the treatment of pre-1970 losses carried into post-1969 years. Hopefully, future regulations will exclude such amounts from an EDA, consistent with the congressional intent to recapture only losses sustained after 1969.

Subtractions From EDA. If a balance exists in the EDA at the close of any taxable year, all taxpayers can reduce this account by the following amounts:

1. Farm net income for the year.
2. Farm deductions which did not reduce current or prior tax liabilities.
3. Capital gains converted into ordinary income by this Sec. 1251 EDA mechanism.

These reductions are made in the sequence indicated.

No subtraction is allowed under category (2) if a farm net loss only caused a partial reduction in tax liability, such as where it was used merely to offset long-term capital gains.

It is uncertain whether these subtractions can reduce an EDA below zero and produce a negative balance. Of course, farm net income cannot be subtracted from an EDA prior to the addition of farm net losses since subtractions can only be made when there is a balance in the account.

Planning Considerations

Keeping Within Dollar Limitations. An individual need not make any additions to his EDA if his nonfarm adjusted gross income is $50,000 or less *or* if his farm net loss is $25,000 or less. Conversely, all of the farm net loss in excess of $25,000 must be added to EDA if nonfarm adjusted gross income exceeds $50,000 by only $1 (Sec. 1251(b)(2)(B)).

Maintaining Records. An EDA is required for the duration of a farmer's life unless its balance is eliminated or the account is transferred pursuant to Sec. 1251(b)(5). Since the EDA balance actually limits the

[12] See discussion of further planning possibilities for Subchapter S corporations later in this chapter.

amount of ordinary income recaptured under the general rule of Sec. 1251(c)(1) (equal to the entire gain realized), adequate records are a necessity in order to minimize the amount of such recapture.

Farm Losses as a Tax Deferral Vehicle. It should be emphasized that Sec. 1251 only converts capital gain into ordinary income under the conditions previously described. Thus, there is no prohibition on the use of farm losses to defer tax on ordinary income to subsequent years.

In addition, this deferral can also result in permanent tax savings if the losses are claimed in high bracket years and recaptured in lower bracket years (such as during a client's retirement).

Subchapter S Corporations. The Subchapter S corporations subject to these relatively favorable dollar limitations are those in which none of the shareholders is an individual who has a farm net loss for his taxable year with which or within which the corporate taxable year ends.

EXAMPLE. Client is an executive who also owns a farm. For 1971, Client anticipates a $100,000 salary and a $75,000 farm net loss. Although the entire $75,000 loss will be deductible in computing Client's 1971 income tax, $50,000 ($75,000 less $25,000) must be added to his EDA.

If, instead, the farm is transferred to a newly created Subchapter S corporation (solely owned by Client) on January 1, 1971, Client can still offset his salary by the corporation's $75,000 net operating loss. However, no additions are required to Client's EDA since he does not, himself, have a farm net loss. Moreover, the corporation is also not required to make any addition to its own EDA because (1) it does not have any individual shareholder who has a farm net loss and (2) the corporation's nonfarm taxable income does not exceed $50,000.

In contrast, if the corporation had another individual shareholder with his own farm net loss, the $50,000 and $25,000 limitations would not apply. Consequently, the entire $75,000 farm net loss would be added to the corporation's EDA.

CAUTION. It is doubtful whether these extreme variations were intended for the treatment of Subchapter S corporations and their shareholders. Consequently, it seems likely that Sec. 1251(b)(2)(B), which apparently permits the results previously exemplified, will be the target of future legislative (or perhaps regulatory) correction. The possibility of such correction should be considered in any tax planning involving the operation of this statutory provision.

Definitions

Farm recapture property consists of the following categories of Sec. 1231 property, if used in the business of farming:

1. Depreciable property held more than six months.
2. Nondepreciable real property (e.g., land) held more than six months.
3. *Livestock,* held for the appropriate holding period.
4. Unharvested crops held more than six months, if the underlying land is simultaneously sold (or otherwise disposed of) to the same person.

Depreciable real property (i.e., Sec. 1250 property), such as buildings and barns, is not subject to the recapture provisions of Sec. 1251. But, see 203.7, for the effect of depreciation recapture under Sec. 1250.

The Code is silent as to the interplay between Secs. 1245 and 1251. Presumably, depreciation would be initially recaptured under Sec. 1245 with any remaining gain subject to Sec. 1251.

Farm recapture property also includes such Sec. 1231 property which was used in the farming business by a transferor involved in certain corporate reorganizations (such as those under Sec. 381) or by a donor of gifts described in Sec. 1251(b)(5)(B). Stock or securities received in a transfer to a controlled corporation under Sec. 351 become farm recapture property to the extent attributable to the fair market value of the farm recapture property transferred. If land is transferred, this carryover taint is limited to the adjusted basis of the land plus its potential gain (subject to recapture) as defined in Sec. 1251(e)(5) (Sec. 1251(d)(6)).

It might be noted that pre-1970 acquisitions can constitute farm recapture property even though only post-1969 gains are subject to recapture to the extent of post-1969 farm net losses.

