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Tax-planning techniques for individuals; Studies in federal taxation 2

Stuart R. Josephs

J. Michael Pusey

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TAX-PLANNING TECHNIQUES FOR INDIVIDUALS Second Edition

AICPA

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STUDIES IN FEDERAL TAXATION

TAX-PLANNING TECHNIQUES FOR INDIVIDUALS

Second Edition

BY STUART R. JOSEPHS, CPA, and
J. MICHAEL PUSEY, CPA

AICPA American Institute of Certified Public Accountants

Tax-Planning Techniques for Individuals

Second Edition

TAX STUDY
NO. 2

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By Stuart R. Josephs, CPA
Seidman & Seidman
and
J. Michael Pusey, CPA

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Studies in Federal Taxation are staff publications of the American Institute of Certified Public Accountants. They are designed as educational and reference material for members of the Institute and others interested in the subject. Members of the Committee on Tax Publications assisted in an advisory capacity.

Foreword

Since publication of the first edition of *Tax Planning Techniques for Individuals* ten years ago, there have been a great many changes in the tax law. In fact, additions and changes to the Internal Revenue Code and the related regulations have been so comprehensive that this new edition is almost an entirely new book.

A book such as this is difficult to prepare because, although there are always new items that the author would like to include, there must be a cut-off date for publication. Perhaps, in this sense, we are fortunate that there has been so little significant tax legislation in the past few months. Although it is certain that new rules and techniques will soon be forthcoming most of this volume will remain current and useful for many years.

We are deeply indebted to the authors, Stuart R. Josephs, CPA, of Seidman and Seidman, San Diego, and J. Michael Pusey, CPA, Los Angeles, for undertaking the monumental effort required to create this book. Their tireless energy and unselfish devotion to every aspect cannot be praised too highly. I also wish to thank Brian Kintish and Marie Bareille, of the Institute's publications division, who worked very closely with Mssrs. Josephs and Pusey in preparing the manuscript.

Kenneth F. Thomas, *Director*
Federal Tax Division

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Introduction

This tax study is concerned with using effective, recognized planning techniques to minimize the federal tax impact on individuals. The thrust of the text will be to spotlight certain areas where these techniques can be applied.

The planning techniques, which appear in bold type throughout chapters, sections, and subsections, form the backbone of this study. In view of the direct conflict between practical space limitations and the nature of the subject matter, only the highlights of such techniques are described. A discussion accompanies each technique in only enough detail to summarize the various opportunities and pitfalls. Brief technical background discussions also serve to elucidate certain complex planning areas.

The book is organized according to four major parts. Chapters 1 through 4 introduce the various taxes involved and ways to mitigate the tax rates. Thereafter, the study follows an individual's assumed economic life cycle.

First, gross income is produced and exposed to taxation. Accordingly, chapters 5 through 22 are concerned with the ways in which an individual retains more of this income by minimizing the income tax imposed on it. Where appropriate, resulting gift and estate tax consequences are also considered.

The production of income invariably gives rise to a host of expenditures, some of which can help to further reduce income taxes by providing deductions against income subject to tax. Chapters 23 through 30 deal with maximizing many of these deductions through effective planning.

Finally, the financially successful individual may desire to transmit his affluence, to the greatest possible extent, to family and philanthropies. The tax planner should start implementing this objective during the individual's lifetime through planning that involves transfers of property to those beneficiaries. These transfers, which should decrease income, estate, and gift taxes and thereby increase the amount of available property, are described in chapters 31 through 36.

The Appendix contains a questionnaire entitled "Checklist of Tax Planning Techniques for Individuals." The 142 checklist questions correspond to the planning techniques that appear in bold type throughout the text; thus, the questionnaire serves as a concise review and outline of the tax study. The questionnaire's main function, though, is as a checklist to which the tax planner can refer in any given engagement situation.

Limitations and Further Reading

This study should serve as a compilation of *selected* practices that may alleviate the individual's tax burden; it is not intended as, and cannot possibly be, an all-inclusive prescription for remedying every tax "illness."

In order to keep the study manageable, we have deliberately limited its scope in certain ways. The study covers individuals who are resident citizens of the United States (exclusive of U.S. possessions) reporting on the calendar-year basis and using the cash-receipts-and-disbursements method of accounting. Moreover, tax consequences arising solely from residence in community-property states will not generally be considered.

Space limitations prevent us from discussing certain advanced planning considerations, such as private annuities, powers of appointment, and disclaimers, each of which is a complex topic to which a separate chapter could be devoted. For a discussion of private annuities, see G.G. Sackett, "Using Private Annuities Today: The Benefits, the Drawbacks and Open Questions," *Journal of Taxation* 49 (July 1978): 48, and I.F. Diamond and M. Walker, *Working With the Revenue Code 1979* (New York: AICPA, 1979), p. 392. For powers of appointment, see G.R. Stout, "Estate Planning: Understanding the Use and Taxation of Powers of Appointment," *Tax Adviser* 10 (August 1979): 462. For disclaimers, see P.N. Frimmer, "Using Disclaimers in Post Mortem Estate Planning: 1976 Law Leaves Unresolved Issues," *Journal of Taxation* 48 (June 1978): 322.

For further discussion of various tax planning considerations, the reader should see the other volumes of the AICPA tax study series. Tax Study 1, R. Steinman's *Tax Guide for Incorporating a Closely Held Business*, rev. ed. (1978), is a book that readers of this study should find particularly useful, and it is frequently cited in this text. The other volumes of the series are I.F. Diamond and R.L. Miller, *Guide to Federal Tax Elections*, Tax Study 3, 3d ed. (New York: AICPA, 1980); W.L. Raby, *Tax Practice Management*, Tax Study 4 (New York: AICPA, 1974); R.M. Sommerfeld and G.F. Streuling, *Tax Research Techniques*, Tax Study 5 (New York: AICPA, 1976); and M.L. Moore and R.N. Bagley, *U.S. Tax Aspects of Doing Business Abroad*, Tax Study 6 (New York: AICPA, 1978). We also recommend Diamond and Walker, *Working With the Revenue Code 1979* (already cited), I.F. Diamond and M. Walker, *Tax Planning Tips 1980* (New York: AICPA, 1980), and successor annual volumes.

Taxation and its mitigation are in a constant state of change. This discussion generally relates to the Internal Revenue Code and Treasury regulations, IRS rulings, and judicial decisions thereunder that were in effect on January 1, 1980; however, the study does reflect certain significant later developments, such as the repeal of the carryover basis provisions for inherited property by the Crude Oil Windfall Profit Tax Act of 1980.

Finally, note that positions taken by the Internal Revenue Service in private letter rulings and technical advice memorandums are often noteworthy and, accordingly, are included when they are considered appropriate; however, the IRS issues private letter rulings and technical advice memorandums with the caveat that code sec. 6110(j)(3) forbids using or citing them as precedents. Accordingly, the reader must realize that their value as authority is limited.

The Various Taxpayers

Tax planning is essentially a rescue operation that 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 that are concocted solely for the purpose of obtaining these benefits.

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 as they are applied to the following functional roles:

- Executives and other employees
- Investors
- Professional and other self-employed persons

Tax Planning for Executives and Other Employees

Planning for taxpayers in their capacity as executives or employees will focus on tax-saving opportunities that may stem from employment-connected transactions. Within this wide sphere of taxpayer endeavor, a distinction should be drawn between those executive-employees who control their employer (for example, 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 or decrease income subject to tax through such measures as fringe benefits, partial conversion of ordinary compensation income into long-term capital gains, and the deferment of income until lower-bracket years, such as during retirement.

Employee-taxpayers, of course, should also be concerned with increasing tax deductions and credits or conserving their retained earnings by adopting techniques permitting certain of their necessary expenditures to be shared with the public treasury. Employees are also, naturally, involved in other activities in common with other types of taxpayers—such as disposing of their personal residences.

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. At this phase of their economic cycle, such employees are among the relatively more affluent members of our society who might wish to plan gifts and bequests with tax advantages in mind.

Tax Planning for Investors

The hallmark of investor taxpayers is the derivation of income through employment of capital rather than personal services (the converse of the situation encountered by the other two taxpayer categories). Therefore, income of investors is deemed to be earned *passively*, as opposed to the employment-connected income of executives, other employees, and self-employed persons, which is *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 and self-employed persons.

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

Self-employed persons are actually a hybridization of 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 income from corporate operations.

In regard to self-employed persons, this study emphasizes their employment by noncorporate business entities and the consequent tax advantages that are available to them and not 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 in regard to 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]

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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* (Chicago: Callaghan & Co.) §§701–771:2).

As a result, tax planning techniques for self-employed individuals cannot simply be a matter of combining the techniques available for employees and those available for investors. With regard to business operations, they constitute 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 important deductions to consider.

Last but not least, the self-employed may also be involved in other activities paralleling those of other taxpayers. All types of taxpayers may experience similar situations, such as the disposal of a residence or the attempt to transmit as much wealth as possible to the objects of their bounty. Therefore, self-employed individuals, in their capacities as U.S. taxpayers in general, may find other parts of this tax study to be of interest.

The Various Taxes

All statutory references (abbreviated by "sec." or its symbol) are to the Internal Revenue Code of 1954 unless otherwise indicated.

Federal Income Tax

The tax imposed by the United States on 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, the income tax is the predominant subject of this study, and planning considerations involving income taxes are devoted solely to the federal income tax.

The 15 percent add-on minimum tax, discussed in chapter 1, is generally ignored in our calculations and considerations involving tax rates. The alternative minimum tax is, however, considered where applicable.

The graduated federal rate structure is applied to annual income. Thus, these rates are *not* cumulatively applied to an individual's lifetime income. The absence of such a unified (or aggregate) income tax system allows for planning opportunities to equalize annual tax brackets. Further planning opportunities may also be present in situations where the maximum rate on personal service income may be applicable.

Federal Estate, Gift, and Generation-Skipping Transfer Taxes

Accumulated net (after-income-tax) income may be exposed to the U.S. estate tax upon a taxpayer's death or may be subject to federal gift tax if transferred during his lifetime. Transfers that purport to save younger generations estate taxes by means of "generation skipping" may be subject to the generation-skipping transfer tax. The consequences of these three transfer taxes constitute related themes appropriate to this tax planning study.

Note that these federal transfer taxes are not confined to property consisting of accumulated taxable income but rather reach many other property interests owned by individuals, without regard to how they were acquired (whether through prior gift, inheritance, or accumulated exempt income).

. . . .

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. 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, also merit contemplation.

Initial Considerations

- ☐ Minimum Taxes and Tax Rate Mitigation

1

Minimum Taxes and Tax Rate Mitigation

Minimum Taxes

101 Add-On Minimum Tax

In arranging transactions involving tax preferences, the taxpayer should consider the impact, if any, of the 15 percent minimum tax on tax preferences. The actual incurrence of minimum tax liability will depend on (1) the amount of total preferences for the taxable year and (2) the amount of taxable income and resulting income tax available as offsets against these preferences.

The Revenue Act of 1978 dramatically changed the minimum tax concept and the treatment of so-called tax preferences. The law retained the minimum tax on tax preferences (or add-on minimum tax), initially imposed by the Tax Reform Act of 1969 and strengthened by the Tax Reform Act of 1976; however, effective for taxable years beginning after December 31, 1978, the capital gain deduction and "excess itemized deductions" are no longer considered tax preferences for purposes of the add-on minimum tax. Net long-term capital gains and excess itemized deductions are now subject to the alternative minimum tax, discussed in 102.

Section 56 imposes a 15 percent minimum tax on tax preference items described in sec. 57. The tax is computed on the individual's total tax preferences for the taxable year, less the greater of

a. An exemption of $10,000 ($5,000 for a married taxpayer filing separately), *or*
b. One half of the taxes otherwise imposed, with certain exceptions.

The tax under *b* is reduced by the allowable credits, ignoring the following:

- Withheld taxes
- Certain uses of gasoline, special fuels, and lubricating oil
- Earned income credits

This minimum tax is not subject to estimated tax requirements (see code secs. 6015(c) and 6654(f)).

101.1 Items of Tax Preference

For 1979 and later years, the tax preferences affecting individuals are the following:

- Accelerated depreciation on real property (1202). (See the discussion of "component depreciation" in 101.2.)
- Accelerated depreciation on leased personal property.
- The excess of allowable depletion over the property's adjusted basis at year-end, without regard to the current year's depletion deduction (2602).
- The bargain obtained upon the exercise of a qualified or restricted stock option. (This treatment applies only to certain options exercised before May 21, 1981. Bargains obtained upon the exercise of options after May 20, 1981, generate ordinary income and, therefore, do not constitute tax preferences.)
- 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.
- The excess of 60-month amortization (under code sec. 188) over accelerated depreciation for child care facilities.
- Excess intangible drilling costs, to the extent they exceed net income from oil, gas, and geothermal properties (see 2602). These excess costs are the amount by which deductions for intangible drilling costs of productive oil, gas, and geothermal wells exceed the amount that would be deductible if such costs were capitalized and either amortized over ten years or, at the taxpayer's election, deducted over the well's life as cost depletion.

Note The above tax preferences also reduce the benefit of the maximum tax on personal service income (see chapter 3).

101.2 Component Depreciation

The use of "component depreciation" for realty may increase depreciation deductions by depreciating the components over their useful lives, which may be shorter than the building shell.[1] Component depreciation *per se* is not considered an accelerated method of depreciation that is a tax preference.

The service accepts the component depreciation concept for both new and used realty.[2] To use the component method of depreciation for a newly constructed building, the taxpayer should have cost data supporting the allocation of cost to the various components. For a used building, the taxpayer should have an appraisal evaluating the various components as of the date of purchase. Despite the acceptance of the component depreciation concept, taxpayers are still vulnerable to attack regarding allocations to the building components and their useful lives.[3]

101.3 Net Operating Losses

Part or all of a particular year's minimum tax is excused for a year that gives rise to a net operating loss carryover to future years. This occurs when a net operating loss is sustained for the year and 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 15 percent of the net operating loss carryover (sec. 56(b)(1)).

If the current year's excess tax preferences (that is, preferences in excess of $10,000, or $5,000 for married persons filing separately) produce future tax reductions, the tax is reimposed for that future year to the extent of 15 percent of the reduction (sec. 56(b)(2)). If the deferral is from a year beginning before 1976, the

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1. For a general discussion, see V.H. Tidwell, "Component Depreciation Can Be a 'Cure' for Excess Depreciation," *Taxes: The Tax Magazine* 55 (February 1977): 116. See also *Working With the Revenue Code 1979*, ed. I.F. Diamond and M. Walker (New York: AICPA, 1979), pp. 63–64, which makes the following comments regarding the negative aspects of component depreciation: "The Sec. 1245 property components are subject to more stringent recapture rules than real (Sec. 1250) property is. Note also that while the useful lives of the personal property elements are shorter than the building's composite life, the building shell will generally have a useful life which is longer than the building's composite life. Moreover, the utilization of the component method of depreciation precludes the adoption of the ADR depreciation system with respect to such property."

2. Rev. Ruls. 66–111, 1966–1 C.B. 46, and 73–410, 1973–2 C.B. 53, as clarified by Rev. Rul. 75–55, 1975–1 C.B. 74.

3. For recent examples of successful IRS attacks on the use of component depreciation, see *University City, Inc.*, T.C.M. 1979–198, and *Donald R. Huene*, T.C.M. 1979–302. See also I.R.S. Ltr. Rul. 7941002, where the IRS, in technical advice, indicated that the district director need not accept an outside consultant's allocation if the taxpayer employs a professional engineering and consulting firm whose employees are competent in matters relating to building construction. However, it ruled, on the basis of the factual information submitted, that "the procedures employed by the taxpayer's consultant can result in a proper allocation of costs to the components of a building for purposes of component depreciation."

tax in the carryover year is 10 percent (the pre-1976 rate) of the amount by which taxable income is reduced by the portion of the carryover attributable to tax preference items in excess of $30,000 (the pre-1976 exemption).

When a carryover is deemed to consist of both preference and nonpreference items, future income is considered to be reduced first by the nonpreference items (sec. 56(b)(3)). This priority is beneficial since it delays reimposition of the minimum tax. If the excess preference items are not consumed within the seven- or five-year carryover period, the corresponding minimum tax is permanently forgiven (regs. sec. 1.56-2(c)(1)).

102 Alternative Minimum Tax

The taxpayer should consider the impact, if any, of the alternative minimum tax when arranging transactions involving long-term capital gains and excess itemized deductions. Because credits other than the foreign tax credit are not allowable against the alternative minimum tax, the tax planner should consider the impact of the alternative minimum tax in planning for credits.

The Revenue Act of 1978 introduced the alternative minimum tax for years beginning with 1979. The base upon which the alternative minimum tax is calculated is generally the sum of taxable income (net of zero bracket amount) plus the tax preferences for capital gains (the long-term capital gain deduction) and excess itemized deductions. Subject to certain modifications and exceptions, excess itemized deductions consist of itemized deductions in excess of 60 percent of adjusted gross income.

Gains from the sale or exchange of a principal residence are not subject to the alternative minimum tax or the 15 percent add-on minimum tax. (In connection with sales of residences, see also 601 and chapter 15.)

The alternative minimum taxable income is then subjected to the following rates.

Alternative minimum taxable income	Tax rate
The first $20,000	Exempt
From $20,000 to $60,000	10%
From $60,000 to $100,000	20%
Over $100,000	25%

A significant feature of the alternative minimum tax is that only a modified foreign tax credit may be used to reduce it. Thus, the taxpayer may be subject to the alternative minimum tax in a year in which the investment credit or other credits substantially reduce or eliminate the taxpayer's regular tax (see column 1 of figure 1-1). Because of the inability to use credits other than the foreign tax credit, it is possible for taxpayers to be subject to the alternative minimum tax even in a year in which they have no net long-term capital gain or excess itemized deductions.

If the alternative minimum tax exceeds the regular tax (the income tax plus add-on minimum tax less nonrefundable credits), the excess is added to the regular tax. In effect, the taxpayer is subject to the higher alternative minimum tax.

The alternative minimum tax is *not* subject to estimated tax requirements (see secs. 6015(c) and 6654(f)).

102.1 Regular Tax

The *regular tax* is the sum of the add-on minimum tax and all income taxes other than certain penalty taxes, the tax on lump-sum distributions from qualified plans under sec. 402(e), and the tax on accumulation distributions from trusts under sec. 667(b). The regular tax is reduced by credits other than the credit for withheld taxes (sec. 31); the credit for certain uses of gasoline, special fuels, and lubricating oil under sec. 39; and the earned income credit under sec. 43.