Farm net loss is determined as follows:

1. Deductions allowed or allowable* which are directly connected with the carrying on of the business of farming	$
2. Less — gross income derived from such business	________
3. Farm net loss (1) less (2)	$ ________

* Under Chapter 1 of the Code.

Farm net income is simply the excess of line (2) over line (1).

Sec. 1251(e)(2) provides that Sec. 1231 gains and losses on the disposition of farm recapture property are not to be included in determining farm net income or loss. For this purpose, gain actually recaptured as ordinary income under Secs. 1245 or 1251 is nevertheless

treated as Sec. 1231 gain. Consequently, ordinary income recognized under Sec. 1245 will not reduce the EDA even though the depreciation deductions, which gave rise to the Sec. 1245 recapture, may have increased the EDA.

Nonfarm adjusted gross income means adjusted gross income (or taxable income for Subchapter S corporations) computed without regard to income or deductions attributable to the business of farming. Thus, nonfarming *itemized* deductions cannot be used to reach the $50,000 annual limitation (which would prevent an addition to the EDA for any farm net loss for the year in excess of $25,000).

Special Rules

EDA additions are not required if inventories are used and capital expenditures are not expensed under other Code provisions (Sec. 1251 (b) (4)). However, such an "accrual" method will tend to defeat the leverage afforded by a farm tax shelter.

In addition, various exceptions and special rules regarding the application of Sec. 1251 are contained in Sec. 1251(d). Further discussion is precluded by the scope of this tax study.

See 502.3 for special rules regarding the sale or exchange of farm land.[13]

Economic Aspects

While overall financial evaluation of livestock investments is obviously beyond the scope of this discussion, it might be noted as a broad generalization that cattle investments entail some significant risk, as well as unusual profits, due to wide market fluctuations.

502.2 Christmas Trees and Other Tree Farms

Capital Gain — Ordinary Deduction Shelter

The elective capital gain treatment offered by Sec. 631(a) for cut timber was discussed in 203.8. This same code section also specifies that the term "timber" shall include evergreen trees which are more than six

[13] For further discussion of the farming provisions of the 1969 Tax Reform Act, see William C. Griffith and Charles I. Joy, "What the Act Does to the Farmer," *Tax Lawyer*, Vol. 23, No. 3, Spring 1970, p. 495; also, John C. O'Byrne, "New Law Greatly Limits the Tax Shelter Formerly Provided by Farming Operations," *The Journal of Taxation*, May 1970, p. 298.

years old when cut and which are sold for ornamental purposes.

Despite this potential for capital gain upon disposal of these trees, ordinary income deductions are available for many of the costs involved in bringing them to the desired state of marketability. For example, in a comparatively recent Tax Court case,[14] the Revenue Service did not object to the classification of weed, brush, and insect control as ordinary and necessary business expenses. However, the Service contended that shearing (trimming) of Scotch Pine trees, raised for use as ornamental Christmas trees, is a capital expenditure pursuant to Rev. Rul. 66-18 (1966-1 CB 59). The shearing costs constituted more than 50 percent of the cost of raising the trees.

The Tax Court held that "the shearing expenses were not incurred primarily to prepare the trees for market but were ongoing, recurring expenses which were ordinary and necessary in order to preserve and maintain the marketability of the trees as ornamental Christmas trees. Hence they are deductible under Sec. 162(a). . . ."

Thus, the Tax Court concurred with a 1967 District Court decision[15] in rejecting Rev. Rul. 66-18.

On the other hand, Regs. Sec. 1.611-3(a) requires amounts paid or incurred in connection with the *planting* of timber, including Christmas trees, to be capitalized and recovered through depletion allowances.

In Rev. Rul. 55-252 (1955-1 CB 319), these costs were described as follows:

> Generally, direct costs incurred in connection with reforestation by planting are capital expenditures, recoverable through depletion as the timber subsequently becomes merchantable and is cut or sold. . . . Such planting costs include:
> (a) preparation of the site, including any girdling or brush removal work to afford good growing conditions;
> (b) cost of seedlings; and
> (c) labor and tool expense, including depreciation of equipment used in planting such as trucks, tree planters, etc.[16]

Recapture of Depreciation and Excess Deductions

The disposition of depletable property, obviously, does not give rise to recapture of depreciation under either Sec. 1245 or Sec. 1250.

Timber subject to the capital gain treatment provided by Sec. 631 is

[14] *Kinley*, 51 TC 1000 (1969), aff'd CA-2, 70-2 USTC ¶9462; cert. not authorized.
[15] *Ransburg*, 281 F. Supp. 324 (So. D., Ind.).
[16] Also see 502.3, herein.

not farm recapture property.[17] Therefore, Sec. 631 capital gains cannot be recaptured as ordinary income under Sec. 1251. (This latter Code section is discussed in 502.1)

Economic Aspects

Again, while economic considerations are beyond our province, the relatively long holding period required for Christmas trees might be noted. As a minimum, Sec. 631(a) imposes a six-year moratorium on capital gain treatment. Moreover, the facts of the *Kinley* case[18] reveal that Scotch Pines have a cultivation period of about nine years. Aside from market conditions, this length of time can have the following drawbacks from a tax-shelter/investment viewpoint:

1. Christmas tree investments may have a longer exposure to the hazards of nature than other types of tax-shelter/investments.
2. Similarly, there may be a longer-than-necessary exposure to the perils of changing tax laws (i.e., capital gain election could be repealed nine years hence).