102.2 Timing Transactions in Light of the Alternative Minimum Tax

A taxpayer who has realized significant capital gains and is subject to the alternative minimum tax may find it advantageous to defer the recognition of ordinary losses in the current year. A comparison of columns 2 and 3 of figure 1-1 demonstrates that additional deductions of $25,000 reduce the taxpayer's tax liability by only $6,250 ($62,250 − $56,000 = $6,250, or 25 percent of $25,000). Thus, the taxpayer may find it advantageous to shift such deductions to a year in which they will be more beneficial.[4]

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4. For formulas to approximate the amount of income or loss that will be subject to the 25% maximum alternative minimum tax rate, see P.J. Streer, "The New Alternative Minimum Tax: Proper Planning Can Mitigate the Impact," *Taxes: The Tax Magazine* 57 (February 1979): 97.

Similarly, the taxpayer may also find it advantageous to accelerate ordinary income into a year in which the alternative minimum tax applies. For example, if the taxpayer in column 3 of figure 1-1 arranges to accelerate other investment income or salaries equal to $25,000 into such a year, he will be in the same position as the taxpayer in column 2. Thus, the incremental tax rate on such income is limited to 25 percent, which may be less than the rate that would apply to the income in another year.

Column 4 of figure 1-1 further demonstrates the possible advantage of deferring excess itemized deductions in a year when the alternative minimum tax will apply. Taxable income in column 4 is the same as in column 3, yet the alternative minimum tax is greater because the ordinary deductions have the taint of being excess itemized deductions.

Taxpayers will also want to consider the alternative minimum tax in timing the recognition of long-term capital gains. The alternative minimum tax should only be a factor (*a*) when the taxpayer will realize relatively large capital gains that will represent all or substantially all of the taxpayer's taxable income or (*b*) when the taxpayer will realize a large capital gain in conjunction with large ordinary losses or significant excess itemized deductions.

102.3 Net Operating Losses

The *General Explanation of the Revenue Act of 1978*, prepared by the staff of the Joint Committee on Taxation, indicates that, because the preferences subject to the alternative minimum tax do not generally create a net operating loss, no special rule is provided similar to the rule under code sec. 56(b) relating to the deferral of the minimum tax liability in the case of net operating losses. However, the joint committee's general explanation also states, "It is intended that any deduction, to the extent it may be carried to another year, is not to reduce alternative minimum taxable income for the current year."[5]

Note The 1979 Technical Corrections Act includes a number of provisions dealing with the alternative minimum tax,[6] including denial of "the use of a deduction against the alternative minimum

5. U.S., Congress, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1978*, 96th Cong., 1st sess., 1979, p. 263.

6. U.S., Congress, Senate, 96th Cong. 1st sess., 1979, S.Rep. 498, pp. 68–72, 83.

taxable incomé base to the extent the deduction is available as a carryover or carryback to another taxable year."[7]

102.4 Technical Observations

Excess Itemized Deductions

Excess (or adjusted) itemized deductions do not include medical expenses, casualty losses, state, local, and foreign taxes, and the deduction for federal and state death taxes attributable to income in respect of a decedent. To make these deductions neutral in the computation of the preference amount, the taxpayer should remove them from the determination of both itemized deductions and adjusted gross income. The amount by which the remaining itemized deductions exceed 60 percent of the modified adjusted gross income is a tax preference subject to the alternative minimum tax. While certain employee business expenses and other itemized deductions may be subject to the alternative minimum tax, the alternative minimum tax is more likely to apply when the taxpayer has significant charitable contributions and interest deductions.

Note Excess itemized deductions also reduce the benefit of the maximum tax on personal service income (see chapter 3).

7. *Ibid.*, p. 69.

Figure 1-1

Regular tax computation	(1)	(2)	(3)	(4)
Investment income	$ 40,000	$ 25,000	$ 25,000	$200,000
Other income (loss)	—	—	(25,000)	—
Net long-term capital gain	150,000	300,000	300,000	300,000
Capital gain deduction	(90,000)	(180,000)	(180,000)	(180,000)
Adjusted gross income	100,000	145,000	120,000	320,000
Itemized deductions	20,000	20,000	20,000	220,000[B]
Less zero bracket amount	3,400	3,400	3,400	3,400
Net itemized deductions	16,600	16,600	16,600	216,600
Personal exemptions	4,000	4,000	4,000	4,000
Total deductions	20,600	20,600	20,600	220,600
Taxable income	79,400	124,400	99,400	99,400
Regular tax	30,154	57,144	41,644	41,644
Investment credit	1,804[C]	—	—	—
Net regular tax[A]	$ 28,350	$ 57,144	$ 41,644	$ 41,644
Alternative minimum tax computation				
Taxable income (net of zero bracket amount)	$ 76,000	$121,000	$ 96,000	$ 96,000
Capital gain deduction	90,000	180,000	180,000	180,000
Excess itemized deductions	—	—	—	28,000
Alternative minimum taxable income	166,000	301,000	276,000	304,000
Alternative minimum tax				
Tax on first $20,000	0	0	0	0
10% tax on next $40,000	4,000	4,000	4,000	4,000
20% tax on next $40,000	8,000	8,000	8,000	8,000
25% tax on balance over $100,000	16,500	50,250	44,000	51,000
	$ 28,500	$ 62,250	$ 56,000	$ 63,000
Tax due (higher of net regular tax or alternative minimum tax)	$ 28,500	$ 62,250	$ 56,000	$ 63,000

(A) It is assumed that a taxpayer and his wife file a joint return in 1980 and that they are entitled to two dependency exemptions. None of the itemized deductions consist of medical expenses, casualty losses, or state and local taxes. The add-on minimum tax is assumed not to be applicable.

(B) The itemized deductions in column 4 are assumed to include $200,000 of investment interest expense; however, the investment interest limitations of sec. 163(d) do not apply because of the $200,000 investment income (see 3001).

(C) Because the taxpayer benefits from the investment credit only to the extent of $1,654, $150 of the investment credit is eligible for carryback or carryforward (sec. 55(c)(3)(C)).

2

Minimum Taxes and Tax Rate Mitigation

Statutory Income Averaging

The progressive rate structure of our federal income tax system strongly motivates taxpayers to equalize income tax brackets between years. The Internal Revenue Code (secs. 1301 through 1305) provides some assistance in equalizing income tax brackets; however, taxpayers may often achieve more effective equalization of income tax brackets by proper timing of tax-affecting transactions (see chapter 4).

The taxpayer should shift income to a year in which a favorable averaging computation applies in order to take advantage of a lower effective tax rate.

Increasing a current year's taxable income may prove advantageous to taxpayers with favorable base-period average income, 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.

This planning technique has several possible applications:

1. The taxpayer's income may be taxed at lower current rates even though the income will not be needed for personal or business purposes until future years, when higher rates may prevail.
2. The taxpayer may currently obtain income that would otherwise be received in future years at higher rates.
3. The taxpayer may transfer income at lower rates to achieve collateral tax benefits.

201 Procedural Aspects of Income Averaging

Data regarding the amount of average base-period adjusted taxable income should be readily available (*a*) for current-year planning and (*b*) for tax return preparation. The taxpayer should maintain continuous running averages.[1]

One way to accomplish 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 1979 return, the taxpayer prepares a blank Schedule G to reflect 1980 as the current (computation) year and 1976 through 1979 as the base period. The taxpayer then completes the first two parts of this advance schedule with regard to its respective base period. This procedure will make the necessary data readily available for 1980 planning. In addition, this procedure will facilitate preparation of the 1980 return by automatically extracting base-period information from the files; this information will determine whether income averaging applies and, if so, will provide the necessary prior years' data for the actual 1980 Schedule G.

202 Averaging Illustrations

A CPA prepares an advance Schedule G, which reveals this data.

Year	Base period income[2]
1976	$15,000
1977	30,000
1978	30,000
1979	30,000

Client anticipates his minimum adjusted taxable income to be $40,000 for 1980 through 1984. The expected marginal ordinary tax rates (on a joint return basis) will be the following.

1980	37%	(Income averaging)
1981-1984	43%	(Not eligible)

1. See *James M. Hill, Jr.*, T.C.M. 1979–133.

2. Base-period income is generally taxable income; however, in the case of any taxable year beginning before January 1, 1977, it is subject to a § 1302(b)(3) adjustment in order to reflect the transition from the standard deduction to the zero bracket amount. (See 2301, herein.)

The presence of potentially lower current-year (1980) tax rates affords an opportunity to realize the following advantages.

202.1 Accelerate Income for Future Needs

Client needs $10,000 for partial payment on a personal residence to be purchased on January 2, 1981. He has earned a bonus for services to his employer, which can be paid either in December 1980 or in January 1981. In view of the prevailing tax rates, Client should receive his bonus by December 31, 1980.

202.2 Shift Otherwise Taxable Income

On December 1, 1980, Client, as a sole proprietor, consummates a $100,000 installment sale for certain fully depreciated equipment and provides for 6 percent simple interest per annum, payable with each installment of principal, to avoid imputed sec. 483 interest and any related effect upon qualification for installment sale treatment. As a result of depreciation recapture under sec. 1245, the entire $100,000 gain will be taxable as ordinary income. The buyer wishes to make a 25 percent initial payment on January 1, 1981. Client should instead seek to obtain this initial payment on December 1, 1980, to take advantage of the opportunity to average afforded by the low-base-period year 1976, about to expire.

Note 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 chapter 4 for other ways of moving income into lower-bracket years and for the monetary effects of such actions.

202.3 Transfer Income to Achieve Collateral Tax Benefits

The CPA advises Client that one of his wholly owned calendar-year corporations is vulnerable to the sec. 531 accumulated earnings tax for 1980 and that, consequently, it would be advisable to declare a dividend to lessen this exposure. A dividend payable prior to December 31, 1980, will be of greater benefit than one paid by March 15, 1981 (under the seventy-five-day rule of sec. 563(a)).

203 Definitions of Averageable Income

Code sections 1301 through 1305 offer limited relief from the progressive income tax rates by providing an averaging mechanism under certain restricted circumstances. Generally, these sections provide for the averaging of income over a five-year period if the current year's income exceeds 120 percent of the average of the four prior years' incomes and if the excess current-year income exceeds $3,000. The excess current-year 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 and individual retirement accounts or annuities.
2. Accumulation distributions received from trusts that 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 $3,000 eligibility requirement.) The tax attributable to this one-fifth portion is then multiplied by five to obtain the actual income tax. 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, the taxpayer must meet certain tests to be eligible.

204 Limitations on Income Averaging

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. There are no present generally applicable statutory provisions for averaging income in the converse situation: 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 their incomes were derived in opposing sequences, as shown in figure 2-1.

Figure 2-1

	Individual	
Year	A	B
1976	$ 10,000	$ 50,000
1977	20,000	40,000
1978	30,000	30,000
1979	40,000	20,000
1980	50,000	10,000
Totals	$150,000	$150,000

204.1 Eligibility Confined to Members of the Labor Force

Section 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. The section provides three exceptions to this rule:

1. Unemployed persons over twenty-five who are not students: Individuals who have attained age twenty-five before a computation year ends may elect income averaging, even though they have not met the support test, if they were not full-time students during at least four taxable years—beginning after they attained age twenty-one and ending with the current (computation) year.
2. Major accomplishment rule: Another exception permits income averaging if more than 50 percent of an individual's adjusted taxable income for a current (computation) year is attributable to work performed in substantial part during at least two of the four base-period years.
3. Spouse supported by others: If not more than 25 percent of joint adjusted gross income is attributable to an individual filing a joint return, the couple may elect income averaging.

204.2 Marriage-Related Problems

To ensure consistency between a current year and its four prior base-period years, sec. 1304(c) provides special rules for reconstructing the income of a husband and wife (*a*) if they filed separate returns for any base-period year or will file separately for the current year or *(b)* if they were married to other spouses during any base-period year.

204.3 Other Limitations

Section 1304(b) precludes a taxpayer who elects income averaging from using the following code provisions, which may also be beneficial to him:

1. The 50 percent maximum tax rate on personal service income (chapter 3).
2. The exclusion, under specified conditions, of income from sources within U.S. possessions.
3. The exclusion of income earned by employees residing in camps located in foreign places that have been designated as hardship areas.

205 Miscellaneous Considerations

205.1 Required Election Made Through Use of Designated Forms

Section 1304(a) permits income averaging only if a taxpayer chooses its benefits for a particular year. Regulations section 1.1304-1(a) requires the taxpayer to file Form 1040, accompanied by Schedule G, for the given year. This choice can be made for any year that is still open for a refund or credit claim.

205.2 Effect of Net Operating Loss Carrybacks

A carryback to a computation year will reduce averageable income and thus reduce the benefit derived from income averaging.

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

Note The taxpayer should also consider the impact of NOL carrybacks on income averaging in deciding whether the election to waive such carrybacks (under sec. 172(b)(3)(C)) is advisable (see chapter 4).

205.3 Special Ten-Year-Averaging Computation for Certain Lump-Sum Distributions From Qualified Retirement Plans

The ordinary income portion of a lump-sum distribution is eligible for regular income averaging if ten-year averaging is not elected (see chapter 11).

3

Minimum Taxes and Tax Rate Mitigation

Maximum Tax Rate on Personal Service Income

The tax planner should consider how the 50 percent maximum tax rate on personal service income affects planning decisions about the following matters:

- **Incorporating a personal service business.**
- **Advantages and disadvantages of restricted property compensation.**
- **Desirability of deferred compensation.**
- **Mix of personal service income and nontaxable fringe benefits.**
- **Utilization of "tax losses."**
- **Interaction with general income averaging.**
- **Recording data to prove "reasonable compensation."**

Tax planning for corporate executives, professional practitioners, and others with significant amounts of personal service income must take into account the 50 percent maximum tax on personal service income.

The effective tax rate on personal service taxable income is actually less than 50 percent because, under the statutory formula prescribed by sec. 1348(a), personal service taxable income is, in effect, taxed first at the regular graduated rates (up to the 50 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 personal service income eligible for the maximum tax must be reduced for tax preferences other than capital gains. Furthermore, these maximum rates are not available if the taxpayer elects income averaging or if the taxpayer is a married individual filing a separate return.

While the maximum tax represents a commendable decision by Congress to limit the tax on income from personal services, there is still a significant tax rate gap between ordinary income from personal services and long-term capital gains. As a result of both the increase in the capital gain deduction from 50 to 60 percent and the elimination of capital gain as a preference item subject to the add-on minimum tax (chapter 1), the maximum tax rate on long-term capital gain is now 28 percent (40 percent times the maximum tax rate of 70 percent). While long-term capital gain may be subject to the new alternative minimum tax imposed by the Revenue Act of 1978 (chapter 1), the alternative minimum tax rates do not exceed 25 percent.

The maximum tax on personal service income has the following tax planning implications:

1. Incorporation of a personal service business may be less desirable because there is a spread of only 4 percent between the 46 percent maximum corporate tax rate and the 50 percent maximum personal service income tax rate. The repeal of the 30 percent limitation also reduces the incentive to incorporate, even where capital is a material income-producing factor in the business. However, the taxpayer may desire to incorporate in order to obtain more favorable treatment for retirement plans and certain other fringe benefits.
2. The incentive to obtain "capital gain compensation" through restricted property (1603) remains significant because of the 22 percent disparity between the maximum tax rates on capital gains (28 percent maximum tax rate) and ordinary income from personal services (50 percent); however, the benefit of the tax savings may be offset by the immediate enjoyment of ordinary compensation as opposed to various restrictive conditions that *may* surround restricted property.
3. Deferred compensation arrangements may defer tax and shift income to lower-bracket years. Deferred compensation is also eligible for the 50 percent maximum tax rate, except for lump-sum distributions from qualified plans, which instead are eligible for capital gains and/or ten-year averaging (chapter 11). This is generally beneficial, but rates as high as 70 percent may apply to very large distributions.

   Additional deferral may be possible for distributions from qualified plans as a result of the rollover provisions (chapter 17); however, the taxpayer can surrender this treatment for estate tax exemption (1103). Despite the generally favorable tax treatment accorded deferred compensation plans, the 50 percent maximum tax rate applicable to current compensation may still be a compelling factor in bypassing deferred compensation since the maximum tax rates are the same and current compensation permits immediate use and enjoyment of the income.

4. Other fringe benefits that constitute exclusions from income continue to be advantageous. Examples of such benefits include health and accident plans providing medical care, group-term life insurance, and the $5,000 death benefit (see chapter 5).
5. "Tax losses" become less desirable to the extent that they affect income taxable at only 50 percent instead of 70 percent. In addition, such losses can constitute tax preferences that reduce personal service taxable income and, accordingly, the benefit of the maximum tax. Tax losses can also constitute tax preferences subject to the 15 percent add-on minimum tax (chapter 1); or, in the case of excess itemized deductions, they can subject the taxpayer to the alternative minimum tax (chapter 1). Because the Revenue Act of 1978 eliminated capital gains as a preference that reduces income subject to the 50 percent maximum tax rate, the possible dilution of maximum tax benefits is no longer a factor in timing capital gain transactions.
6. For any given taxable year, the individual tax planner must perform calculations to determine whether income averaging (chapter 2) or the maximum rates will be more advantageous under the particular circumstances.
7. Incorporated entrepreneurs are often familiar with the "reasonable compensation" limitation that affects the sec. 162 corporate deduction and the extent to which such income qualifies for the 50 percent maximum tax rate. Compensation in excess of reasonable compensation does not qualify as personal service income.[1]

Because, under prior law, no more than 30 percent of profit qualified under sec. 1348 if capital was a material income-

1. See U.S., Congress, Joint Committee on Taxation, *General Explanation of the Revenue Act of 1978*, 96th Cong., 1st sess., 1979, pp. 274–75. Also see *James D. Kennedy, Jr.*, 72 T.C. no. 69 (1979).

producing factor, the reasonable-compensation issue was seldom raised with respect to the unincorporated entrepreneur. The repeal of the 30 percent limitation by the Revenue Act of 1978 will result in much more frequent disputes with the IRS, as well as possible litigation, regarding the determination of reasonable compensation. Accordingly, unincorporated entrepreneurs for whom capital is a material income-producing factor, as well as incorporated entrepreneurs, should maintain appropriate records that will be helpful in resolving reasonable compensation controversies. These may include diaries or other records indicating hours worked and duties performed, correspondence, telephone messages, financial data relating to the business or industry, and other information that may help establish the value of the entrepreneurial efforts.

301 Defining Personal Service Income

The following terms are statutorily defined under code sec. 1348(b):

- Personal service income
- Personal service net income
- Personal service taxable income

Only personal service taxable income is actually subject to the 50 percent maximum tax rate; however, this tax base is determined by reference to personal service net income, which in turn is based on personal service income.

301.1 Personal Service Income

Personal service income includes wages and salaries, professional fees, and other compensation for personal services actually rendered.