Similar problems may plague other tree farms. For example, in a Tax Court case concerned with whether a tree farm was operated as a business or hobby,[19] testimony was given that 35 to 50 years are required to produce commercial saw logs. (This physical holding period tends to cause the six-month holding period, specified by Sec. 631 for *non*-Christmas trees, to be illusory in many instances.)

502.3 Fruit Orchards

Capital Gain — Ordinary Deduction Shelter

Although the sale of fruit to customers in the ordinary course of business produces ordinary income, a sale of an orchard per se (land and trees) should qualify for favorable Sec. 1231 treatment (described in 203.4) — except for the ordinary income generated by several recapture provisions. In the case of land, limited recapture occurs to the extent of prior deductions for soil and water conservation expenditures or for land clearing expenditures. With regard to trees, depreciation allowed or allowable after 1961 is subject to recapture. These various recapture provisions are discussed later.

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[17] See Secs. 1251(e)(1)(A) and 1231(b)(2).
[18] See footnote 14.
[19] *D. J. St. Germain*, 18 TC Memo 355 (1959).

Unharvested fruit sold at the same time to the same vendee also qualifies for Sec. 1231 treatment (Sec. 1231(b)(4)). However, as indicated in 502.1, this type of asset constitutes farm recapture property. Therefore, any Sec. 1231 gains are converted into ordinary income to the extent of the balance in the seller's excess deductions account (see discussion in 502.1).

Moreover, Sec. 268 disallows ordinary deductions for expenses, depreciation, and so forth, attributable to the production of such unharvested crops. On the other hand, under Sec. 1016(a)(11) these disallowed items are added to the basis of the orchard and at least serve to reduce the ordinary and/or Sec. 1231 gain (or increase a Sec. 1231 loss). In addition, the excess deductions account can be reduced for these unallowable deductions.

Regs. Sec. 1.268-1 requires amended returns to be filed in order to reflect this disallowance for years other than the year of sale. Presumably, this requirement only affects open years.

A Fruitgrower's Choice. By picking fruit at the right time or by not picking it at all, a fruitgrower may also be able to select the right tax answer as a result of the interplay between Secs. 268, 1016 (a) (11), and 1231 (b) (4). Of course, this answer will also be affected by the various recapture provisions (Secs. 1245, 1251, and 1252). The available choices can be categorized as follows:

	Harvest *before* sale of orchard	Sale of orchard *with* unharvested crop
Selling price of crop	Ordinary income	Potentially taxable as capital gain (Sec. 1231 treatment) to the extent ordinary income recapture can be overcome
Expenses of producing crop	Ordinary deductions	Offset against ordinary and/or capital gain

Thus, a fruitgrower should measure these tax consequences against the fair market value of his crop compared with the amount of production expenses paid (or incurred) in open years. Where such expenses are small in relation to the amount realizable for the crop, it may be advisable to forego these ordinary deductions in order to reap greater capital gains. In the converse situation, of course, the fruit should be picked prior to the sale of the orchard.

Types of Expenditures Qualifying as Ordinary Deductions

The treatment of orchard expenditures is geared to the functional phases of the orchard's life, as the following chart indicates:

Functional phase of orchard's life	*Explanation*	*Treatment of expenditures*
Preparatory	Expenditures incurred to permit growing process to begin	Capitalize
Developmental	Expenditures incurred so that growing process may continue in a desired manner	Expense or capitalize at taxpayer's option (Regs. Sec. 1.162-12)
Productive	Expenditures incurred after productive stage has been reached	Expense

CAUTION. Expenses of developing a citrus grove must be capitalized if incurred within four years after the grove is planted. Portions of a grove planted in one year are treated separately from a portion planted in another year.

This requirement, imposed by Sec. 278(a), applies to taxable years beginning after 1969. Apparently, the four-year limitation period relates to the grower's taxable years rather than growing seasons or calendar years.

However, capitalization is not required for expenditures incurred in replanting a citrus grove damaged or destroyed (while in the taxpayer's hands) by frost, disease, drought, pests, or casualty. In addition, Sec. 278 (a) does not apply to planting or replanting costs incurred prior to December 30, 1969 (Sec. 278 (b) (1) and (2)).

A doubling up of deductions will result if destroyed trees are replanted in the same year.

Examples of Various Types of Expenditures

Preparatory expenditures include land clearing and planting of trees.

NOTE. Land clearing expenditures not exceeding $5,000 or 25 percent of annual taxable income derived from farming can be deducted under a special election provided by Sec. 182. However, such deductions may be recaptured as ordinary income as subsequently explained.

Developmental expenditures include irrigation, cultivation, pruning, fertilizing,[20] and spraying.