If a taxpayer is engaged in a trade or business in which both personal services and capital are material income-producing factors, his personal service income consists of a *reasonable* compensatory allowance for personal services rendered. Whether capital is a material income-producing factor is a factual question, but capital is not generally considered material in the practice of a profession even if there is a substantial investment in professional equipment (regs. sec. 1.1348-3(a)(3)(ii)). Prior to the Revenue Act of 1978, there was a further limitation: Where both capital and services were material income-producing factors, personal service income could not exceed 30 percent of the income from the business. The 30 percent limitation was repealed for taxable years beginning after 1978 "to eliminate the potential disparity between the tax treatment of personal service compensation from incorporated and unincorporated trades and businesses."[2] Prior to repeal of the 30 percent limitation, there was an incentive to incorporate and withdraw entrepreneurial profits as reasonable compensation not subject to the 30 percent limitation.

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

The statutory definition of personal service income includes "an amount received as a pension or annuity which arises from an employer-employee relationship or from tax-deductible contributions to a retirement plan" (sec. 1348(b)(1)(A)). The benefits of the maximum tax apply to deferred compensation, including pensions, annuities, and income deferred under individual retirement account arrangements.[3]

Items *not* included in personal service income are

1. Lump-sum distributions from qualified employee or self-employed retirement or annuity plans eligible for either capital gain treatment or sec. 402(e) special averaging computations.
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. Penalty distributions from individual retirement accounts.

301.2 Personal Service Net Income

Personal service net income is simply personal service income less allocable deductions allowable under sec. 62. Allowable deductions include the following:

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2. *General Explanation of the Revenue Act of 1978*, p. 274.
3. U.S., Congress, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976*, 94th Cong., 2d sess., 1976, p. 110 (1976–3(2) C.B. 122).

1. Nonemployee business expenses, including contributions on behalf of self-employed persons to qualified retirement plans.
2. Employees' travel and transportation expenses.
3. Business expenses of outside salesmen.
4. Moving expenses.
5. Contributions to individual retirement plans.

301.3 Personal Service Taxable Income

Personal service taxable income is determined as shown in figure 3-1.

Figure 3-1

Line		
1. Percentage of personal service net income to adjusted gross income (cannot exceed 100%)		______%
2. Total taxable income multiplied by line 1 percentage	$______	
3. Less reduction for tax preferences	______	
4. Personal service taxable income	$______	

Code section 57 lists tax preferences for purposes of the add-on minimum tax (chapter 1) and excess itemized deductions for purposes of the alternative minimum tax (chapter 1). Capital gains are considered a tax preference for purposes of the alternative minimum tax, but they are not considered a tax preference for purposes of "tainting" the maximum tax.

302 Computation of Maximum Tax on Personal Service Income

To apply the maximum tax on personal service income, an individual computes the actual tax under the three-phase statutory formula prescribed by sec. 1348(a) (as shown in figure 3-2).

Example Client's 1980 joint federal income tax return discloses the data shown in figure 3-3. The computation of his 1980 joint tax liability under the maximum tax formula, and the resulting tax savings, appear in figure 3-4.

Figure 3-2

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 personal service 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 sec. 1348)	$______
(ii) Less tax on personal service taxable income (similarly computed)	______
(iii) Tax on other taxable income	$______

Figure 3-3

Salary	$160,000	
Less allocable travel expense	10,000	
		$150,000
Interest income		40,000
Net long-term capital gain	50,000	
Capital gain deduction	(30,000)	
		20,000
Losses from tax shelter partnerships		(10,000)
		200,000
Itemized deductions	19,400	
Zero bracket amount	3,400	
		(16,000)
Exemptions		(4,000)
Taxable income		$180,000

In addition, the taxpayer's distributive share of tax preferences from the partnerships are as follows:

Accelerated depreciation		
On real property	$ 5,000	
On leased property	5,000	
Total tax preferences		$ 10,000

Figure 3-4

Tax Computation

Personal service income	$160,000	
Personal service net income	$150,000	
Personal service taxable income:		
Line		
1. Percentage of $150,000 to $200,000 (adjusted gross income)		75%
2. $180,000 (total taxable income) multiplied by 75%		$135,000
3. Less tax preferences		10,000
4. Personal service taxable income		$125,000

Statutory Formula

Phase 1

Tax on $60,000, which is highest amount of taxable income on which marginal rate does not exceed 50%		$ 19,678

Phase 2

Personal service taxable income	$125,000	
Less phase 1 taxable income	60,000	
Excess	$ 65,000	
50% of excess		32,500

Phase 3

Tax on $180,000 (total taxable income)	$ 93,432	
Less tax on $125,000 (personal service taxable income)	57,528	
Difference		35,904
Total tax under formula		88,082
Less regular tax on total taxable income (above)		93,432
(Savings)		($ 5,350)

4

Minimum Taxes and Tax
Rate Mitigation

Accelerating or Postponing Income and Deductions

When statutory income averaging is unattainable, or when an individual desires to compound its favorable effects, he 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 mitigates the harshness of the progressive rates. Of course, the taxpayer should only consider this technique if a net *economic* (or overall) gain will result.

401 Directing the Flow of Income and Deductions to Particular Years

The taxpayer can level off income by increasing taxable income (*a*) through acceleration of income and/or (*b*) through postponement of deductions. Conversely, an individual can reverse this process by postponing income and/or accelerating deductions.

Since cash basis taxpayers recognize income and deductions upon their actual receipt or disbursement, the timing of these transactions—to the extent that they are within a client's control—affects the amount of taxable income reportable for particular years. Moreover, the recognition of income may also be affected by the "constructive receipt doctrine," discussed in chapter 18. (However, a counterpart "constructive payment doctrine" is *not* generally available for reporting deductions.)

The following are several techniques that a taxpayer may employ to achieve effective timing of income and deductions.

401.1 Acceleration of Income

Where business conditions permit, a taxpayer can request the receipt of deposits or other advance payments prior to the end of his taxable year. If possible, these deposits should be nonrefundable.

If, for some reason, the taxpayer cannot actually receive the income, the tax planner should consider whether the constructive receipt doctrine can be invoked to recognize the income currently. In this regard, Income Tax Regs. sec. 1.451-2(a) states the following:

> 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 sec. 1341 benefits (relief computations under the "claim-of-right doctrine") would not appear to be available for the later year. Under sec. 1341(a)(1), the claim-of-right doctrine applies when an item has previously been included in gross income because of an apparent unrestricted right to the item. Therefore, the restrictions governing refundable deposits seem to remove such deposits from the ambit of sec. 1341.

401.2 Postponement of Deductions

Although cash basis taxpayers can simply defer physical payment of deductible disbursements, such an action must also be viewed within the context of realistic financial possibilities. A tax planner considering the postponement of deductions for tax purposes must also consider the inherent business exigencies and legal requirements that would be involved in such a decision.

401.3 Postponement of Income

There are various situations in which income may be postponed. See the discussion of deferred income, particularly the following:

- Restricted property (chapter 16, section 1603).

- Avoiding actual or constructive receipt of unwanted income (chapter 18).
- Installment sales (chapter 19).

401.4 Acceleration of Deductions

The pertinent deductions are the four major categories of itemized deductions—medical expenses, contributions, taxes, and interest. The postponement or acceleration of deductions should also be considered in conjunction with the use of the zero bracket amount (described in 2301) and with the impact on the alternative minimum tax (chapter 1). The timing of business-connected deductions is beyond the scope of this study.

Medical Expenses

Since expenses for medical and dental services or for medicine and drugs are allowable as deductions when they are 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 toward the end of a year (when 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 compels proper attention to the timing of medical payments. They should be concentrated in a year in which the client exceeds the limitations rather than in a year in which they would be wasted by these statutory limits.

Prepayments for medical services are not deductible in the year of payment. In *Robert S. Bassett* (26 T.C. 619) the Tax Court construed sec. 23(x) of the Internal Revenue Code of 1939 to allow medical deductions *only* for expenses incurred in the taxable year. The court held that "expenses are not incurred in the taxable year unless a legal obligation to pay has arisen." (Deductions were allowed for expenses incurred in prior years and paid in the year under review.) Consequently, medical expenses paid in a year prior to that in which the services are rendered are deductible in the year of payment if the institution imposes an obligation to pay (Rev. Ruls. 75-302 and 75-303, 1975-2 C.B. 86–88).

Section 213(a) of the 1954 code contains language substantially similar 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 make advance medical deposits in the unfortunate position of being unable to obtain *any* deduction for the expenditures, *either* in the year of payment *or* in the year in which they are incurred.[1]

Contributions

Regulations section 1.170A-1(b) states, in regard to the timing of a contribution, "Ordinarily, a contribution is made at the time delivery is effected. 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 a taxpayer can claim contributions as deductions is largely within his 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. Contributions of appreciated property to public charities are eligible up to a 30 percent limitation, unless the taxpayer elects under sec. 170(b)(1)(C)(iii) to take appreciation into account. In the latter case, the 50 percent limit applies. A five-year carryover period is available for all excess contributions to public charities (see chapter 31).

Taxes

A client may deduct the payment of a deductible tax in the year in which it is paid. In addition, advance payments of tax, if pursuant to law (or otherwise bona fide because of express administrative approval and consent) and if made in good faith, are also deductible when paid.[2]

Construction-period taxes must be amortized as provided in sec. 189.

Interest

Payment of current interest is deductible upon disbursement. As a general rule, prepaid interest is not deductible in the year of payment. Section 461(g) provides that if a cash basis taxpayer pays

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1. See Mertens, *Law of Federal Income Taxation*, vol. 5 (Chicago: Callaghan & Co.), §31A.07a, n.27.

2. *First National Bank of Mobile (Lowenstein Est.)*, 12 T.C. 694, acq. 1949–2 C.B. 2, aff'd on other grounds, 183 F.2d 172 (5th Cir. 1950); *Glassell*, 12 T.C. 232, acq. 1949–2 C.B. 2; *Est. of Frank Cohen*, T.C.M. 1970–272; Rev. Rul. 71–190, 1971–1 C.B. 70. Also see Rev. Rul. 56–124, 1956–1 C.B. 97.

interest that is allocable to a future taxable period the payment must be capitalized and treated as paid in the period to which it is allocable. Added by the Tax Reform Act of 1976, this rule generally places cash basis taxpayers on an accrual basis with respect to prepaid interest. The rule applies to interest paid for personal, investment, or business purposes.

Variable interest arrangements may also run afoul of sec. 461(g). The Senate report on the 1976 Tax Reform Act states, "In certain cases, the Treasury is authorized to treat interest payments under a variable interest rate as consisting partly of interest computed under an average level effective rate of interest and partly of an interest prepayment allocable to later years of the loan."[3] The Senate report goes on to state that a loan tied to the prime rate or some other objective measurement does not necessarily involve prepaid interest.[4]

Although it has limited importance from a planning standpoint, there is an important exception for points paid in connection with a personal residence. Section 461(g) does not apply to points paid in respect to any debt incurred in connection with the purchase or improvement of the taxpayer's principal residence and secured by that residence. Payment of points must be an established local business practice, and the amount must not exceed the amount generally charged in the area.

An interest deduction attributable to an investment by a noncorporate taxpayer is subject to certain limitations if the deduction exceeds $10,000 (as described in 3001). Construction-period interest must be amortized as provided in sec. 189.

Constructive Payments

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

3. U.S., Congress, Senate, 94th Cong., 2d sess., 1976, S.Rep. 938, p.104 (1976-3 (3) C.B. 142).

4. *Ibid.*, n.8.

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,* § 10.18; emphasis supplied]

402 Monetary Factors

Since taxation can never be completely separated from other economic facts of financial life, the tax planner, though vitally concerned with tax savings, should always consider the overall net after-tax economic gain or loss resulting from any suggested transaction. If planning involves losing the use of money, the individual should obtain adequate monetary compensation.

The acceleration of income may require the taxpayer to make a compensating monetary adjustment to the payor. If the payor does *not* demand interest, income acceleration will further benefit the client by supplying him with interest-free funds. Similar monetary considerations pertain to the postponement of deductions.

The tax planner should always weigh the interest factor when contemplating the deferral of income or the acceleration of a deduction. Of course, the inability to secure sufficient compensation for losing the immediate use of the funds will lessen the ultimate economic gain to be derived from the potential tax reduction.

The taxpayer can minimize these nontax consequences by keeping the acceleration or deferral period to a minimum. For example, the shift of a property tax payment from January 1, 1981, to December 31, 1980, should have virtually no nontax effect, in contrast to a 1980 prepayment of a charitable contribution pledge not due until 1986.

403 Absorption of Expiring Carryovers

Preventing the loss of expiring carryovers can prove a collateral benefit of controlling the year-to-year influx of taxable income.

The Tax Reform Act of 1976 provided an additional two-year carryover of net operating losses incurred in taxable years ending after December 31, 1975. Prior to amendment, the law provided a three-year carryback and five-year carryover period. For net operating losses incurred in taxable years ending after December 31, 1975, net operating losses may be carried back three years and forward seven years.

Taxpayers may elect to forego the carryback of a net operating loss for any taxable year ending after December 31, 1975 (sec. 172(b)(3)(C)). The election, which is irrevocable, must be made by the due date (including extensions) of the return for the taxable year of the net operating loss. The election may benefit an individual whose income for the earlier years is low because such an individual may save more taxes by using the net operating loss as a carryover to a future year. An individual should also consider the election if the net operating loss carryback will adversely affect the carryback year. For example, the election may avoid the adverse effect of Rev. Rul. 75-299, which provides that, where a net operating loss is carried back to a prior year, the minimum tax liability for that year must be recomputed to reflect the reduction in regular income taxes that originally reduced that year's minimum tax base. NOL carrybacks and carryovers may also affect income averaging (discussed in chapter 2).

403.1 Net Operating Loss Carryover

Client, a single taxpayer, sustained a $75,000 net operating loss in 1975 and has used $35,000 of the loss through carrybacks to 1972-74 and carryovers to 1976-79. The last year in which the remaining $40,000 loss can be deducted is 1980. Computations by his CPA in early December 1980 reveal the information shown in figure 4-1.

Figure 4-1

	Actual (through November)	Estimated (December)	Total (1980)	Estimated (1981)
Commissions	$25,500		$25,500	$10,000
Interest on redemption of U.S. Series E bonds				15,000
Rent (net lease)				36,000
	25,500		25,500	$61,000
Interest expense	2,000		2,000	
Property tax		$2,000*	2,000	
State income tax	500	1,000*	1,500	
Contributions		2,000	2,000	
	2,500		7,500	
Zero bracket amount	−2,300		−2,300	
Excess itemized deductions	200		5,200	
Exemption	1,000		1,000	
Taxable income	$24,300	$(5,000)	$19,300	

*Due January 1981.

On the basis of these facts, the CPA recommends—

1. Pay property tax, state income tax, and contributions in January 1981 rather than in December 1980.
2. Redeem Series E bonds in December 1980.[5]
3. Induce the lessee (through a 2 percent discount against the February 1981 rent) to pay the January 1981 rent of $3,000 on December 31, 1980.

Client's 1980 income tax return should disclose the following.

Commissions	$25,500
Interest	15,000
Rent	3,000
Gross income	43,500
Less net operating loss carryover	40,000
Adjusted gross income	3,500
Less excess itemized deductions and exemption	1,200
Taxable income (zero bracket amount)	$ 2,300
Tax	$ none

5. In the case of a decedent, the executor may elect to include accumulated interest for Series E bonds owned by the decedent (Rev. Rul. 68–145, 1968–1 C.B. 203) or his grantor trust (I.R.S. Ltr. Rul. 7907120) on the decedent's final return. See also *Working With the Revenue Code 1979*, ed. I.F. Diamond and M. Walker (New York: AICPA, 1979), pp.209–11.

403.2 Contributions Carryover

Client expects to earn $10,000 in 1980. He has a $7,500 contributions carryover from 1975, and he plans to make contributions of $1,000 in December 1980. In addition, he intends to redeem Series E bonds in 1981 on which he has elected to defer reporting interest. The bonds will have accrued interest of $5,000 upon redemption in 1981 (as reflected in figure 4-2).

Figure 4-2

Line	Actual (through November)	Estimated (December)	Total (1980)	Estimated (1981)
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 1975	$ 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 1981 (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 1975 is allowed. Since the contribution carryover period is only five years, the remaining 1975 carryover of $3,500 cannot be carried to 1981. The computation required by sec. 170(d)(1)(A) would prevent *any* carryover to 1981:

Contribution to public charity paid in 1980	$1,000
Less 50% of 1980 contribution base	5,000
Excess contribution—carryover to 1981	$None

The CPA thereupon suggests the following steps to Client:

1. Redeem the Series E bonds in 1980.
2. Make the $1,000 contribution in 1981.

Client's 1980 return should reflect the following results:

Salary	$10,000
Interest	5,000
Adjusted gross income	$15,000
Contributions: carryover from 1975	$ 7,500
Allowable (limited to 50% of $15,000)	$ 7,500

The CPA's suggestions will enable Client to utilize his 1975 carryover fully and, accordingly, to obtain $8,500 in allowable deductions for 1980-81 rather than the $5,000 originally contemplated. (This $3,500 additional deduction represents the nondeductible portion of the 1975 carryover that would have expired under the original plan.)

403.3 Investment Credit Carryover

Investment credits can be claimed as offsets against tax liabilities, subject to the limitation shown in figure 4-3.

Figure 4-3

Line	
1. Total investment credit	$125,000
2. Less first $25,000 of tax liability	25,000
3. Balance	$100,000
4. Pertinent percentage for 1980*	70%
5. Additional credit (line 3 × line 4)	$ 70,000
6. Allowable credit (lines 2 and 4)	$ 95,000
7. Unused credit (line 1 less line 6)	$ 30,000

*The pertinent percentage for 1981 will be 80%. For 1982 and thereafter, it will be 90%.

The unused credit (line 7) can be carried back three years and forward seven years. Carryovers from pre-1971 years are subject to a ten-year carryover period (sec. 46(b)). The risk of investment credits expiring unused is mitigated by the FIFO utilization of investment credits under sec. 46(a)(1), as follows:

1. Carryovers, the earliest credits being the first utilized.
2. Credits earned during the year.
3. Carrybacks, the earliest credits being the first utilized.

Note Similar principles apply to the use of other expiring carryovers, such as foreign tax credits, job credits, and residential energy credits (discussed in 2504).

Minimizing Income Subject to Tax

- ☐ Exempt Income
- ☐ Deflected Income
- ☐ Long-Term Capital Gains
- ☐ Deferred Income

5

Exempt Income

Employment-Connected Fringe Benefits

Higher-bracket employees (including employee-stockholders) should attempt to induce their employers to furnish suitable fringe benefits as part of the total compensation package.

There are various economic benefits that an employee may receive from his employer for services rendered. The present discussion is concerned with benefits that have the following characteristics:

1. *They are not taxable to the employee.* Although representing personal or living expenses paid by an employer on his employee's behalf, fringe benefits are not taxable to the employee.
2. *They are deductible by the employer.* Such expenses are deductible by the employer although, if paid by the employee, they usually would not be deductible by the employee.
3. *They are of value to the employee.* The ultimate value that a fringe benefit has for an employee depends on his top tax bracket; however, it normally is worth more than its face value. 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 pretax compensation to pay for a fringe benefit that costs his employer $250.[1]
4. *They are available.* Fringe benefit treatment is available to all employees, although benefits offered to employee-stockholders of closely held corporations require extra attention. The courts are divided in regard to whether partners can qualify for fringe benefit treatment. For a favorable fifth circuit decision, see

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1. See R. Steinman, *Tax Guide for Incorporating a Closely Held Business*, Federal Tax Study 1, rev. ed. (New York: AICPA, 1978), p.209.

Anne L. Armstrong, 394 F.2d 661. At the same time, beware of the contrary precedents in *Cliff C. Wilson*, 376 F.2d 280 (Court of Claims) and Rev. Rul. 80, 1953-1 C.B. 62.[2] The statutes specifically permit partners to participate in educational assistance programs (505) and qualified group legal service plans (506). A sole proprietor or investor, lacking an employer, generally does not have fringe benefit advantages; however, sole proprietors are permitted to participate in educational assistance programs (505) and qualified group legal service plans (506).

A highly compensated individual may be subject to tax on otherwise nontaxable fringe benefits pursuant to sec. 125 if the employer's plan permits a choice between taxable and nontaxable fringe benefits and if the plan discriminates in favor of highly compensated individuals (see the discussion of cafeteria plans or flexible benefit plans in 507).

In September 1975 the Treasury proposed controversial regulations dealing with the taxation of fringe benefits.[3] These regulations were subsequently withdrawn in December 1976.[4] In order to consider possible legislation in the area, Congress banned the Treasury from issuing new fringe benefit regulations prior to 1980.[5] Accordingly, there may be developments in the foreseeable future that will materially affect the treatment of fringe benefits. A bill (H. R. 5224), which was enacted on December 29, 1979, prohibits the IRS from issuing fringe benefit regulations until June 1, 1981.

The following are the fringe benefits most widely used today, as well as some new fringe benefits recently enacted into law:

- Life insurance protection (501).
- Other death benefits (502).
- Medical plans (503).
- Wage continuation (disability plans) (504).
- Educational assistance programs (505).
- Qualified group legal service plans (506).
- Cafeteria plans (507).

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2. See McKee, Nelson, & Whitmore, *Federal Taxation of Partnerships* (Boston: Warren, Gorham & Lamont, 1977), ¶13.03(6)(c).

3. 40 Fed. Reg. 41,118 (1975). Also see M. Siegel, "Taxation of Perquisites," *N.Y.U. Institute on Federal Taxation (ERISA Supplement)* 36 (1978): 35.

4. 41 Fed. Reg. 56,334 (1976).

5. Pub. L. 95–427 (October 7, 1978), §1.

- Meals and lodging furnished for the employer's convenience (508).
- Courtesy discounts to employees (509).
- Qualified commuter transportation (510).
- Rental value of parsonages (511).

The remainder of the chapter presents various planning techniques involving each of these benefits.

501 Life Insurance Protection

Employees can receive employer-provided life insurance protection at relatively favorable tax cost under either of the following arrangements: (1) group-term life insurance or (2) split-dollar insurance.

501.1 Group-Term Life Insurance

Section 79 provides an exception to the general rule that employer-paid life insurance premiums on an employee's life are taxable to the employee if the proceeds are payable to the employee's beneficiary.[6] Under the 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.[7]

Although coverage in excess of $50,000 produces taxable income, the reportable value of the additional benefit is determined by reference to the favorably low insurance costs listed in regs. sec. 1.79-3(d)(2).

> In addition, although the coverage may not "discriminate," it may vary with the *class* of employees—and a class might consist of "Company Executive Officers," for example. See Regs. Sec. 1.79-0. While the company's policy might be to insure the life of each employee for an amount—say $10,000—it might also provide that the executive officers be insured for more—say $500,000—with permanent, level premium life insurance that accumulates cash value.[8]

The IRS, although it had issued proposed regulations that would have denied the sec. 79 tax advantage to plans that com-

6. Regs. §1.61–2(d)(2)(ii)(a). But see regs. §1.61–2(d)(6) regarding "transfers" of property subject to §83. The possible effect of §83 is discussed elsewhere in the text.

7. U.S., Congress, House, 88th Cong., 1st sess., 1963, H.Rep. 749, p.A-30.

8. S. Tuller, "Group-Term Life Insurance Still Good Tax Planning Tool," *Tax Adviser* 10 (October 1979): 605.

bined group-term life insurance and permanent insurance, in 1979 issued regulations that permit group-term life insurance to be combined with permanent life insurance coverage if certain requirements are satisfied (see regs. sec. 1.79-1(b)).[9] One requirement is that the policy or the employer must designate in writing the part of the death benefit that is group-term life insurance; another is that the employee must be able to elect to decline or drop the permanent benefit.

Note The regulations regarding the sec. 83 restricted property rules (1603) provide that the cost of life insurance protection is taxable under the general sec. 61 rules rather than under sec. 83 during the period in which the contract is substantially nonvested (as defined in regs. sec. 1.83-3(b)).[10] The cost of such life insurance protection is the reasonable net premium cost of the current life insurance protection provided by the contract. Regulations section 1.83-3(e) provides that *property*, for purposes of sec. 83, is only the cash surrender value of a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection.

The impact of these regulations (promulgated July 21, 1978) on group-term insurance plans is not entirely clear, but the practitioner should be cautious in situations that may involve a transfer (that is, acquisition of a beneficial ownership interest under regs. sec. 1.83-3(a)) of a group policy with a cash surrender value. One commentator suggests that this may be a problem when a group-term life insurance plan covers retirees and there is an express or implied obligation to continue premium payments until death.

> The employee at [the time of his retirement] has a vested right in something which might be considered property which would be taxable in accordance with the rules prescribed in section 83. Only the current premium is excludable from gross income under section 79(b), and so the employee would have income for the value of the property over and above this premium if section 83 were applicable. This would be a radical departure from the existing treatment of

9. See Rev. Proc. 79–29, 1979–22 I.R.B. 24, which establishes a procedure to determine the cost of permanent benefits and the death benefit provided by policies that include both group-term life insurance and permanent benefits. For a discussion of regulations pertaining to permanent benefits, as well as rules on evidence of insurability and retired lives reserves, see I. Salem and R.L. Schmalbeck, "Group-Term Life Insurance: IRS Creates New Solutions, Questions and Challenges," *Journal of Taxation* 50 (September 1979): 130.

10. Regs. §1.83–1(a)(2).

group-term insurance and it is doubtful that the Service intended any such change. It is understood that the Service is currently considering this question.[11]

While the practitioner should be aware of these difficulties, the problem appears to be limited in the case of group-term life insurance because only those plans that combine term protection and permanent benefits have a cash surrender value that can be considered property subject to sec. 83.

Estate Tax Aspects

If the employee dies, the face value of his group-term protection is includible in his gross estate *unless* he has divested himself of all incidents of ownership in the policy.

The taxpayer should assign incidents of ownership if the terms of Rev. Rul. 69-54 (1969-1 C.B. 221) can be met.

This ruling recognizes such assignments as effective for estate tax purposes under the following conditions:

1. *Both* the group policy and state law permit an employee to make an absolute assignment of all his incidents of ownership in the policy.[12]
2. Upon termination of employment (when coverage ceases), an assignee acting alone can convert to an individual policy of equal face amount.
3. An employee makes an irrevocable assignment of *all* his incidents of ownership in the policy, *including the conversion privilege.*[13] The power to convert solely by terminating employment is not considered an incident of ownership.[14]

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11. W.L. Sollee, "Final Section 83 Regs. Endanger Employer Deductions, Premium on Employee Election," *Journal of Taxation* 49 (December 1978): 346.

12. "Only Alaska, Delaware, and the District of Columbia do not have laws specifically permitting the assignment of group life insurance policies. Alaska and Delaware have broad and general insurance assignment laws, which could be construed as allowing assignments of group policies by insured persons" (*CCH Federal Estate and Gift Tax Reporter*, vol.2, ¶7020.052). An assignment has even been upheld where the master contract permitted the assignment but the individual contracts did not (*M.J. Gorby*, 53 T.C. 80 (1969), acq. 1971–1 C.B. xvi). However, the master contract must not specifically prohibit assignment (*Bartlett*, 54 T.C. 1590 (1970), acq. 1971–1 C.B. 1), although it may be possible to secure a waiver of this prohibition. See L. Murphy, "Assignment of Group Life Insurance for the Purpose of Estate Tax Avoidance," *Taxes: The Tax Magazine* 55 (July 1977): 479.

13. See, e.g., *E.M. Schwager*, 64 T.C. 781 (1975), where a right to prevent a unilateral change of beneficiaries was held to be an incident of ownership.

14. Rev. Rul. 72–307, 1972–1 C.B. 307.

There is conflicting authority on the question of whether retention of the right to elect settlement options subjects the life insurance to tax in the insured's estate.[15] The safer approach is to transfer all such rights.

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

Can one assignment suffice? The IRS has not indicated (*a*) whether an assignment can be designed to apply to any subsequent renewal of coverage by the employer, (*b*) what the effect of a continuous group policy is, or (*c*) if future assignments will be necessary when coverage is renewed. The answer may hinge on whether the old policy is merely amended or a new policy is issued.[16] The IRS has ruled that, although in 1971 an employee had "assigned" to his spouse all rights under any future life insurance arrangements that the employer might make, the purported assignment was not effective in 1977 as a present transfer of the rights under a new policy.[17] In 1977 the employer substituted the new contract, with a different insurer, for its old insurance contract. The employee also assigned the rights in this new policy to his spouse, but the insurance was included in his gross estate when he died, less than three years later.

Assignments within three years of death Section 2035 provides that transfers made within three years of the donor's death be included in the gross estate, regardless of the donor's motive. There is an exception for gifts that need not be reported on a gift tax return, but the Revenue Act of 1978 made this exception inapplicable to "any transfer with respect to a life insurance pol-

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15. *Est. of Lumpkin*, 474 F.2d 1092 (5th Cir. 1973), vac'g and rem'g 56 T.C. 815 (1971), nonacq. 1973–2 C.B. 4; contra *Est. of Connelly*, 551 F.2d 545 (3d Cir. 1977). See also Rev. Rul. 76–261, 1976–2 C.B. 276. Cf. Rev. Rul. 77–156, 1977–1 C.B. 268.

16. "Of course, many term policies and most accidental death policies are written for terms of less than three years so that with the issuance of each new policy, the three year period (of Sec. 2035) begins again" (S.D. Stiller, 111–3rd *Tax Management*, *Life Insurance*, p.A–13). Murphy, "Assignment of Group Life Insurance," p.479, states, "It is argued that the annual renewal constitutes a new contract (for purposes of sec. 2035) each year and that therefore any transfer is necessarily within the three-year presumptive period. . . . However, there is authority for the view that group life insurance is a continuing contract, rather than a new policy issued annually, when renewed each year by payment of an adjusted premium" (citations omitted). See also *A. Genshaft*, 64 T.C. 282 (1975), acq. 1976–2 C.B. 2.

17. Rev. Rul. 79–231, 1979–31 I.R.B. 9.

icy."[18] Accordingly, if an employee owns a $50,000 group-term life insurance policy and gratuitously transfers the incidents of ownership within three years of his death, the $50,000 proceeds are apparently includible in his gross estate.

The IRS gives no indication of taking the position that payment of premiums by the employer within three years of the employee's death causes the proceeds of the policy to be included in the estate (under sec. 2035), as long as the employee transferred ownership more than three years prior to death. It also appears that the IRS will recognize assignments of group policies, although the employer's substitution of a new insurer would necessitate a new assignment and the beginning of a new three-year period.[19] However, if there is attributed income to the employee because coverage exceeds $50,000, it may be necessary to include the attributed income for the last three years in the gross estate (under sec. 2035).[20] If the assignment is made more than three years prior to the employee's death but the plan is contributory and the employee pays part of the premium, only the amount of the premium may be included in the gross estate.[21] If the assignee pays the premiums, neither the insurance nor the premium payments causes any inclusion in the gross estate. For income tax purposes, the payments are treated as "an amount paid by the employee" and thus are not includible in the employee's income.[22]

Note Since, under sec. 2035, the policy's proceeds are includible in the gross estate within the first three years of the transfer of

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18. The following discussion is found in U.S., Congress, Joint Committee on Taxation, *General Explanation of the Revenue Act of 1978*, 96th Cong., 1st sess., 1979, p.429: "This exception does not apply to any transfer with respect to a life insurance policy. However, the exception does apply to any premiums paid (or deemed paid) by the decedent within three years of death to the extent that such payments, together with other gifts to the donee, are excludable under the annual exclusion. On the other hand, the exception does not apply to any transfer which would have resulted in inclusion in the gross estate of the proceeds of the policy under the law prior to the 1976 Act because the transfer was considered made within three years of death (by reason of policy renewal rights, premium payments, or any other factor, other than the existence of a contemplation of death motive, to the extent these factors were relevant to includibility of the proceeds in the gross estate of a decedent under prior law)."

19. See Rev. Rul. 79–231, 1979–31 I.R.B. 9.

20. R.I. Bruttomesso, "Group-Term Life Insurance Plans: An Analysis of Their Current Applications," *Journal of Taxation* 46 (March 1977): 185, citing Rev. Rul. 71–497, 1971–2 C.B. 329.

21. Rev. Rul. 71–497, 1971–2 C.B. 329. But see the *General Explanation of the Revenue Act of 1978*, p.429, for the reference to excluding from the estate premium payments within three years of death that are excludible under the annual exclusion.

22. Rev. Rul. 71–587, 1971–2 C.B. 89.

ownership, regardless of whether the employee or the assignee pays any premium on contributory insurance, there may be relatively little estate tax incentive to have the assignee pay the premiums. If the policy's proceeds are includible in the gross estate, the premiums may not also be includible.[23] It is important, though, to have the assignee pay the premiums if the employee never owned the policy.

Avoiding incidents of ownership from the start The IRS has ruled that an employee had no incidents of ownership in the following situation.[24] If the employee did not enroll for coverage, a spouse or other adult relative could have applied, paid the premiums, and had all rights in the policy. If the policy were terminated by divorce or any other event, the employee would again be able to enroll for insurance in his own name. In this case the wife enrolled for the group life insurance and paid the premiums out of her separate funds. Within three years, the employee died. The IRS ruled that the insurance was not included in his gross estate because neither the employee nor his estate possessed any incidents of ownership. The IRS did not consider the right to enroll again in the case of divorce an incident of ownership or reversionary interest.

Apparently, such an arrangement would not be includible in the estate as a transfer within three years of death.[25] The employee should avoid paying premiums, directly or indirectly, because premium payments may be considered a transfer subject to sec. 2035, even though the insured employee never owned the policy.[26]

Gift Tax Considerations

Because group-term insurance does not have any cash surrender value, an assignment should not result in gift tax.[27] Nonetheless, premium payments by the employer have been deemed transfers subject to gift tax.

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23. See *Est. of Peters*, 572 F.2d 851. See also *General Explanation of the Revenue Act of 1978*, p.429.

24. Rev. Rul. 76–421, 1976–2 C.B. 280.

25. Cf. *Est. of Kahn*, 349 F. Supp. 806 (D. Ga. 1972).

26. See, e.g., Rev. Rul. 71–497, 1971–2 C.B. 329; *Bel*, 452 F.2d 683 (5th Cir. 1971), cert. denied 406 U.S. 919. It appears that the amendment of §2035 has not mitigated this problem. See the *General Explanation of the Revenue Act of 1978*, p.429.

27. See Rev. Rul. 76–490, 1976–2 C.B. 300.

In Rev. Rul. 76-490, the employee assigned a group-term policy to an irrevocable trust. (The advantages of insurance trusts are discussed in connection with split-dollar arrangements.) The premium payments by the employer were considered transfers subject to gift tax, although they were not considered gifts of future interests and, thus, the $3,000 annual exclusion was available.[28] Under the terms of the trust, the beneficiary, or the beneficiary's estate, was to receive the full proceeds of the policy immediately upon the employee's death.

The service ruled that a similar assignment of a group-term policy *was* a gift of a future interest because the trustee was required to retain the proceeds and to pay trust income to the children until the death of the last surviving child, and then to distribute the assets to the grandchildren.[29]

501.2 Split-Dollar Insurance

If group coverage is not feasible, or if additional protection is desired, employees should seek split-dollar arrangements.

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

Under a split-dollar program, 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.[30] In the view of the IRS, the annual value of these benefits constitutes taxable income to the employee, which is computed as shown in figure 5-1.

This computation does not generally produce an undue tax detriment. For example, consider the limited amounts of additional taxable income realized by a forty-five-year-old employee who is insured for $100,000 (figure 5-2).

The employer should consider giving the employee a bonus to

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28. For other examples in which the annual exclusion has been available, see *H. Halsted*, 28 T.C. 1069 (1957), acq. 1958–1 C.B. 5 and I.R.S. Ltr. Rul. 7826050. Also see *Crummey*, 397 F.2d 82 (9th Cir. 1968), rev'g T.C.M. 1966–144.

29. Rev. Rul. 79–47, 1979–6 I.R.B. 19.

30. This may be true even if the owner of the policy is a relative of the employee. Regarding the tax consequences of such arrangements, see Rev. Rul. 78–420, 1978–2 C.B. 67.

Figure 5-1

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 C.B. 11, and 66-110, 1966-1 C.B. 12.
*Cost ascertainable through tables published in Rev. Ruls. 55-747, 1955-2 C.B. 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 C.B. 11.

cover the economic benefit, which the employee would contribute to the plan. The bonus would not result in any incremental taxable income to the employee because the contribution to the plan eliminates the economic benefit from the insurance, which otherwise would be taxable; but the bonus would be deductible by the employer.[31]

Figure 5-2

(i) Policy Year	(ii) Employee's Coverge*	(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).

Figure 5-2 indicates that $24 of the first-year premium ($609, the total premium, less $585, the 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. The tax

31. See B. Weinberg, "Split Dollar Insurance: Some New Techniques That Can Enhance the Benefits of This Device," *Estate Planning* 6 (September 1979): 287. Mr. Weinberg also discusses the "double bonus" variation of this approach, whereby the employee has cash to pay both his contribution and his income taxes.

planner can prevent this by dividing the total amount of employee premiums by the number of years in the policy's term to ascertain an average annual premium payment. In this way, *all* employee premiums are *fully* utilized to reduce the additional taxable income generated by employer-provided insurance coverage. Furthermore, this procedure stabilizes the employee's insurance expense over the policy's term.

If averaging is worthwhile, the employer should discuss it 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 on the loans may not be deductible because of sec. 264(a)(3). Interest-free employer loans may create still further taxable income.[32]

See the discussion in 501.1 of applicability of sec. 83 to transfers of life insurance policies.

501.3 Comparative Evaluation—Group-Term and Split-Dollar Insurance

Income Tax

Group-term life insurance is an attractive fringe benefit because *constant* coverage can be obtained at less expensive group rates. A further saving is that the employer usually can deduct the premiums as compensation, and this benefit results in little or no taxable income to the employees.