Production expenditures are the same as developmental expenditures.[21]

Special Rule for Soil and Water Conservation Expenditures

> Under Sec. 175, a farmer may deduct his soil or water conservation expenditures which do not give rise to a deduction for depreciation and which are not otherwise deductible. The amount of the deduction is limited annually to 25 percent of the taxpayer's gross income from farming. Any excess may be carried over and deducted in succeeding taxable years. As a general rule, once a farmer has adopted this method of treating soil and water conservation expenditures, he must deduct all such expenditures (subject to the 25 percent limitation) for the current and subsequent taxable years. If a farmer does not adopt this method, such expenditures increase the basis of the property to which they relate [Regs. Sec. 1.175-1].

NOTE. These deductions may also be recaptured as ordinary income as subsequently explained.

Depreciation Recapture

Trees are Sec. 1245 property since they have been held to be "other tangible property" used as an integral part of manufacturing, production, or extraction.[22] Although these rulings dealt with eligibility for the now terminated investment credit, they appear viable for depreciation recapture purposes since all property which was eligible for the investment credit also constitutes Sec. 1245 property.[23]

Thus, some or all of the gain recognized upon the sale of an orchard will have to be reclassified as ordinary income to the extent of depreciation recapture (i.e., depreciation claimed after 1961 with respect to the trees). (Sec. 1245 recapture is further considered in 203.7.)

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[20] See Sec. 180 and its accompanying regulations, as well as S. Rep. No. 1767 (86th Cong., 2nd sess.), 1960-2 CB 829, at p. 837.

[21] For further discussion of this subject, see *Robert L. Maple*, 27 TC Memo 944 (1968) and *Est. of R. R. Wilbur*, 43 TC 322 (1964).

[22] See Rev. Rul. 67-51, 1967-1 CB 68 and Rev. Rul. 65-104, 1965-1 CB 28, clarified on other grounds by Rev. Rul. 66-183.

[23] In particular, compare the similar definitions in Sec. 1245(a)(3)(B)(i) and Sec. 48(a)(1)(B)(i).

Recapture of Deductions for Soil and Water Conservation or Land Clearing Expenditures

Gain recognized on the sale or exchange of land is taxed as ordinary income under Sec. 1251 to the extent of the balance in the excess deductions account (see 502.1). However, the amount of this recapture is limited to the following deductions, with respect to the land, which are allowable for the taxable year and the four previous taxable years:

1. Soil and water conservation expenditures (allowable under Sec. 175).
2. Land clearing expenditures (allowable under Sec. 182).

This limitation does not apply to any other kind of disposition. Thus, gain recognized on an involuntary conversion could be treated as ordinary income to the full extent of the balance in an excess deductions account even though no ordinary income would result if, instead, the land was sold (assuming no allowable Secs. 175 or 182 deductions).

In addition, a second statutory recapture provision, Sec. 1252, might apply to convert any remaining Sec. 1231 gain into ordinary income. This recapture also affects only deductions for soil and water conservation or land clearing expenditures. However, Sec. 1252 applies *regardless* of any balance in the excess deductions account and is *not* limited to deductions incurred within five years of the land's disposition. On the other hand, there is no Sec. 1252 recapture if farm land was held for at least ten years.

Where such land is disposed of within five years of its acquisition, full recapture applies under Sec. 1252 (but only to the extent the gain is not recaptured under Sec. 1251). Recapture of deductions with respect to land disposed of within six to nine years after acquisition is reduced by 20 percent a year under a sliding scale set forth in Sec. 1252 (a) (3). (Farm land is any land for which Sec. 175 or Sec. 182 deductions have been allowed.)

NOTE. This sliding scale only applies to the recapturable deductions and not to the lower of the total gain realized or the amount of such deductions (as may be the case for depreciation recaptured under Sec. 1250).

Sec. 1252 recapture applies only to dispositions in post-1969 taxable years and only to expenditures made after December 31, 1969.[24] This would appear to eliminate recapture for pre-1970 soil and water

[24] Sec. 1252 (b) authorizes regulations to prescribe operating rules similar to those under Sec. 1245 (which are discussed in 203.7, herein).

conservation expenditures which are carried over to post-1969 years. (Such a carryover is described in Regs. Sec. 1.175-1, quoted earlier. There is no carryover for land clearing expenditures.)

It is possible for Sec. 175 and Sec. 182 deductions to be recaptured twice since Sec. 1252 recapture does *not* reduce the excess deductions account required for Sec. 1251 recapture purposes. This pitfall can be experienced if land is sold (e.g., in 1977) prior to the year in which other farm recapture property, such as livestock, is sold (e.g., in 1978).

PLANNING SUGGESTION. Since Sec. 175 or Sec. 182 deductions are not mandatory (as previously indicated), consideration should be given as to whether they should be capitalized in order to prevent recapture under either Sec. 1251 or Sec. 1252 (upon disposition of the underlying land). Generally, such consideration will involve such factors as:

1. The client's ordinary income tax brackets in the years the deductions are claimed and for the year of the land's disposition.
2. The financial benefit (i.e., interest factor) derived from accelerated tax reductions.
3. The anticipated holding period for the land, including plans for *no* disposition during the client's lifetime.[25]

Economic Aspects

Broadly speaking, the fruit orchard market appears to be experiencing gradual increases. It also seems less subject to the wide market fluctuations affecting livestock and, thus, may constitute a more stable investment.