However, regs. sec. 1.79-0 contains various requirements regarding the composition of an acceptable group of *employees*. (Generally, a group must include at least ten full-time employees, except for situations permitted under regs. sec. 1.79-1(c).) These requirements preclude individual selection of either coverage or amount of protection; however, coverage may vary with the class of employee. (See pros and cons, p. 58.)

A related avenue that the tax planner might explore is the interest-free loan (see chapter 10).

Employee's Estate and Gift Tax

A gift of life insurance is desirable, since its pure protection value (1) is not subject to either gift or estate tax and (2) constitutes a

32. See Goldstein, "Business Uses of Life Insurance," *N.Y.U. Institute on Federal Taxation* 24 (1966): 474, for additional discussion of this interest problem. Interest-free loans are also discussed in chap. 10, herein.

Split-Dollar Insurance	
Pros	**Cons**
• It is extremely flexible in regard to individual selectivity. • The employee's tax cost is fairly nominal. • The employee's protection is highest during the policy's early years, when his need may be greatest.	• Premiums are based on higher individual rates. • There is no employer deduction for use of funds (which provide employee's benefits). • Employee coverage declines. However, this can be remedied if the employer pays its share of the proceeds as a death benefit (under a separate plan), or if the employee is entitled to policy dividends and they are used to buy additional term insurance.[33]

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:

- The proceeds are payable to beneficiaries *other than* the employee's creditors or his estate (executor, administrator, etc.).[34]
- The employee has relinquished all incidents of ownership in the insurance policy.[35]

This exclusion applies regardless of whether the insurance is financed entirely by the employer (group-term), through a split-

33. For a discussion of variations of split-dollar arrangements, including the "company-pay-all variation," see B. Weinberg, "Split Dollar Insurance," pp.284–94.

34. Regs. §20.2042–1(b).

35. Regs. §20.2042–1(c). With respect to incidents of ownership on the life of a corporation's controlling shareholder, see Rev. Rul. 76–274, 1976–2 C.B. 278. See also *Est. of J.L. Huntsman*, 66 T.C. 861 (1976), acq. 1977–1 C.B. 1; *Est. of A. Dimen*, 72 T.C. no. 17 (1979); *Est. of M.L. Levy*, 70 T.C. 873 (1978).

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

A precise judgment regarding which form of insurance fringe benefit is preferable, or whether split-dollar should supplement group-term insurance, can only be made by a practitioner who is fully aware of his client's circumstances, including comparative insurance rates, insurability problems, and the group size required by sec. 79.

To avoid application of sec. 2035 to transfers within three years of death or accumulations of significant values that may aggravate any gift tax problem, the tax planner should consider making the spouse the original owner of the policy. Under this "collateral assignment" arrangement, the employee's spouse applies for and owns the policy. The spouse then executes an assignment evidencing the employer's interest in the policy.[36] It would be advisable for the spouse to pay the premiums in such a case (see 501.1).

A recent revenue ruling dealt with such a split-dollar insurance arrangement in which the wife owned the policy and shared the premiums with the corporate employer.[37] The ruling held that the employee had taxable income equal to the amount by which the value of the insurance protection exceeded the premiums paid by the wife and that this amount was a transfer subject to gift tax. The $3,000 annual exclusion should be available, since the wife possessed all the incidents of ownership.[38]

To derive additional estate tax savings at the time of the beneficiary's death, the tax planner should consider the feasibility of a life insurance trust.

Further estate tax savings can be obtained at the beneficiary's death if the life insurance proceeds can be diverted from her outright ownership (and thus excluded from her gross estate).[39] This diversion may be possible if the beneficiary's financial position enables her to use these proceeds only as a source of income and as a *limited* source of capital. Under such circumstances, a life

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36. See B. Weinberg, "Split Dollar Insurance," pp.290–92.

37. Rev. Rul. 78–420, 1978–2 C.B. 67.

38. See Rev. Rul. 76–490, 1976–2 C.B. 300.

39. This discussion specifically relates to only those situations in which the employee's beneficiary is his surviving spouse.

insurance trust can be established to receive gifts of the unmatured policies.

The trust indenture may provide that the beneficiary has the noncumulative right to withdraw the greater of $5,000 or 5 percent of the trust's principal annually. At her death, only the amount of trust principal subject to this right (which has not yet lapsed) is included in her estate. (Section 2041(b)(2) excludes the value of the rights that have previously lapsed.) However, if the surviving spouse is the trustee of the trust, a controversy may develop about whether the trust should be included in her gross estate because the surviving spouse possesses incidents of ownership in a fiduciary capacity.[40] If the beneficiary's financial position does not necessitate this provision, it should be deleted so that further estate tax savings can occur. Such a trust may entail gifts of a future interest, in which case the $3,000 annual gift tax exclusion does not apply (Rev. Rul. 79-47).

The tax planner *cannot* save income taxes 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 is 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.

Future estate tax is avoided if the children succeed their mother as life income beneficiaries, with corpus distributable upon their deaths to their children (the donor's grandchildren). The extent to which a trust can be perpetuated in this way is governed by any applicable local rules.[41] Such arrangements may also be subject to the generation-skipping transfer tax discussed in 902.

If a client has previously created a life insurance trust, the practitioner should consider the extent to which it should be made the recipient of life insurance that has been provided as a fringe benefit. The practitioner should also consider whether to achieve this through lifetime gifts or testamentary transfers. In other situations, the practitioner should consider the establishment of a trust for this purpose.

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40. Rev. Ruls. 76–261, 1976–2 C.B. 276, and 77–156, 1977–1 C.B. 268. To the contrary, see *Hunter*, 474 F. Supp. 763 (D. Mo. 1979), appealed by gov't to 8th Cir. Also see Rev. Rul. 79–353, 1979–44 I.R.B. 27.

41. See A.J. Casner, "Extent of Tax Avoidance Possible Under Present Law by Use of Generation-Skipping Transfers," in "American Law Institute Federal Estate and Gift Tax Project," *Tax Law Review* 22 (May 1967): 573.

502 Other Death Benefits

There is no income tax on the first $5,000 of death benefits to employees' beneficiaries (including their estates). The desirability of contractual arrangements depends upon the parties' relationship and the employees' estate tax exposure.

502.1 Income Tax Aspects

Where possible, employees should arrange with their employers for the direct payment of death benefits to their beneficiaries (including their estates).

The $5,000 exclusion applies to benefits paid by an employer as the result of an employee's death *if*, at the time of his death, the employee did not have a nonforfeitable right to receive the benefits while living (as in the case of 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 special averaging and possibly for long-term capital gain treatment, as described in chapter 11.)

Only one $5,000 exclusion per employee is available, regardless of the number of employers or beneficiaries.[42] Regulations section 1.101-2(a)(1) states that this exclusion is available "whether or not . . . made pursuant to a contractual obligation of the employer."

502.2 Estate Tax Implications

The existence of a contractual obligation on the part of an employer, whether or not it exceeds $5,000, may give rise to a corresponding contractual right on the part of the employee, which may be subject to estate taxes. On the other hand, death benefits that are not paid under a contract, regardless of the amount, are usually excludible from the employee's gross estate. Contractual payments may be excludible if the employee had no postemployment benefits.

> If an employee wants deferred compensation paid to his widow, and so specifies in a contract with his employer, the amount paid to the widow would be includible in his estate since the courts would probably deem them "vested." If, on the other hand, . . . no mention is made of "deferred compensation," a pure death benefit paid to the widow would probably be excluded from the estate. To be

42. Regs. §1.101–2(a)(3).

absolutely safe, if the employee trusts his employer, he may leave it to his employer's discretion as to whether to make such payments to his widow (or estate) upon his death.[43]

Voluntary payments should be beyond the scope of sec. 2039, despite the regulations' contention that an employer's consistent practice is equivalent to a contract or agreement. The Tax Court's view of an inferred contract, 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 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.[44] [Emphasis supplied]

The service also contended that the death benefits paid to Mrs. Barr were taxable under the generic sec. 2033, entitled

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43. S. Hagendorf, "Death Bargains for Executive Compensation—Gift and Estate Tax Consequences of Executive Compensation Techniques," *N.Y.U. Institute on Federal Taxation* 36 (1978): 247–48. See also A.G. Miller, "Certain Aspects of Estate Planning for the Business Owner," *N.Y.U. Institute on Federal Taxation* 33 (1975): 120–30.

44. *Barr*, 40 T.C. 227 (1963), acq. in result only, prior acq. withdrawn, 1978–1 C.B. 1. In I.R.S. Ltr. Rul. 7851010 the "gratuitous and noncontractual plan" provided a monthly pension to a specified class of employees and reduced the pension to the widow at the employee's death. The IRS explains its disagreement with the rationale of *Barr* as follows: "In *Barr*, the court concluded that the facts indicated that the death benefits were not paid in accordance with an established or consistent course of conduct by the decedent's employer. This determination was based, in large part, on the court's conclusion that the contract or agreement must be enforceable. We do not agree with this interpretation of the term 'contract or agreement.' We believe a payment is includible in the decedent's estate if it can be shown that the payments are in accordance with an established or consistent course of conduct by the employer regardless of whether the agreement is enforceable. Moreover, the *Barr* case is distinguishable from the instant case since the decedent was in fact receiving an annuity at the time of his death. Under section 20.2039–1(b)(1), a finding of enforceability under these circumstances is specifically not required."

"Property in Which the Decedent Had an Interest." The Tax Court held that sec. 2033 was inapplicable, reasoning 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]

An *unenforceable* corporate resolution that was adopted prior to the employee's death and that authorized payment of death benefits was beyond the scope of sec. 2033.[45]

Death benefit contracts payable to the beneficiary may be excluded from the gross estate if the deceased employee had no employment benefits. In *Estate of Firmin D. Fusz, et al.*, an employment contract provided for a salary payable to the decedent and monthly payments to his widow for the rest of her life if he died during the contract's term.[46] Neither the decedent nor anyone other than his widow received, or was entitled to receive, any postemployment benefits.[47] 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 or agreement, the deceased employee was not

45. *Est. of Bogley*, 514 F.2d 1027 (Ct. Cl. 1975). See also *Est. of Tully*, 528 F.2d 1401 (Ct. Cl. 1976), in which a death benefit paid to a 50% stockholder was considered beyond the scope of §§2033 and 2038.

46. *Fusz*, 46 T.C. 214 (1966), acq. 1967–2 C.B. 2. See also Rev. Rul. 77–183, 1977–1 C.B. 274, holding that benefits accruing to a decedent while he was an active employee under an employer's sickness and accident income plan (which is in the nature of compensation) cannot be considered together with the benefits accruing under the same employer's survivor's income benefit plan for purposes of determining the includibility of the value of the survivor's benefits in the decedent's gross estate under §2039. Thus, the value of the survivor's benefit was not includible in the gross estate.

47. Cf. *Bogley*, 514 F.2d 1027 (Ct. Cl. 1975), in which a corporate resolution was construed as a contract and the death benefit was considered taxable under §2037. The court held that there was a lifetime transfer and retention of a reversionary interest by virtue of the death benefit being payable to his widow or estate. See also *Est. of H. Fried*, 445 F.2d 979 (2d Cir. 1971), cert. denied 404 U.S. 1016; Rev. Rul. 78–15, 1978–1 C.B. 289. Cf. *L.D. Hinze*, 72–1 U.S. Tax Cas. ¶12,842 (D. Cal. 1972); *J.N. Harris, Ex'r of Est. of H.C. Harris*, 72–1 U.S. Tax Cas. ¶12,845 (D. Cal. 1972).

receiving, or entitled to receive, any postemployment benefits at the date of his death.

The decision did not affect any other estate tax sections;[48] however, in a subsequent case involving the same issue, the Court of Claims held that secs. 2036 and 2038 (described in 901.5) and sec. 2033 (the generic gross estate section), as well as sec. 2039, were inapplicable.[49]

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

1. *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.[50]
2. *Disability provisions as employment benefits.* A crucial factor in the *Kramer* decision, which has significant planning overtones, concerned the interpretation of a contract clause dealing with the employee's incapacity to act in his designated position. In the event of incapacity, 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 considered this clause to constitute an employment arrangement. Thus, the $12,000 annual salary was not a postemployment benefit, such as a retirement annuity, which would cause the widow's payments to be subjected to immediate estate tax.
3. *Disability provisions as postemployment benefits.* The Court of Claims had earlier held in *Bahen* that disability compensation benefits, contingently payable to an employee as part of a deferred compensation plan, were retirement benefits and that

48. "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" (n.2 of opinion).

49. *Carrie Kramer et al.*, 406 F.2d 1363 (Ct. Cl. 1969), cert. not authorized.

50. See also *Est. of Tully*, 528 F.2d 1401 (Ct. Cl. 1976). Rev. Rul. 76–304, 1976–2 C.B. 269, holds that an employee's agreement to provide services in exchange for an employer's agreement to pay a death benefit is a transfer subject to §2038.

the total proceeds paid to his widow under the plan had to be included in his estate.[51]

4. *Separate retirement plans for decedent and beneficiary.* 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 in conjunction with an includible deferred compensation plan.[52]

These cases uphold the sec. 2039 regulations, which specify, "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."[53] The cases also uphold the sec. 2039 regulations, which require that all rights and benefits accruing to an employee and others as a result of his employment, except rights and benefits under qualified plans exempt from estate tax (see chapter 11), be considered jointly in a determination of whether sec. 2039 applies. The scope of sec. 2039 cannot be limited by indirection.[54]

In situations in which an employee can choose whether his death benefits will be contractually guaranteed, his decision depends on the economic realities that he anticipates after his death—to the extent that they can be gauged. The need for a contract may be greatly diminished in the case of a closely held family corporation or a wholly owned corporation. If business and personal conditions permit, a client may consider foregoing a death benefit contract in order to exclude the benefits from estate tax.

The *Barr* case, in which the IRS acquiesced only in the result, did not involve a closely held family corporation as the payor of the benefits. (The payor was actually the Eastman Kodak Company.)

If possible, the tax planner should avoid circumstances that may give rise to a "constructive agreement."[55] If challenged on this point by an estate tax examiner, the practitioner should not overlook the Tax Court's interpretation of regs. sec. 20.2039-1(b)(2), example (4), set forth in the *Barr* decision.

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51. *Est. of J.W. Bahen,* 305 F.2d 827 (Ct. Cl. 1962). See also *Silberman,* 333 F.Supp. 1120 (D. Pa. 1971), and *Est. of W.V. Schelberg,* 70 T.C. 690 (1978).

52. For a decision to the same effect, see *James Gray, Ex'r. u/w of H. Gray,* 410 F.2d 1094 (3d Cir. 1969). See also *Est. of W.V. Schelberg,* 70 T.C. 690 (1978), holding that disability payments were predominantly postemployment benefits, not wage continuation payments, and includible in the gross estate under *Bahen.* Cf. Rev. Rul. 77–183, 1977–1 C.B. 274.

53. Regs. §20.2039–1(b)(1)(ii).

54. See regs. §20.2039–1(b)(2) ex. (6).

55. See Estate Tax Regs. §20.2039–1(b)(2) ex. (4) and (6) and regs. §20.2039–1(b)(1)(ii).

The tax planner should consider all tax, financial, and personal aspects in determining whether it is desirable for an employee to forego retirement benefits so that, at his death, contractual death benefits to his beneficiary might escape estate tax.

In *Estate of Porter*, the IRS has successfully construed benefits under a death benefit agreement to be a sec. 2035 "transfer" (a transfer within three years of death).[56] The gift rationale of *Porter* apparently subjects such transfers to gift tax; however, the value of the gift should be minimal because of the contingencies involved.[57]

503 Medical Plans

To prevent the taxation of all compensation expended for medical purposes, the employer should be requested to include the employee in a medical reimbursement plan.

Without a medical reimbursement plan, income used to pay medical expenses is taxable to the employee; it is taxable to the extent of 3 percent of his adjusted gross income if he itemizes deductions, and it is fully taxable if he does not itemize. With a plan, the employee is *not* taxed on compensation that is used to defray medical costs.

503.1 Plan Coverage

In addition to covering the employee, a plan can also provide reimbursement for medical expenses of the employee's spouse and dependents (as defined for federal income tax purposes by sec. 152).[58]

All expenditures for medical care are eligible for reimbursement. The definition of medical care is the same one used for purposes of claiming medical deductions (set forth in sec. 213(e)—see chapter 24).

As a matter of prudent economics, the employer may set maximum limitations on his reimbursement obligations. These limitations may be annual or overall (cumulative for the duration of employment). The employee, his spouse, and his dependents can be treated individually or jointly in establishing the limits.

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56. *Est. of Porter*, 442 F.2d 915 (1st Cir. 1971). See also *Tully*, 528 F.2d 1401 (Ct. Cl. 1976), and Rev. Rul. 76–304, 1976–2 C.B. 269.

57. S. Hagendorf, "Death Bargains for Executive Compensation," p.263.

58. See §105(b).

503.2 Discrimination in Coverage Is No Longer Permissible

Effective for medical claims filed and paid in taxable years beginning after December 31, 1979,[59] *uninsured* medical reimbursement plans may subject highly compensated individuals to tax on medical reimbursements from plans that discriminate in favor of certain officers, shareholders, or other highly paid personnel.[60] Reimbursements to such individuals under a discriminatory plan will now be wholly or partially included in the recipient's income under sec. 105(h), added by the Revenue Act of 1978.

For the benefit to be fully excludible by all employees, the medical reimbursement plan must extend to a nondiscriminatory group of employees. This eligibility requirement is satisfied under rules similar to the nondiscriminatory eligibility requirements for qualified pension plans (sec. 410(b)). The plan must benefit at least 70 percent of all employees (or at least 80 percent of all eligible employees if at least 70 percent of all employees are eligible), or the plan must benefit a classification of employees that the IRS finds to be nondiscriminatory. In applying these tests, the IRS may exclude any employee who (*a*) has not completed three years of

59. U.S., Congress, *Conference Committee Report on the Revenue Act of 1978*, 95th Cong., 2d sess., 1978, H.Rep. 1800, p.254, states that the conference agreement "applies to claims filed and paid in taxable years beginning after December 31, 1979." The *General Explanation of the Revenue Act of 1978*, p.223, merely says, "The provision applies for taxable years beginning after December 31, 1979."

The 1979 Technical Corrections Act makes a number of technical amendments relating to self-insured medical reimbursement plans, including amendment of the effective date: "Under the rules provided by the Revenue Act of 1978 for medical reimbursement plans, excess reimbursements made during a plan year are includable in the gross income of a highly compensated individual for the taxable year in which (or with which) the plan year ends. . . .

"Because the rules apply for taxable years beginning after December 31, 1979, excess reimbursements made during 1979, in a plan year beginning after December 31, 1978, and ending after December 31, 1979, will be includable in the 1980 gross income of a highly compensated individual whose taxable year is the calendar year. . . .