On the other hand, a longer maturity period may be involved which necessitates greater exposure to such risks as natural perils and changing tax laws. For example, in the previously referred to *Wilbur* case (43 TC 322), the Tax Court made the following observation:

> . . . A tree will not bear a crop of commercial value for at least several years after planting; thus, a peach tree will not produce a paying crop until the fourth year of its life, a prune tree until the sixth year, and an English walnut tree until the eighth year . . . .

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[25] See 201.6, this study, regarding appreciated property acquired from a decedent.

APPENDIX

Check List of Tax Planning Techniques For Individuals

The Assumed Economic Life Cycle

This questionnaire is intended to serve as a summary of various tax planning techniques which were presented in the text according to the following assumed economic life cycle of an individual:

Phase of cycle	*Economic processes*	*Tax planning techniques*	*Discussed in chapter*
I	Gross income is encountered and exposed to taxation.	Minimizing income subject to tax.	2
II	Expenditures incident to ownership of wealth.	Maximizing income tax deductions.	3
III	Further disbursement of wealth.	Transfers and other inter vivos transactions which may reduce income, estate, and gift taxes.	4
IV	Investment of remaining wealth.	Tax shelters.	5

This broad sequence of economic events is basically followed in our check list.

Moreover, as explained in 102, individual taxpayers can be categorized as (1) executives and other employees, (2) investors, or (3) professional and other self-employed persons.

Since tax planning for each of these groups cannot be uniform, appropriate designation (see below) has been provided to indicate the categories to which a technique will apply.

E – Executives and other employees
I – Investors
P – Professional and other self-employed persons

Introduction

(See Chapter 1)

Question	*See in text*	*Tax planning for*
1. Can steps be taken to avoid undue fluctuations in annual taxable income?	104	E I P
2. Can income be shifted to a year in which a favorable income averaging computation applies?	104.1	E I P
(a) Is general income averaging more beneficial than:		
• Alternative capital gains tax computation?	203	E I P
• 50 percent maximum tax rate on earned income?	105.2	E P
• Special "forward" averaging computations for certain lump sum distributions from qualified retirement plans?	203.1 305.1	E P
(b) Can standard deduction be used to secure tax savings through income averaging?	104.1	E I P
(c) Is base period data always readily available?	104.1	E I P
3. Is it possible and desirable to direct the flow of income and deductions to particular years through one or more of the following processes? • Accelerating income. • Postponing deductions. • Postponing income. • Accelerating deductions.	104.2	E I P
4. Are nontax considerations, such as monetary factors, properly evaluated in planning for the shifting of income or deductions?	104.2	E I P
5. Can proper timing of income or deductions be effectively utilized to absorb expiring carryovers?	104.2	E I P
6. Should gifts be made to equalize estate and gift tax brackets?	202.2	E I P
7. Is the effect of the 10 percent minimum tax considered in arranging transactions involving tax preferences?	105.1	E I P

Key:

E - Executives and other employees
I - Investors
P - Professional and other self-employed persons

	See in text	Tax planning for
8. Will the 50 percent maximum tax rate on earned income be reflected in planning for such matters as: (a) Incorporating a personal service business? (b) "Capital gain compensation"? (c) Deferred compensation? (See Question 54) (d) Earned income versus nontaxable fringe benefits? (e) Utilization of tax losses?	105.2	E P

Minimizing Income Subject to Tax

(See Chapter 2)

9. Can income be obtained exempt from tax?	201	E I P
10. Can a sale of a residence be arranged to minimize tax?	201.1	E I P
11. Are any or all of the following fringe benefits desirable? • Reimbursement of medical expenses. • Wage continuation or sick pay plans. • Life insurance protection. • Other death benefits. • Supper money and other meals and lodging furnished for the employer's convenience. • Rental value of parsonages. • Courtesy discounts.	201.2	E
12. Are investments in municipal bonds advantageous?	201.3	E I P
13. Is it advisable to secure maximum dividend exclusions?	201.3	E I P
14. Should otherwise wasted carryovers be salvaged by increasing the basis of property tax-free?	201.4	E I P
15. Can appreciation on property held by fiduciaries permanently escape tax?	201.5	E I P
16. Is it feasible to weigh interrelationship between estate tax and future income taxes? If so, can appropriate action be taken to control or determine estate tax values?	201.6	E I P

	See in text	*Tax planning for*
17. Is insurance coverage for certain extraordinary living expenses desirable?	201.7	E I P
18. Will it be worthwhile to channel income to related entities?	202	E I P
19. Should income-producing properties be incorporated? Are there any estate and gift tax advantages or disadvantages in incorporating property?	202.1	E I P
20. Should gifts be made to family members?	202.2	E I P
21. Are outright gifts always advisable?	202.2	E I P
22. What are the collateral income tax effects, if any, of outright gifts?	202.2	E I P
23. Can gift taxes be minimized? • Are staggered or partial gifts practical? • Should maximum exclusions always be obtained for gifts to minors?	202.2	E I P
24. Are gifts also beneficial for estate tax purposes?	202.2	E I P
25. Should gifts be made net of gift taxes? Can advantageous income tax consequences be obtained for net gifts in trust?	202.2	E I P
26. What benefits can be derived through a balanced gift program?	202.2	E I P
27. Should ineffective gifts, such as the following, be avoided? • Retained life estates. • Revocable transfers. • Gifts taking effect at death. • Gifts in contemplation of death.	202.2	E I P
28. How can trusts be effectively used for income tax purposes?	202.3	E I P
29. What estate tax advantages can also be obtained through the use of trusts?	202.3	E I P

Key:

E - Executives and other employees
I - Investors
P - Professional and other self-employed persons

	See in text	Tax planning for
30. Are joint savings accounts desirable in order to split income without making taxable gifts?	202.4	E I P
31. Can interest-free loans be made to family members in order to shift earnings to lower bracket relatives? Would such loans precipitate any adverse gift or income tax consequences?	202.5	E I P
32. Could interest-free loans also be made to employees as a nontaxable fringe benefit?	202.5	E
33. Is it possible and desirable to achieve long-term capital gains treatment for a variety of income?	203	E I P
34. Are lump sum distributions from qualified employees' trusts *always* desirable? Is the seven-year averaging computation advantageous (when available)?	203.1	E
35. Should such distributions include appreciated employer securities which would provide further tax benefits? Can tax on such appreciation be permanently avoided without sacrificing substantial financial benefits?	203.2	E
36. Are qualified stock options always desirable as a form of capital gains compensation?	203.3	E
37. Which other types of compensation should be evaluated? (See Question 54.) What criteria should be employed in making these comparisons?	203.3	E
38. What steps should be taken, where practicable, to avoid matching Sec. 1231 gains and losses?	203.4	E I P
39. Can capital gain treatment be obtained upon complete or partial disposition of shareholder equities? • Will collapsible corporation status be an obstacle in fulfilling this objective? If so, would statutory relief measures provide a satisfactory solution? • Can Sec. 306 stock be disposed of without generating ordinary income?	203.5	I

	See in text	*Tax planning for*
40. Can capital gain treatment be obtained for sales of subdivided real property? • Is it possible and desirable to comply with the requirements of Sec. 1237? • If not, can ordinary income still be avoided?	203.6	I
41. Can ordinary income resulting from depreciation recapture be eliminated or curtailed by such means as: • Multiple asset accounts? • Installment sales? • Sales of stock instead of property? • Reliance upon statutory exceptions?	203.7	E I P
42. Should recapture of depreciation on real property subject to Sec. 1250 be completely avoided by using straight-line depreciation, or using other permissible methods for certain other properties and holding such properties for designated holding periods?	203.7	E I P
43. Are capital gain opportunities advantageous with regard to such natural resources as: • Oil and gas? • Cut timber? • Timber, coal and domestic iron ore royalties?	203.8	I P
44. Can transfers of patent rights qualify for capital gain treatment under Sec. 1235? If not, can such favorable treatment be attained through other means?	203.9	E I P
45. Are capital losses advantageous for tax purposes? (a) Can short-term capital losses be realized in lieu of long-term capital losses? (b) If not, can such long-term losses be applied against net short-term capital gains? (c) Is it possible to convert some capital losses into ordinary losses?	203.10	I

Key:

E - Executives and other employees
I - Investors
P - Professional and other self-employed persons

		See in text	*Tax planning for*		
46.	Is it possible and desirable to defer income in order to avoid immediate tax payments?	204	E	I	P
47.	Can such deferment be perpetual?	204	E	I	P
48.	Is sale, exchange, or involuntary conversion of residence handled in most advantageous manner?	204.1	E	I	P
49.	Are maximum benefits derived from deferred compensation plans?	204.2	E		P
50.	Is restricted property advisable as a means of timing compensatory income?	204.3	E		P
51.	Should a restriction which will never lapse be cancelled? Should such cancellation be compensatory?	204.3	E		P
52.	Should an employee or other recipient of restricted property exercise the election to be taxed immediately (under Sec. 83 (b))?	204.3	E		P
53.	Is it feasible to shift income through the restricted property rules?	204.3	E		P
54.	Should restricted property be compared with other forms of compensation? (See Question 37.) Is restricted property eligible for the 50 percent maximum tax rate? (Also see Question 8.)	204.3	E		P
55.	Are phantom stock plans advisable as a means of timing compensation?	204.3	E		
56.	When are nonqualified stock options beneficial?	204.4	E		P
57.	What planning considerations are involved upon the involuntary conversion of property?	204.5	E	I	P
58.	Are installment sales desirable from a financial viewpoint in order to: • Control timing of income for tax purposes? • Mitigate effects of depreciation recapture?	204.6	E	I	P
59.	Conversely, should the installment method be elected to equate tax payments with cash collections?	204.6	E	I	P