"The bill provides that the medical reimbursement plan rules apply only to reimbursements paid after December 31, 1979."

This provision is effective as if it had been included in §366 of the 1978 Act. [U.S., Congress, Senate, 96th Cong., 1st sess., 1979, S.Rep. 498, pp.64–65]

60. §105(h)(5) defines a highly compensated individual as (*a*) one of the five highest paid officers, (*b*) a more-than-10% shareholder, applying the §318 attribution rules, or (*c*) one of the highest paid 25% of all employees, other than excluded employees. Even prior to the introduction of the antidiscrimination rule, the IRS's vigilant policing of possible abuse cases in this area had created a rather thin line between taxable stockholder dividends and nontaxable employee medical reimbursements. Exemplifying this distinction is *Alan B. Larkin*, 394 F.2d 494 (1st Cir. 1968), aff'g 48 T.C. 629 (1967) on the one hand and *Bogene, Inc.*, T.C.M. 1968–147, on the other.

service, (*b*) has not attained the age of twenty-five, or (*c*) is a part-time or seasonal employee. In addition, union employees can be excluded if accident and health benefits are the subject of good-faith bargaining.[61]

In addition to satisfying the eligibility requirements, benefits under the medical reimbursement plan must not discriminate in favor of certain officers, shareholders, or other highly compensated individuals.

Medical reimbursements under an *insured* plan should generally be tax exempt, even if the plan is discriminatory. The Revenue Act of 1978 did not subject insured plans to the antidiscrimination provision, because "underwriting considerations generally preclude or effectively limit abuses in insured plans. . . ."[62] Accordingly, an employer who is willing to pay the premium costs may purchase individual medical insurance policies for valued employees and thereby confer a tax-free benefit.

Congress has directed the Treasury to issue the following regulations:

> [The regulations] will provide that reimbursement for diagnostic procedures (medical examinations, X-rays, etc.) need not be considered by an employer to be a part of a medical reimbursement plan. However, this exception is to apply only for diagnostic procedures performed at a facility which provides no services other than medical services and ancillary services and applies to travel expenses only to the extent such expenses are ordinary and necessary.[63]

Thus, an employer should be able to reimburse an employee for such expenses without generating taxable income, regardless of whether any discrimination exists.

504 Wage Continuation (Disability) Plans

The employer should be requested to institute a wage continuation (disability) plan so that the employee can avail himself of the social security exclusion for any wages (or payments in lieu of wages) received for periods in which he is absent from work because of sickness or accident disability.

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61. *General Explanation of the Revenue Act of 1978*, pp.221–22.
62. U.S., Congress, Senate, 95th Cong., 2d sess., 1978, S.Rep. 1263, p.186.
63. *Conference Committee Report on the Revenue Act of 1978*, p.254.

Section 3121(a)(2) excludes from wages, for social security tax (FICA) purposes, payments made under a plan or system to, or on behalf of, an employee or any of his dependents on account of sickness or accident disability. Such wages are still subject to income withholding.

As the taxable wage base for social security taxes increases, the cost to both employees and employers will skyrocket. By 1987 each party's share of FICA will be $3,045.90 (7.15 percent of $42,600). The employer can achieve payroll tax savings by establishing a plan or system for paying employees for sickness or accident disability.

Before establishing a plan, the employer should carefully examine certain considerations. One is the possibility that rank and file employees may abuse the plan through increased absenteeism. Another consideration, especially important as the taxable wage base increases, is the potential reduction of employee retirement benefits. Employees earning more than the annual taxable wage base ($42,600 beginning in 1987) will not save FICA tax under such a plan, but in 1987 how many employees will be earning more than $42,600?

Section 3121(a)(2) provides that the plan can be for employees generally or for one or more classes of employees. This appears to allow flexibility.

For income tax purposes, sec. 105(d) provides a limited exclusion for taxpayers who have not attained age sixty-five, have retired on disability, and were totally and permanently disabled when they retired. The exclusion is limited to a weekly rate of $100, and even that is phased out as the taxpayer's adjusted gross income exceeds $15,000.

505 Educational Assistance Programs

Through 1983 employees and self-employed individuals may receive tax-free educational benefits if certain conditions are met.

An individual's educational expenditures are deductible as ordinary and necessary business expenses if they are job-related, are not required to meet the minimum educational requirements for a job, and do not qualify the individual for a new trade or business (see 2804.5). Prior to the Revenue Act of 1978, reimbursements by employers for expenses that did not satisfy these tests were considered taxable wages and were subject to employment taxes and withholding.[64]

There is also a limited exclusion for scholarship and fellowship grants. This exclusion "is restricted to educational grants by relatively disinterested grantors who do not require any significant consideration from the recipient. . . ."[65]

Section 127 excludes from an employee's gross income (without any apparent dollar limitation) amounts paid, or expenses incurred, by the employer for educational assistance to the employee. These educational expenses need not be job-related, nor must they relate to a degree program. An "employee," for this purpose, includes a self-employed individual.

Meals, lodging, and transportation are not covered, although such expenditures may still qualify for deduction if they are allowable under the pre-1978 tests. The employee cannot exclude the cost of employer-provided tools or supplies that the employee may retain after completion of the course. The exclusion also does not apply to educational courses involving sports, games, or hobbies, except where they relate to the employer's business. For a program to qualify for the exclusion, the employee must not be able to choose taxable benefits in lieu of educational benefits. The program must not discriminate in favor of employees who are officers, owners, or highly compensated individuals, although a plan is not discriminatory merely because it is used to a greater degree by a particular class of employees.[66]

An individual who owns all interest in a business is treated as his own employer. A partnership is considered the employer of each partner. Accordingly, self-employed individuals can participate in educational assistance programs. However, not more than 5 percent of the amounts incurred by the employer under such a program may be provided for owners or shareholders (or their spouses or dependents) who own more than 5 percent of the stock or of the capital or profits interest in the employer.[67]

To prevent double tax benefits, sec. 127(c)(7) disallows deductions or credits for any amounts excluded from income.

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64. See regs. §§31.3121(a)-1(h), 31.3306(b)-1(h), and 31.3401(a)-1(b)(2); Rev. Ruls. 78-184, 1978-1 C.B. 304, 76-62, 1976-1 C.B. 12, 76-71, 1976-1 C.B. 308, and 76-352, 1976-2 C.B. 37.

65. *General Explanation of the Revenue Act of 1978*, p.124, citing *Binglar v. Johnson*, 394 U.S. 741 (1969).

66. *Ibid*, p.127.

67. §127(b)(3).

506 Qualified Group Legal Service Plans

For taxable years ending before January 1, 1982, an employer may establish a written plan to provide prepaid legal services to employees, their spouses, and their dependents.

If the plan meets the requirements for a qualified group legal services plan, the employee's income does not include the following:

- Employer contributions to the plan
- The value of legal services provided
- Amounts paid for legal services

A sole proprietor is considered his own employer. A partnership is considered the employer of the partners. Thus, self-employed individuals may be able to participate in such plans.

The plan must be in writing, must provide prepaid legal services, and must not discriminate in favor of officers, shareholders, the self-employed, or highly compensated employees.[68] Not more than 25 percent of the amount contributed to the plan may be provided for owners or shareholders (or their spouses or dependents) who own more than 5 percent of the stock or more than a 5 percent capital or profits interest in the employer.[69]

The employer must notify the IRS that the plan is applying for recognition as a qualified plan.[70] Form 1024 must be used for this purpose.

507 Cafeteria Plans

Under prescribed conditions, an employee may choose between tax-free benefits and taxable benefits.

The *General Explanation of the Revenue Act of 1978* describes a *cafeteria plan* or *flexible benefit plan* as a "package of employer-provided fringe benefits, some of which may be taxable (for example, group-term life insurance in excess of $50,000) and some of which may be nontaxable (for example, health and accident insur-

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68. Contributions must be made to insurance companies, organizations or persons that provide personal legal services, or other organizations or trusts described in §120(c)(5).

69. Attribution rules are set forth in §120(d)(6).

70. See prop. regs. §1.120(c)(4)-1.

ance)."[71] The statutory definition of a cafeteria plan clearly implies that a plan providing a choice between nontaxable benefits and straight compensation is considered a cafeteria plan.[72] A cafeteria plan cannot provide for deferred compensation.[73]

Under sec. 125 employer contributions to a written cafeteria plan that permits employees to elect between taxable and nontaxable benefits are excluded from gross income to the extent that the employee elects nontaxable benefits. In the case of a highly compensated employee (an employee who is an officer, a more-than-5 percent shareholder, a member of the highest paid group of all employees, or an employee who is a spouse or dependent of such an individual), the exclusion does not apply unless the plan meets specified antidiscrimination requirements regarding participation, contributions, and benefits.

Section 125 may mitigate the general rules regarding inclusion in taxable income, but in some cases sec. 125 may be more restrictive (see chapter 18). While sec. 125(a) provides an exclusion and sec. 125(b) denies the exclusion to highly compensated participants if the plan is discriminatory, the legislative history states, "Amounts contributed under a cafeteria plan *will be included* in gross income for the taxable year in which the plan year ends, to the extent the individual could have elected taxable benefits unless the plan meets specified antidiscrimination standards with respect to coverage and eligibility for participation in the plan and with respect to contributions or benefits" (emphasis supplied).[74] Thus, sec. 125 may accelerate the recognition of taxable employee benefits (except qualified and nonqualified deferred compensation) under a discriminatory cafeteria plan.[75]

The cafeteria plan rules are generally effective for plan years beginning after 1978.[76]

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71. *General Explanation of the Revenue Act of 1978*, p.79.

72. § 125(d)(1).

73. § 125(d)(2).

74. *General Explanation of the Revenue Act of 1978*, p.80. See also *Conf. Rep. on the Revenue Act of 1978*, p.206, and § 125(b)(2). See the *General Explanation of the Revenue Act of 1978*, p.80, for a discussion of the antidiscrimination standards.

75. In regard to qualified deferred compensation, see §§ 125(d)(2) and 402(a)(8). In regard to nonqualified deferred compensation, see § 125(d)(2).

76. The legislative history of the 1979 Technical Corrections Act describes present law as follows: "Under the cafeteria plan rules added by the Revenue Act of 1978, amounts required to be included in income by a highly-compensated participant because the plan does not satisfy nondiscrimination standards will be treated as received or accrued in the participant's taxable year in which the plan year ends. The cafeteria plan rules are effective

508 Meals and Lodging Furnished for the Employer's Convenience

The value of meals and lodging furnished to an employee, his spouse, or his dependents by, or on behalf of, his employer is tax-free to the employee if they are furnished for the employer's convenience on its business premises.

Supper, unlike other meals furnished for an employer's convenience, does not have to be furnished on the employer's business premises:

> "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.[77]

The Supreme Court has stated that sec. 119 rejects the rationale of Office Decision 514.[78] The Court declined to decide whether the supper money exclusion might be justified on other grounds.[79] It is apparently still IRS policy not to tax supper money.

The IRS has refused to apply the supper money exclusion to one-day business trips.[80]

509 Courtesy Discounts to Employees

Employers can promote goodwill by granting discounts to employees.

Courtesy discounts on purchases are not taxable to employees if they (*a*) are offered to employees generally, (*b*) are of relatively

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for taxable years beginning after December 31, 1978. . . . [The act] makes the cafeteria plan provisions of the Revenue Act of 1978 effective for plan years, rather than for participants' taxable years, beginning after December 31, 1978. Thus, highly compensated participants in fiscal-year plans will not have income solely because of the new cafeteria plan rules until 1980. In addition, to comply with the cafeteria plan rules, amendments to plans will not have to be effective before the beginning of the first plan year after 1978. . . . This provision is effective as if it had been included in the Revenue Act of 1978 as enacted." [H.Rep. 96–250, pp.16–17] The report also indicates that the act makes "it clear that the cafeteria plan participation standard is based on years of employment rather than years or hours of service" (p.16).

77. Office Decision 514, 2 C.B. 90 (1920).

78. *Kowolski*, 434 U.S. 77 (1977).

79. See *Kowolski*, n.28.

80. I.R.S. Ltr. Rul. 7803046.

small value, and (*c*) are offered merely to promote employee health, goodwill, contentment, or efficiency.[81]

IRS Publication 17, *Your Federal Income Tax,* contained a similar statement about the nontaxability of courtesy discounts until 1975, after which the paragraph was dropped, presumably because of proposed Treasury regulations that were subsequently withdrawn. The Treasury reportedly still considers courtesy discounts to be tax exempt, even though its publication no longer contains this paragraph.[82] On the other hand, *Your Federal Income Tax* states, "If you buy property from your employer at a reduced price, you must include in your income as additional compensation the difference between what you paid and its fair market value."[83]

510 Qualified Commuter Transportation

Through 1985 an employer may provide qualified transportation between the employee's residence and place of employment as a tax-free fringe benefit.

Section 124 excludes from an employee's gross income the value of commuter transportation provided in a "commuter highway vehicle" (described in sec. 124(b)). The seating capacity of such a vehicle must be at least eight adults (not including the driver), and at least 80 percent of its mileage use must reasonably be expected to be (*a*) for purposes of transporting employees between their residences and place of employment and (*b*) on trips during which the number of employees is at least one half of the adult seating capacity of the vehicle (not including the driver).

The transportation must be provided pursuant to a written plan. The plan must provide that the value of any transportation is furnished in addition to, not in lieu of, any compensation otherwise payable to the employees. The plan must not discriminate in favor of employees who are officers, stockholders, or highly compensated individuals. This exclusion does not apply to self-employed individuals.

81. Employment Tax Regs. §31.3401(a)-(1)(b)(10).
82. R.I.A. Fed. Tax Coordinator 2d, H-1703.
83. *Your Federal Income Tax*, I.R.S. Pub. 17, 1979 ed., p.31.

511 Rental Value of Parsonages

Practitioners whose clients include clergymen or religious institutions should recommend maximum use of the benefits provided by sec. 107.

Section 107 permits a clergyman to exclude from income either (*a*) the rental value of a home, including utilities, furnished to him as part of his compensation or (*b*) a compensatory rental allowance, to the extent that it is 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 that 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). The service has ruled that a rental allowance is not excludible to the extent that it exceeds reasonable compensation.[84]

84. Rev. Rul. 78–448, 1978–2 C.B. 105.

6

Exempt Income

Residence-Related Exclusions

601 Sale or Exchange of Residence

Whenever possible, an individual who contemplates selling his home at a gain should arrange the sale so that it qualifies for the sec. 121 exclusion or the sec. 1034 deferment of gain.

In accordance with regs. sec. 1.262-1(b)(4), losses sustained on sales or exchanges of personal residences are normally not deductible (except in the situations discussed in chapter 25). In contrast, gains realized on such sales or exchanges are usually taxable. The code harbors two major relief provisions that can materially mitigate the resulting tax, even though it is computed at favorable capital gain rates. One relief measure can provide individuals who are at least fifty-five years old with a $100,000 tax exemption; the second relief provision permits deferral of these gains 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 chapter 15.)

601.1 Planning to Qualify Under Section 121

Section 121 excludes a limited amount of gain received from the sale or exchange of a personal residence from the gross income of taxpayers who have reached age fifty-five before the sale or exchange occurs. To be eligible for this treatment, they must have owned and used the property as their principal residence for three of the five years immediately preceding the sale or exchange. If financial and family circumstances permit, a proposed sale should be delayed until these requirements are satisfied.

Example Client and wife, whose child has grown up and moved out, no longer need their jointly owned family homestead, which they purchased twenty years ago for $15,000. Their home is currently worth $80,000. The Clients 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 on the homestead's sale.

Client has just turned fifty-four, and his spouse is fifty. Accordingly, a CPA advises them, solely from a tax standpoint, to delay the sale of their home for one year (until Client is fifty-five).

A similar one-year delay should be planned if the client were over fifty-four but had owned and used the property as his principal residence for only two years.

If the property is jointly held, the age, ownership, and use requirements must be satisfied by one spouse if a joint return is filed for the year of sale.[1] For this reason, joint ownership, which does not include tenancy in common, may be preferable to separate ownership.

In the case of a sale or exchange of a residence before July 26, 1981, a taxpayer who is sixty-five on the date of disposition may elect to substitute a five-of-the-last-eight-years ownership and use test. If a taxpayer made an election under sec. 121 prior to its amendment for a sale or exchange on or before July 26, 1978, the taxpayer is eligible for the new sec. 121 election without reduction of the excludible amount.[2]

The application of sec. 121 is limited to $100,000 ($50,000 in the case of a separate return by a married individual).

Regulations section 1.121-5(e) provides that if a residence is used only partially for residential purposes, only that part of the gain allocable to the residential portion is excluded under sec. 121(a). The service has ruled that business use of a residence limits the benefits of sec. 1034, even if expenses are not deductible due to the requirements of sec. 280A. (See the discussion in chapter 15 of IRS Ltr. Rul. 7935003.) Accordingly, taxpayers may want to avoid using a home for any purpose other than residential use to avoid the possibility that it will jeopardize the benefits of sec. 121.

1. Regs. §1.121–5(a).
2. §121(b)(3).

601.2 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, the exclusion is elective; it may be made or revoked at any time before the expiration of the period for claiming a tax credit or refund (approximately three years after the year of the sale or exchange).[3] Regulations section 1.121-2(b)(1)(ii) deals with the situation of two taxpayers who, before their marriage, own and use separate residences. If after their marriage both residences are sold, whether or not in a single transaction, a sec. 121(a) election may be made with respect to the 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.

Regulations section 1.121-4(b) requires a taxpayer and his spouse to sign a statement of election and to provide other information indicating compliance with sec. 121. The regulation also refers to Form 2119 and its instructions. Although Form 2119 does *not* require a signature for this purpose, the taxpayer and his spouse may find that signing it is advisable.[4]

If a taxpayer is married at the time of the sale or exchange, sec. 121(c) requires the taxpayer and his spouse to make a dual election (or revocation). Should the taxpayer's spouse die after the sale or exchange, her personal representative must join in any subsequent election. However, regs. sec. 1.121-4(a) states, "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. . . ."

As a precaution, a signed statement pursuant to regs. sec. 1.121-4(b) should accompany an amended return if the election is retroactively exercised within the subsequent three-year period.

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3. §121(c).

4. See *H.M. Welch*, T.C.M. 1979–9, denying the exclusion where the taxpayer failed to submit a signed statement as required by the regulations. The taxpayer apparently did not file Form 2119 or any other statement.

Prior Election and Subsequent Remarriage

As previously indicated, a spouse must join in an election that can only be exercised once by either a client *or* his spouse. Regulations section 1.121-2(b)(2) contains examples that illustrate the effect of an election made in a prior marriage, its subsequent revocation, and other timing factors that can provide some planning opportunities in similar situations.

Revocation of Election

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

Regulations section 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." The taxpayer and his spouse should consider the feasibility of a positive testamentary direction to join in any future revocation.

Certain revocations also require the taxpayer to file a consent to a one-year extension of the statutory period for assessment of any deficiency (to the extent that the deficiency is attributable to the revocation of the election). This additional requirement is imposed if the revocation is filed within a year of when the statutory assessment period for the year of the election is due to expire. The consent must be filed before such expiration.[5]

Tax Return Filing Requirements

Section 6012(c) requires calculation of gross income *without* regard to any sec. 121 exclusion for the purpose of determining tax return filing requirements.

601.3 Special Rules

Section 121(d) prescribes special rules to cover the following:

- Property jointly held by husband and wife.
- The sale of property previously owned by a deceased spouse.
- Tenant-stockholders in cooperative housing corporations.
- The effect of involuntary conversions.

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5. Regs. §1.121-4(c).

- Property partially used as a personal residence.
- Marital status.
- Relationship to involuntary conversions (sec. 1033) and other relief provisions (sec. 1034).

See regs. sec. 1.121-5 for a detailed explanation of these special rules. There is also a special rule for principal residences that are repossessed and resold within one year (sec. 1038(e)).

602 Minimum Rental Use

If practical, the taxpayer should rent his residence or vacation home for less than fifteen days in order to exclude the rentals from income.

If a residence or vacation home used as a residence during the taxable year is rented for less than fifteen days during the taxable year, the rental income is not included in gross income.[6] Deductions otherwise allowable because of rental use are not allowed. The rules pertaining to rentals of vacation homes are discussed more fully at 3002.

603 Insurance Reimbursement for Certain Living Expenses

Individuals should consider insurance programs that provide for receipt of reimbursements to cover extraordinary living expenses in the event that a casualty causes the loss of their residence.

If a taxpayer receives insurance proceeds as reimbursement for living expenses that he and members of his household have incurred because they have lost the use of their principal residence, the taxpayer can exclude the proceeds from gross income in either of two circumstances:

1. The residence has been damaged or destroyed by fire, storm, or other casualty.
2. Access to the residence has been denied by governmental authorities because of the occurrence, or threat of occurrence, of such a casualty (sec. 123).

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6. §280A(g)(2).

The exclusion is subject to the following limitation:

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

In order to avoid any controversy with the IRS regarding 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 offers 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][7]

7. U.S., Congress, Senate, 91st Cong., 1st sess., 1969, S.Rep. 91–552, pp.272–73.

7

Exempt Income

Investments and Other Properties

701 Exempt Investment Income

701.1 Municipal Interest

When making investment decisions, the tax planner should consider the tax exemption granted to interest on municipal bonds.

Section 103(a)(1) exempts from federal income tax the interest earned on obligations of states, territories, U.S. possessions, the District of Columbia, or their political subdivisions. (This well-known exemption has become a factor in setting the yield rate on municipal bonds.)

701.2 Dividend Exclusions

A taxpayer should spread the ownership of income-producing stocks within his family to obtain multiple $100 exclusions.

For 1981 and 1982 only, individuals can exclude up to $200 of combined interest and dividends ($400 on a joint return).

The merits of a gift program are discussed elsewhere in this study. (See chapter 9, regarding deflection of income to lower brackets). Where these gifts consist of dividend-producing stocks, additional $100 exclusions may be possible—depending on 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 1980 joint return as follows.

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

Client is advised by a CPA to give twenty shares each to his four children and their spouses on January 2, 1981. These gifts would result in the following reporting on each of the five 1981 joint returns.

Dividends received	$ 200
Less exclusion	200
Taxable dividends	$ None

This example assumes that each return also reported $200 of interest income (described in sec. 116(c)(1)). The gifts to the children's spouses are made to obtain additional gift tax exclusions. In 1983 Client should give twenty shares to his wife to continue to obtain the maximum exclusion.

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

At the very least, *both* husband and wife should attain the full use of their separate $100 exclusions—in the absence of personal reasons to the contrary—in 1980 and after 1982.

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

It may not be necessary to avoid a joint interest in stock (with right of survivorship) for a gift of stock to a spouse. Under sec. 2040(b) (discussed in 3502) the inclusion in the gross estate is limited to one half the value of a qualified joint interest. One of the requirements of sec. 2040(b) is that the creation of the qualified joint interest must be the result of a completed gift. For example, a transfer of separate funds to a joint brokerage account where securities are held in a street name is not a completed gift.[1] Of course, the desirability of a qualified joint interest or some other form of

1. Rev. Rul. 69–148, 1969–1 C.B. 226.

ownership must be evaluated in the context of the individual's overall estate plan.

Section 116 authorizes the exclusion for dividends received from qualified corporations, which are generally taxable domestic corporations. Accordingly, dividends from the following sources are not eligible for the exclusion:

- Foreign corporations, including controlled foreign corporations.
- So-called exempt organizations (charitable, fraternal, and so forth) and exempt farmers' cooperative organizations.
- Regulated investment companies, except for amounts designated as dividends for these purposes.
- Real estate investment trusts.
- Subchapter S corporations to the extent that the amounts are distributed from current earnings and profits. For this purpose, current earnings and profits are limited to taxable income for the year.[2]

702 Increasing Basis of Property

An individual should use expiring carryovers to step up the basis of property tax-free through wash sales.

Chapter 4 discusses the acceleration of income and the postponement of deductions as means of preventing the waste of expiring net operating loss, investment credit, and contribution carryovers. But, acceleration or postponement may not always be possible.

If such is the case, an individual can salvage the use of these carryovers by increasing the basis of property through currently taxable dispositions in order to reduce any future gains (or increase any future losses). The current tax generated by the basis increase should not exceed the amount necessary to absorb the tax value of the expiring carryover. In order to protect the investment position in the property being disposed of, the taxpayer can acquire substantially identical property near the time of the disposition.

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

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2. §1375(b).

Example Client, a single individual, has an unused net operating loss carryover of $40,000 that expires in 1980. His projected taxable income for 1980 is $19,000, computed as follows.

Commission income		$25,000
Charitable contributions	$2,000	
Property tax	1,400	
State income tax	1,500	
Interest expense	2,400	
	7,300	
Zero bracket amount	2,300	
Excess itemized deductions	5,000	
Personal exemption	1,000	6,000
Estimated taxable income excluding net operating loss carryover		$19,000

For reasons beyond his control, Client is unable to follow any of his CPA's suggestions for accelerating any 1981 income or postponing any 1980 deductions. The CPA then suggests that Client sell and purchase his stock in Universal Airlines, since it has the attributes shown in figure 7-1.

Figure 7-1

Unrealized appreciation	
Current market value	$62,250
Less Client's original basis (cost)	4,000
Unrealized appreciation	$58,250
Future disposition	
(1) To be sold in five years (1985) to finance expected business and personal projects	
(2) Estimated 1985 gain:	
Estimated 1985 market value	$80,000
Less original basis	4,000
Estimated gain	$76,000

The CPA's recommendation can decrease the estimated 1985 gain by $58,250 at a 1980 tax cost of only $1,495, as shown in figure 7-2.

Figure 7-2

1985		
Estimated selling price		$80,000
Less basis (cost) of stock purchased in 1980		62,250
Estimated gain		17,750
Less gain previously estimated		76,000
Decrease in estimated gain		($58,250)
1980		
Additional long-term capital gain		$58,250
Commission income		25,000
Gross income (revised)		83,250
Less		
Capital gain deduction (60% of $58,250)	$34,950	
Net operating loss carryover	40,000	74,950
Adjusted gross income (revised)		8,300
Less		
Itemized deductions	7,300	
Zero bracket amount	2,300	
Excess itemized deductions	5,000	
Personal exemption	1,000	6,000
Taxable income (zero bracket amount)		2,300
Regular Tax		$ None
Alternative minimum taxable income		
Taxable income (net of zero bracket amount)		$ -0-
Capital gain deduction		34,950
Alternative minimum taxable income		$34,950
Alternative minimum tax		$ 1,495

703 Appreciated Property Distributed by Fiduciaries

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 the fiduciary. The beneficiary's taxable gain is reduced when he subsequently disposes of the property. Accordingly, appreciation in the property's value at the time of its distribution by the fiduciary will forever escape income tax.

Regulations section 1.661(a)-2(f) lists the following consequences that occur if property is paid, credited, or required to be distributed in kind by a complex (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.[3]
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]

Figure 7-3 shows how a beneficiary can acquire property from a fiduciary at a stepped-up basis without any correlative recognition of gain.[4]

Tax planners must remember that regs. sec. 1.661(a)-2(f) is equally applicable in the reverse situation (distribution of property that has declined in value). *Therefore, the fiduciary should avoid distributions of property resulting in a stepped-down basis, since the corresponding loss is not recognized by either fiduciary or beneficiary.*

In the case of a terminating trust with a large potential accumulation distribution, it may be advantageous to distribute appreciated assets equal to the accumulation distribution within the year immediately preceding the year of termination, thereby achieving a step-up in basis to fair market value. The remaining assets in the trust can then be distributed during the final short period, with a

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3. In Rev. Rul. 67–74, 1967–1 C.B. 194, distribution of appreciated securities resulted in capital gain to a simple trust equal to the difference between the basis of the stock and the amount of the obligation satisfied. Distribution (within two years of a transfer to a trust) that satisfies a specific obligation may also trigger §644 gain, which is discussed in 902, herein.

4. Also see Rev. Rul. 63–314, 1964–2 C.B. 167, which illustrates the application of these regulatory provisions when several assets are distributed in kind. For additional discussion and illustration, see B. Barnett, "The Taxation of Trust Distributions Revisited After the '76 Act," *Tax Adviser* 9 (January 1978): 32.

Figure 7-3

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

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

carryover basis to the beneficiaries. To attain the maximum benefit from this technique, the fiduciary should, if possible, distribute only cash in the termination year.[5]

The Treasury-supported proposed carryover basis simplification act (H.R. 4694) would have repealed this stepped-up basis for distributions made by trusts in taxable years beginning after 1979. The carryover basis provisions were repealed by the Crude Oil Windfall Profit Tax Act of 1980, which, however, did not repeal the stepped-up basis for trust distributions.

704 Handling Appreciated and Declined-in-Value Properties Prior to Death

If possible, appreciated property should not be sold prior to a taxpayer's death in order to permit otherwise taxable gains to be eliminated by stepped-up basis. Conversely, declined-in-value property should be sold

5. See regs. §1.661(a)–2(f)(3). Also see *Working With the Revenue Code 1979*, ed. I.F. Diamond and M. Walker (New York: AICPA, 1979), pp.268–69. For additional considerations dealing with terminations of trusts and estates, see 3203 of this study.

to recognize losses otherwise eliminated by stepped-down basis acquired at the taxpayer's death.

Appreciation in the value of property completely escapes income tax upon the owner's death, since the new owner's basis generally equals the value placed on the property for estate tax purposes. In turn, the estate tax value is the fair market value at the date of death or at the alternate valuation date (generally six months later). Consequently, the operation of these provisions also means that declines in property values escape income tax recognition, in the form of capital (or ordinary) losses, as a result of death.

Although a sale may be advisable from an income tax standpoint, the sale may be inadvisable for personal or investment reasons.

704.1 Special Carryover Basis Election

Executors could have elected carryover basis for certain decedents; however, the deadline for the election expired on July 31, 1980.

8

Deflected Income

Incorporation of Income-Producing Properties

When possible, the tax planner should expose taxable income to lower corporate rates. Incorporation may also be beneficial in valuing property for estate and gift tax purposes.

The following table (figure 8-1) illustrates the attractiveness of diverting a higher-bracket individual's unneeded income to corporate taxation. Income is shifted from the individual's highest marginal bracket to a corporate rate as low as 17 percent.

Figure 8-1

Marginal Rates for 1980

Taxable income	Corporate	Individual: Joint return	Individual: Single	Individual: Head of household
0–$25,000	17%	14%–32%	14%–39%	14%–36%
$25,001–$50,000	20%	32%–49%	39%–55%	36%–54%
$50,001–$75,000	30%	49%–54%	55%–63%	54%–59%
$75,001–$100,000	40%	54%–59%	63%–68%	59%–63%
Over $100,000	46%	59%–70%	68%–70%	63%–70%

There are advantages and disadvantages to incorporating income-producing properties. These are discussed extensively in the AICPA Federal Tax Study 1, *Tax Guide for Incorporating a Closely Held Business*. A similar analysis would be beyond the scope of this study. Although that study primarily concerns properties that produce business income, many of the principles that it considers apply equally to assets that produce nonbusiness income.

801 Personal Holding Company Consequences

The tax planner should try to avoid personal holding company classification.

The incorporation of passive investments generally creates a "personal holding company" (PHC) whose pitfalls are described in 204.2 of Tax Study 1 (revised edition). The pitfalls can be avoided if the new corporation (1) receives the proper mixture of business and investment income or (2) pays dividends as required by the code's personal holding company provisions.

Section 532(b)(1) exempts personal holding companies from the accumulated earnings tax. Thus, a corporation may escape personal holding company classification only to be exposed to the accumulated earnings tax.[1] On the other hand, accumulated earnings tax rates are considerably less than personal holding company rates, as is shown by the following comparison.

	Accumulated earnings tax	Personal holding company tax
First $100,000 of accumulated taxable income	27.5%	
Accumulated taxable income in excess of $100,000	38.5%	
Undistributed personal holding company income		70%

For further consideration of the impact of the accumulated earnings tax on the question of incorporation, see 204.1 of Tax Study 1.

801.1 Sheltering Income

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

1. §533(b) states, "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. §1.533-1(b) and (c), respectively. See also *Rhombar Co., Inc.*, 386 F.2d 510 (2d Cir. 1967), aff'g 47 T.C. 75 (1966), acq. 1967-2 C.B. 3; *Dahlem Foundation, Inc.*, 54 T.C. 1566 (1970), acq. 1971-2 C.B. 2; and *Cockrell Warehouse Corp.*, 71 T.C. no. 93 (1979).

The personal holding company problem is most acute when PHC income consists of such passive investment income as interest or dividends. Even then, partial sheltering may be possible through recourse to the relief procedure illustrated in the following example.

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 figure 8-2.

Figure 8-2

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 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 item *c* is at least 60 percent of item *d*.

This result can be avoided if adjusted income from rents is eliminated from personal holding company income. To accomplish this, the corporation must satisfy *both* of the following requirements:

1. Adjusted income from rents constitutes 50 percent or more of adjusted ordinary gross income. This test is met:

		% 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 the amount by which nonrent personal holding company income exceeds 10 percent of ordinary gross income. This test is *not* met:

(*a*)	Nonrent 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

The CPA advises Client to pay a $21 dividend before year-end and thus avoid personal holding company classification.[2]

802 Estate and Gift Tax Aspects of Property Incorporation

Incorporation can provide more realistic valuations for property that would otherwise be difficult to value. Also, discounts from underlying asset values may possibly result from corporate ownership and from estate freezing.

802.1 More Realistic Values

The incorporation of property facilitates the transfer of ownership interests and thus establishes greater flexibility regarding their disposal than is possible for unincorporated property. This market can provide meaningful comparisons for determining the fair market value of property transmitted by death or by gift, which is necessary for ascertaining estate or gift taxes.

The extent to which incorporation can be used to determine fair market value depends on the activity of the particular market.

2. Based on the example in U.S., Congress, Senate, S. Rep. (Supplemental) 830, part 2, 88th Cong. 2d sess., 1964, p.249, explaining the operation of §543(a)(2), as amended by the Revenue Act of 1964.

Listed securities frequently traded in a nationally recognized stock exchange present virtually no valuation problems; at the other extreme, a comparative market test alone may not suffice for inactive closely held stock.

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

802.2 Discounted Values

Although fair market usually is based on selling prices or bid and asked prices, additional valuation criteria are permitted "if it is established" that such prices do not reflect fair market value.[3] These additional criteria apply if the sales activity is unreliable or if a significant quantity of shares is involved. In most instances, the use of such criteria results in reduced values, although the opposite may be true in the case of a controlling interest.

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."[4] Hence, discounts for lack of marketability have been allowed.[5]

Blockage Rule

Where the selling price or the 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

3. Estate Tax Regs. §20.2031-2(e).

4. Estate Tax Regs. §20.2031-2(e).

5. *The Central Trust Company, Ex'r. et al.*, 305 F.2d 393 (Ct. Cl. 1962). See generally R.E. Moroney, "Why 25% Discount for Nonmarketability in One Valuation, 100% in Another," *Taxes: The Tax Magazine* 55 (May 1977): 316.

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.[6]

In the latter circumstance, a *premium* value is invariably ascribed to the controlling interest.

In *Schnorbach, Exr., v. Kavanagh,* the blockage rule was held to be inapplicable in the absence of an existing open market.[7] Nevertheless, the court considered the lack of an active market that could immediately have absorbed the amount of stock in issue as evidence 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.[8]

One of the primary areas for application 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."[9]

In determining the fair market value of a holding company, the practitioner should consider applying the blockage theory to the stock held in its investment portfolio.

Applying the blockage rule tends to invite scrutiny, since regs. sec. 20.2031-2(e) requires the taxpayer to submit complete data with the estate tax return in support of any blockage allowance claimed.

The value of closely held real estate and other investment companies might be reduced by a discount for income taxes and other disposal costs.[10]

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6. Estate Tax Regs. §20.2031-2(e).

7. *Schnorbach, Ex'r., v. Kavanagh*, 102 F.Supp. 828 (D. Mich. 1951).

8. I.R.S., *Appellate Conferee Valuation Training Program*, In-Service Training Publication no. 6126-01 (4-67), in CCH, *Standard Federal Tax Reports* (Chicago: Commerce Clearing House) no. 17, part II (March 29, 1978): 58, states that the blockage theory would not apply to unlisted class A voting common that, except for voting rights, was identical to class B nonvoting stock that was listed on the NYSE.

9. Mertens, *Law of Federal Gift and Estate Taxation* (Chicago: Callaghan & Co.), §8.06, n.24, citing *Ivens Sherr*, 10 T.C.M. 671 (1951). Also see *Est. of Matthew I. Heinold*, T.C.M. 1965-6, aff'd 363 F.2d 329 (7th Cir. 1966), cited in Mertens Supp. See also *Est. of Ethyl L. Goodrich*, T.C.M. 1978-248.

10. *Obermer*, 238 F.Supp. 29 (D. Hawaii 1965), which distinguished the contrary *Cruikshank*, 9 T.C. 162 (1947), case on the grounds that expert testimony about the adverse effect of such factors was not offered. Discounts for income taxes were similarly disallowed in *E.A. Gallun*, T.C.M. 1974-284, and *Est. of J.E. O'Connell*, T.C.M. 1978-191. See also

802.3 Freezing the Estate Through Stock Ownership

An important consideration is the structuring of ownership and voting rights in the corporation.

An individual may incorporate and retain preferred stock, which represents the bulk of the corporation's initial value, while his children receive the common stock, which will gain in value as a result of future appreciation. This arrangement effectively freezes the estate or gift tax value of the preferred stock. Even if the children receive the common stock as gifts, the gift tax consequences should be minimal, since the common stock has relatively little initial value.