	See in text	*Tax planning for*
60. Can the following installment method pitfalls be overcome? • Imputed interest. • Election requirements. • Payments in year of sale. • Minimum number of installment payments. • Disposing of installment obligations.	204.6	E I P
61. Should short sales be used to: • Equalize tax brackets? • Offset existing short-term gains against any subsequent capital losses? • Postpone or completely avoid tax payments? • Freeze profits on volatile stock acquired through qualified options?	204.7	E I P
62. Can comparable objectives be accomplished through options to sell property and executory contracts?	{204.8 {204.9	E I P
When can stock and/or other securities be exchanged tax-free?	204.10	E I P
64. Are like kind tax-free exchanges of eligible property always desirable? • Can taxable boot be reduced where mortgaged properties are involved? • How can advantageous three-way exchanges be arranged?	204.11	E I P
65. Is it desirable and possible to designate loan repayments as either principal or interest?	204.12	E I P
66. Are return of capital distributions considered in investment decisions?	204.13	E I P
67. Can unwanted income be avoided through such means as: (a) Installment sales (also see Questions 58-60)? (b) Avoiding actual or constructive receipt?		

Key:

E - Executives and other employees
I - Investors
P - Professional and other self-employed persons

	See in text	Tax planning for
(c) Restricted receipts including: • Bona fide loans? • Substantive escrow or trust arrangements? • Nonnegotiable contractual obligations?	204.14	E I P

Maximizing Income Tax Deductions

(See Chapter 3)

	See in text	Tax planning for
68. Are any tax savings available by working with the standard deduction?	301	E I P
69. What steps should be taken to preserve dependency exemptions?	302	E I P
70. Are there any particular problems concerning exemptions for parents or children?	302.1	E I P
71. When can multiple support agreements be utilized?	302.1	E I P
72. Are maximum deductions claimed for medical expenses including insurance, travel, capital expenditures, and other less obvious types of expenses?	303.1	E I P
73. Are medical expenses of dependents properly handled? Can multiple support agreements increase medical deductions?	303.1	E I P
74. Is substantiation of medicine and drugs effectively controlled?	303.1	E I P
75. Can medical payments be properly timed to overcome the income limitation? Would separate returns for married couples also be advisable for this purpose?	303.2	E I P
76. Should medical expenses paid by a decedent's estate within a year after his death be deducted for income tax or estate tax purposes? Should expenses be paid, instead, by the surviving spouse?	303.3	E I P

	See in text	Tax planning for
77. Can certain employees conserve working capital through delayed additional withholding?	304.1	E
78. Are travel and entertainment expenses properly substantiated?	304.1	E I P
79. Are deductions claimed, where permissible, for such common activities as:		
• Travel away from home?		E I P
• Travel of wives?		E P
• Commuting?		E P
• Education?		E P
• Partial business use of home?	304.1	E I P
80. Are certain expenses more favorably claimed as deductions "towards" (as opposed to "from") adjusted gross income?	304.2	E P
81. Has consideration been given to all advantages and disadvantages of self-employed retirement plans?	305.1	P
82. Can the limitation on deducting investment interest be avoided for years beginning after 1971?	306.1	I
83. Are all allowable investment expenses claimed as deductions against ordinary income or capital gains?	306.2	I
84. Is a reasonable formula used to allocate deductions to exempt income?	306.2	I
85. Can some investment losses give rise to ordinary deductions?	306.2	I
86. Are charges for professional services carefully allocated and itemized as applicable to:		
• Deductible functions?		
• Capital expenditures?		
• Personal expenses?		E I P
Can satisfactory indemnification agreements be executed upon sale of business?	307.1	I P

Key:

E - Executives and other employees
I - Investors
P - Professional and other self-employed persons

	See in text	*Tax planning for*
87. Are most advantageous tax consequences negotiated in divorce proceedings?	307.2	E I P
88. Can otherwise nondeductible loss on sale of personal residence be converted into limited deductible loss?	307.3	E I P
89. When can depreciation and maintenance expenses be deducted on abandoned residence?	307.4	E I P
90. To what extent can unreimbursed or reimbursed moving expenses be deducted?	307.5	E P
91. How can wasting carryovers be effectively utilized? (Also see Question 14.)	307.6	E I P

Further Lifetime Advanced Planning For Income, Estate, and Gift Tax Purposes

(See Chapter 4)

92. Does client wish to make charitable contributions?	401	E I P
93. Are lifetime gifts to charity preferable to testamentary transfers?	401.1	E I P
94. Should such lifetime gifts be incomplete for estate tax purposes so that additional estate tax savings may be possible through increased marital deduction (if otherwise available)?	401.1	E I P
95. Should gifts be made outright or should they consist of limited interests in property, such as gifts of income or remainder interests?	401.2	E I P
96. Have the following factors been considered in deciding whether to make outright gifts? • Appreciation versus decline-in-value of potential gift property. • Varying consequences of giving capital assets versus ordinary income properties. • Bargain sales of capital assets to recover donor's cost. • Various collateral tax effects.	401.2	E I P

	See in text	*Tax planning for*
97. Are gifts of the following types of partial interests advisable? • Remainder interests in personal residences or farms. • Outright gifts of undivided interests.	401.3	E I P
98. What benefits can be derived from gifts to the following varieties of charitable remainder trusts? • Annuity trusts. • Unitrusts. • Pooled income funds.	401.3	E I P
99. What are the advantages and disadvantages of charitable gifts of income interests?	401.3	E I P
100. What can be done to prevent permanent loss of charitable contributions deductions through operation of the income limitation and carryover rules? In particular, should the following kinds of contributions be avoided? (a) Gifts to private foundations where excess public charity contributions exist. (b) Gifts "for the use of charity" if the 50 percent limitation and/or carryovers are desired.	401.4	E I P
101. When will it be advantageous to elect the 50 percent limitation for contributions of certain appreciated property?	401.4	E I P
102. Are short-term trusts, of more than ten years duration, advisable as a means of bypassing the income limitations on charitable contributions?	401.4	E I P
103. Is there proper substantiation for noncash contributions exceeding $200?	401.5	E I P
104. Can appreciated and declined-in-value properties be astutely handled prior to death?	402	E I P
105. Will a decedent's debts be deducted for *both* estate and income tax purposes?	403.1	E I P

Key:

E - Executives and other employees
I - Investors
P - Professional and other self-employed persons

	See in text	Tax planning for
106. Should administration expenses allocable to *non-exempt* income be deducted for *either* income tax or estate tax purposes? Does this comparison include consideration of residual beneficiaries' income tax brackets?	403.2	E I P
107. Can administration expenses be deducted for income tax purposes without reducing the amount of stock which can be favorably redeemed under Sec. 303?	403.2	E I P
108. Are selling expenses deductible for both income and estate tax purposes?	403.2	E I P
109. Is it possible to properly time fiduciary deductions, such as estate administration expenses, so that they might be deducted by either the fiduciary or beneficiaries, whichever is in the higher income tax bracket?	403.3	E I P
110. Can United States bonds be acquired at a discount and used in payment of estate tax at par value?	404	E I P
111. Is it desirable to execute powers of attorney to assure a sufficient supply of such bonds in case of incapacity before death? Can this objective also be achieved through bond purchases by trustee of existing revocable trust?	404.1	E I P
112. Are sales and acceptable repurchases of U.S. Treasury bonds advisable in a declining bond market?	404.2	E I P
113. Can gifts, which are ineffective for estate tax purposes, nevertheless provide incidental estate tax savings?	405.1	E I P
114. Is it feasible to make gifts in contemplation of *imminent* death to maximize such estate tax savings?	405.2	E I P
115. Should marital deductions be used for estate and gift tax purposes?	406	E I P
116. Is the maximum marital deduction always advisable?	406.1	E I P

	See in text	Tax planning for
117. How can such maximum deductions be obtained?	406.2	E I P
118. Can an "estate trust" be used to bypass a surviving spouse's high income tax brackets?	406.2	E I P
119. Is gift-splitting by married couples always advantageous?	407	E I P
120. Should provision be made for post-mortem consent to such gift-splitting?	407.1	E I P
121. Are there circumstances when such consent should be refused by a surviving spouse?	407.2	E I P
122. Are adequate records maintained, prior to death, to prevent unnecessary double estate taxation of certain jointly owned property?	408	E I P
123. When should Sec. 2515 (c) election be made regarding creation of a tenancy by the entirety in real property?	409	E I P
124. Is it possible to depreciate or amortize, for income tax purposes, the gift tax applicable to a gift of an income interest in a limited term trust?	410	E I P
125. Is further lifetime planning advisable in such areas as: • Private annuities? • Powers of appointment? • Extended consideration of post-mortem matters, and so forth?	411	E I P

Other Tax Shelters

(See Chapter 5)

126. Are tax shelters advisable in any or all of the following investment areas? (a) Real estate.	501	E I P

Key:

E - Executives and other employees
I - Investors
P - Professional and other self-employed persons

	See in text	*Tax planning for*
(b) Farm operations, such as		
• Livestock.	502.1	E I P
• Christmas trees and other tree farms.	502.2	E I P
• Fruit orchards.	502.3	E I P
127. Will such shelters be "engaged in for profit" to prevent denial of deductions under Code Sec. 183?	502	E I P
128. Can recapture (as ordinary income) of certain farm operating losses be avoided by:		
(a) Sustaining farm net losses of not more than $25,000 or realizing nonfarm adjusted gross income of not more than $50,000?		
(b) Utilizing Subchapter S corporations?	502.1	E I P
129. Will adequate records be maintained for the excess deductions account?	502.1	E I P
130. Are there any recapture provisions affecting Christmas trees or other tree farms?	502.2	E I P
131. Are citrus groves treated less favorably than other fruit orchards?	502.3	E I P
132. What steps can be taken to minimize or eliminate recognition of ordinary income upon the sale or exchange of certain farm land?	502.3	E I P
133. Can double recapture be prevented for deductions of soil and water conservation expenditures or land clearing expenditures?	502.3	E I P

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