The parent may also retain voting control via the preferred stock; however, if the preferred stock is valued at a discount, voting rights should not be structured so that the executor can obtain the underlying assets by liquidating the corporation. If control is necessary to effect a liquidation during the individual's lifetime, the charter may effectively vest voting control in the common stock at death. This may permit a lower valuation at death. Since such valuation at the moment of death is a "difficult problem, the alternate valuation (sec. 2032) might be considered."[11]

802.4 Tax Pitfalls of Incorporation

Incorporation of properties also requires consideration of their future ownership.

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

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Est. of F.J. McTighe, T.C.M. 1977-410, including n.8 thereof. For further information on this subject, the reader is directed to such articles as "How to Use a Personal Holding Company as an Effective Estate, Financial Planning Tool," *Journal of Taxation* 42 (April 1975): 202; "How to Sustain a Lower Valuation for Stock of a Closely Held Investment Company," *Journal of Taxation* 25 (July 1966): 40; "Reduction in Value of Closely Held Stocks Due to Income Tax Liabilities," *Taxes: The Tax Magazine* 44 (July 1966): 487; and "Valuation of Closely Held Securities: Accounting Know-How is the Key," *The Journal of Accountancy* 121 (March 1966): 47.

On the other hand, the planner should be aware of I.R.S. Ltr. Rul. 8010017, which rejected discounts for family minority interests. It has been reported that the IRS intends to propose regulations along these lines.

11. See Shop Talk, ed. B. Kanter, *Journal of Taxation* 44 (May 1976): 320–21.

corporation is formed, it will be more difficult to divide it up later into brother-sister corporations in a tax-free transaction.[12]

For example, assume that a client owns two office buildings and desires to devise the buildings separately to his two children. He also wishes to incorporate the buildings during his lifetime. If both buildings are incorporated in one corporation, it may be difficult to avoid an IRS challenge regarding compliance with sec. 355 in achieving a tax-free separation of this solitary corporation after the client's death.

Accordingly, in this type of a situation, an individual should carefully consider the merits of a multiple incorporation.[13] The individual should remember, though, that multiple corporations that are members of a controlled group are entitled to one set of graduated rate schedules and a single accumulated earnings credit. The decision whether to use multiple corporations must take into account sundry other income tax factors, as well as such estate tax considerations as the possibility of losing the relief provisions of secs. 303 and 6166 or 6166A.[14]

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12. R. Steinman, *Tax Guide for Incorporating a Closely Held Business*, Federal Tax Study 1, rev. ed. (New York: AICPA, 1978), p.66.

13. *Est. of Moses L. Parshelsky*, 303 F.2d 14 (2d Cir. 1962), rev'g and rem'g T.C.; *J.V. Rafferty*, 55 T.C. 490 (1970), aff'd 452 F.2d 767 (1st Cir. 1971), cert. den. 408 U.S. 922; and *M. Wilson et al.*, 353 F.2d 184 (9th Cir. 1965), rev'g and rem'g T.C.

14. Steinman, *Tax Guide for Incorporating a Closely Held Business*, pp.64–67.

9

Deflected Income
Gifts

A taxpayer should use gifts to shift income to lower-bracket family members.

901 Outright Lifetime Gifts

This technique involves other planning considerations, such as the choice between outright lifetime gifts and other donative dispositions, collateral income tax effects of outright lifetime gifts of depreciable property, minimization of gift taxes, the effect of the unified transfer tax system, ineffective gifts, and net gifts.

The deflection of income to lower-bracket taxpayers has obvious income tax advantages. This form of income shifting can be readily accomplished through gifts; however, Justice Holmes stated in a Supreme Court opinion, "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."[1] To be effective for income tax purposes, gifts of income also require gifts of the underlying property that produces the income. In terms of Justice Holmes's metaphor, a gift of fruit alone will not be recognized unless also accompanied by a gift of the fruit-producing tree.

This section assumes that gifts of income are desirable and, hence, is concerned only with the effects of the requisite gifts of principal.

1. *Lucas v. Earl*, 281 U.S. 11 (1930). To the same effect, see the Supreme Court's decision in *Paul R. Horst*, 311 U.S. 112 (1940), 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. See also *Basye*, 410 U.S. 441 (1973).

901.1 Outright Lifetime Gifts vs. Other Donative Dispositions

An outright lifetime gift requires the taxpayer to forfeit this enjoyment of, and dominion over, the underlying property and its income for the balance of his life. The tax planner should weigh the relative merits of outright lifetime gifts versus testamentary transfers.

An outright lifetime gift of property channels the income it produces to the donee's income tax bracket, beginning *immediately* on the effective date of the gift. Such a gift, in contrast to a testamentary transfer, can remove income from a client's bracket during his lifetime, but this income tax benefit can only be gained through the surrender of control over property and its income. If lifetime control over property is paramount, an individual can deflect income through the use of limited-term trusts that meet the statutory standards prescribed by secs. 671 to 679. (These trusts are discussed in 902.)

901.2 Collateral Income Tax Effects of Outright Lifetime Gifts

The tax planner should consider the collateral income tax effects of outright lifetime gifts.

Investment Credit Recapture

Regulations section 1.47-2(a)(1) states that a gift is included among the premature dispositions that can cause recapture of the investment credit. (Section 47(b)(1) specifically excepts a transfer by reason of death from the recapture provision.)

Carryover of Depreciation Recapture

A gift of depreciable property does not trigger the recapture of the donor's depreciation deductions as ordinary income.[2] However, the ordinary income potential of depreciation and similar deductions carries over into the donee's hands. The donee takes into account the donor's depreciation deductions, which may produce ordinary income upon the donee's disposition of the property.

Gifts of Section 1250 Property

The donee receives the benefit of the donor's holding period. The donor and donee are treated as though they are one person, with

2. §§1245(b)(1) and 1250(d)(1).

the result that, upon any subsequent sale by the donee, the amount treated as ordinary income is the same as it would be if the donor held the property throughout the entire period.

Similarly, the holding period of both the donor and the donee is used to determine the percentage decrease in total gain to be taken into account as ordinary income. A smaller proportion of the gain is treated as ordinary income than would be the case if only the donee's holding period were used.[3]

With the limited exception for low-income rental housing, there is now complete recapture of all post-1975 sec. 1250 depreciation in excess of straight-line (as discussed in 1202). The holding period necessary to avoid sec. 1250 recapture of pre-1976 depreciation in excess of straight-line is shown in figure 12-5 of chapter 12.

Before making gifts of depreciable property, an individual should consider the following points:

1. He should give appreciated property to shift ordinary income potential to a lower-bracket donee.
2. Extending the holding period by means of a gift (that is, continuing the holding period of the donor and donee) may reduce or eliminate sec. 1250 recapture for certain properties and not others.
3. A bargain sale transfers appreciation to the donee but allows the donor to recover his adjusted basis.[4] As an alternative, the donor can mortgage the property for the same amount before making the gift.[5] If multiple assets are involved (for example, land, buildings, and equipment), proceeds should be allocated according to fair market values; otherwise, unnecessary gain can result for a particular asset even though there is no overall gain.
4. The basis of property acquired by gift is generally the basis of the property in the hands of the donor,[6] increased, in the case of gifts made after 1976, for the gift tax attributable to the net

3. Regs. § 1.1250-3(a)(3)(ii).

4. A part-sale, part-gift to a transferee other than a charity should not result in a taxable gain unless the amount realized exceeds the property's adjusted basis (regs. § 1.1001-1(e)).

5. There should be no taxable gain unless the debt exceeds basis. Regs. § 1.1001-1(e); *J.W. Johnson, Jr.*, 59 T.C. 791 (1973), aff'd 495 F.2d 1079 (6th Cir. 1974), cert. den. 419 U.S. 1040; *Est. of Aaron Levine*, 72 T.C. no. 68 (1979); Rev. Rul. 77-402, 1977-2 C.B. 222. Also see prop. regs. § 1.1001-2.

6. If basis is greater than fair market value at the time of the gift, then the basis for determining loss is fair market value (§ 1015(a)). Therefore, declined-in-value property should not be the subject of a gift to avoid this step-down in basis.

appreciation on the gift.[7] While sec. 1015(d)(1) prevents the addition to basis for gift tax from increasing basis above fair market value, this limitation apparently does not affect post-1976 gifts, since only the gift tax on the net appreciation is added to basis. In valuing property not susceptible to objective determination, the practitioner should keep in mind the possible interrelationship between transfer and income taxes. For example, the gift tax valuation may affect the estate tax valuation of nonmarketable securities, which may result in a significantly higher income tax basis to the donee's heirs under sec. 1014 (see 704).

5. If property is held until death, the income that would otherwise be taxed may be exempt from income tax as a result of this stepped-up basis.
6. The donor should not give declined-in-value property. The depreciation taint carries over to the donee, who may subsequently recognize this ordinary income potential upon a taxable disposition. Instead, the individual should sell such property in order to claim his sec. 1231 loss. Depreciation recapture is inapplicable to dispositions in which losses are realized. Section 267 usually disallows the loss on a sale to a would-be donee. The loss cannot be shifted to a donee in a higher bracket than the donor's, since the donee's basis for the property would be its fair market value at the time of the gift.[8]
7. The donor should consider gifts of assets that will change the composition of the estate to qualify for a sec. 303 redemption (discussed at 1302) or deferred payment of estate tax.[9]

901.3 Minimizing Gift and Estate Taxes

A donor can avoid taxable gifts, even after the unified credit has been exhausted, by not making gifts to any one donee that exceed the available $3,000 exclusion ($6,000 if marital gift splitting applies). If the value

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7. "Congress believed that prior law was too generous in that it permitted the basis of the gift property to be increased by the full amount of the gift tax paid on the gift and not just the gift tax attributable to the appreciation at the time of the gift. Consequently, the Act provides that the increase in basis of property acquired by gift is limited to the gift tax attributable to the net appreciation on the gift." U.S., Congress, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976*, 94th Cong., 2d sess., 1976, p.561.

8. § 1015(a). Compare the potential for deductible losses on sales between an estate and its beneficiaries, discussed in *Working With the Revenue Code 1979*, ed. I.F. Diamond and M. Walker (New York: AICPA, 1979), p.90.

9. §§6166 and 6166A.

of the property to be given cannot be confined to the amount of these exclusions, the donor can still keep the amount of reportable (gross) gifts within the exclusion limit through partial gifts or certain staggered gifts. Also, by meeting express statutory requirements, the taxpayer can obtain exclusion for gifts to minors, even if the gifts constitute future interests.

Partial and Staggered Gifts

The gift tax provisions of the Internal Revenue Code permit taxpayers to compute gifts by subtracting the following items from the value of gifts that they have made during the year:

- 50 percent of gifts to third parties that are deemed to be made by the donor's spouse, in accordance with the consent of both spouses pursuant to sec. 2513 (see 3602).
- The $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").
- The marital deduction (generally, the first $100,000 of qualifying gifts to a spouse and 50 percent of gifts in excess of $200,000) (see 3302).
- The deduction for charitable gifts (see chapter 31).

In addition, the donor may subtract the unified credit of $42,500 in 1980 ($47,000 after 1980) in computing the gift tax. The unified credit translates into the equivalent of a deduction, commonly termed the "exemption equivalent," of $161,563 in 1980 and $175,625 after 1980.

Under the unified transfer tax system introduced by the Tax Reform Act of 1976, lifetime gifts directly affect the estate tax computation. (See the discussion at 901.4.)

A married client can transfer up to $363,250 in gifts to his daughter over the two-year period of 1980-1981 without incurring gift tax (as shown in figure 9-1, p.104). It is assumed that neither the client nor the client's spouse has made prior taxable gifts.

Example 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 1980. His CPA suggests that he transfer 300 shares in December 1980 and the balance in early January 1981 rather than all 600 shares in 1980.

In the *Haygood* case, a mother transferred property in 1961 to her sons in return for vendor's lien notes secured by trust deeds for

Figure 9-1

Client	1980	1981
Current gifts	$329,126	$ 34,124
Less gifts attributable to spouse under sec. 2513	164,563	17,062
Balance	164,563	17,062
Less annual exclusion	3,000	3,000
Balance	161,563	14,062
Prior taxable gifts	—	161,563
Total taxable gifts	161,563	175,625
Tentative gift tax	42,500	47,000
Less		
Prior gift taxes paid	—	—
Unified credit	42,500	47,000
Gift tax payable	$ None	$ None
Spouse		
Gifts attributed from spouse	$164,563	$ 17,062
Less annual exclusion	3,000	3,000
Balance	161,563	14,062
Prior taxable gifts	—	161,563
Total taxable gifts	161,563	175,625
Tentative gift tax	42,500	47,000
Less		
Prior gift taxes paid	—	—
Unified credit	42,500	47,000
Gift tax payable	$ None	$ None

the value, payable at $3,000 per year; she then canceled the payments as they fell 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.[10]

The taxpayer won a similar victory in *Kelley*, in which the taxpayer transferred property in exchange for valid vendor's lien notes and forgave the notes at or about the time they became due.[11] To prevent such a transfer from being a completed gift of

10. 42 T.C. 936 (1964), nonacq. 1977-2 C.B. 2.

11. 63 T.C. 321 (1974), nonacq. 1977-2 C.B. 2.

the entire value of the transferred property, it is "essential that the notes issued by the donees constitute valid legal indebtedness and meet all the requirements of the applicable state law, including proper filing of such notes with the appropriate state or local bodies. . . ."[12]

However, the service has nonacquiesced in both the *Haygood* and *Kelley* decisions. It also issued Rev. Rul. 77-299, which holds that a purported sale of non-income-producing property to grandchildren in exchange for non-interest-bearing, nonnegotiable notes secured by a purchase money mortgage constituted gifts equal to the values of the properties transferred. The grandchildren did not have other funds or sources of income with which to buy the property. Notes were executed in amounts equal to the $3,000 annual exclusion, and the grandparent indicated that it was intended that each payment be forgiven as it came due.

Although the service's position has been criticized, the service clearly intends to attack, or at least carefully scrutinize, family loan arrangements that take advantage of the $3,000 annual exclusion by means of annual forgiveness of note payments.[13] If the purported buyer is not in a position to pay the notes, because of an absence of income or other funds, the IRS is especially likely to attack the transfer as a completed gift at the time of transfer. The service may argue that the "buyer's" dubious ability to pay may result in at least a sizeable gift, measured by the difference in the value of the notes and the value of the property transferred.[14]

Another significant problem is the handling of interest. Non-interest-bearing or low-rate term loans have been held to result in taxable gifts, measured by the difference in the value of the property transferred and the fair market value of the notes received in exchange. Charging but cancelling interest may result in a gift

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12. See analysis of the *Kelley* decision by B.A. Abbin, "Significant Recent Developments Concerning Estate Planning (Part III)," *Tax Adviser* 6 (May 1975): 282.

13. See analysis of Rev. Rul. 77-299 (1977-2 C.B. 342) by B.A. Abbin et al., "Significant Recent Developments Concerning Estate Planning (Part III)," *Tax Adviser* 9 (May 1978): 290–91; G.I. Carp, "Intrafamily 'Sale' for Notes: IRS vs. T.C.," *Tax Adviser* 9 (July 1978): 422; and J.R. Krahmer and J.L. Burke, "Family Loans as Gifts," *Estates, Gifts and Trust Journal* (July-August 1978): 4.

14. See *Est. of Reynolds*, 55 T.C. 172 (1970), cited in Rev. Rul. 77-299 and discussed in the context of a "valuation approach" by Krahmer and Burke in "Family Loans as Gifts." See also R.J. Mintz and D. Braddock, "The Installment Gift Technique: How It Works; The Problems Involved in Its Use," *Journal of Taxation* 49 (September 1978): 158. In *Reynolds* the notes bore no interest, absent default, but there were significant principal payments on the notes by the transferees.

equal to the amount forgiven. (Interest-free or low-interest-rate loans are discussed in chapter 10.)

A purported sale for notes may also result in income taxes to the transferor.

To help thwart an IRS challenge to such a transaction, the tax planner should consider the following advice:

- The contract of sale should recite the consideration and state the method of payment.
- Fully executed, enforceable, and assignable interest-bearing notes should be delivered to the vendor.
- The vendor should retain a vendor's lien (purchase money mortgage) to secure payment of the notes, and the mortgage should be recorded.
- No notes should be forgiven at closing, or until the succeeding tax year. When notes are forgiven, the vendor should then reaffirm the existence and enforceability of the remaining notes and convey, in writing, his intent to enforce the remaining notes as they come due.
- The obligors on the notes should acknowledge, in writing, the existence of the notes, their enforceability, and an intent to repay the notes remaining due. This acknowledgment should be made each year following the forgiveness of the preceding year's notes.
- The notes should be part of the vendor's financial statements.
- The notes can be delivered to an agent of the vendor to assure collection. If anything happens to the vendor, the notes are not forgiven, unless the vendor's will so provides. At no time should the vendor advise the vendee that he or she intends to forgive the notes as they come due.[15]

If the IRS successfully challenges the transaction as a completed gift at the time of transfer, in an amount equal to the value of the property transferred, any subsequent payments on the note may also be challenged as taxable gifts from the purported buyer to the purported seller. In view of this danger, the donor might consider "partial gifts."

Example Client, a widower, owns a lot, worth $12,000, which he desires to give his son. His CPA points out that, from a gift tax standpoint, Client should not make a gift of this lot entirely in 1980. Instead, the procedure on p.107 would be preferable.

This technique requires the donor to make a gift each year, and it partially defers the shifting of the incidence of income

15. In G.I. Carp, "Intrafamily 'Sale' for Notes: IRS vs. T.C."

Year	Total value of lot	Value of Client's remaining interest	% of undivided interest given	Value of gift
1980	$12,000	$12,000	25	$3,000
1981	12,000	9,000	33⅓	3,000
1982	12,000	6,000	50	3,000
1983	12,000	3,000	100	3,000

taxation to the donee. It may not be advantageous if the donor anticipates rapid appreciation in the property's value.

Partial gifts, which 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)."[16]

Regulations section 25.2511-1(e) provides the following:

> 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]

Regulations section 25.2503-3(a) precludes exclusion for a "future interest" in property:

> 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]

16. Gift Tax Regs. §25.2503-3(b).

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 is "limited to commence in use, possession, or enjoyment at some future date."[17] Thus, the gift represents a future interest, which is ineligible for the $3,000 annual exclusion.

Nevertheless, sec. 2503(c) expressly provides the following:

> 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).[18]

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, as opposed to mandatory, accumulations of income, the statutory requirements are still satisfied if the following is true:

> 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.* [Emphasis supplied][19]

According to Mertens, "Whether a provision for mandatory

17. Regs. §25.2503-3(a).

18. The exclusion is not affected in states that have lowered the age of majority to 18 years and that require property to be distributed to the donee at age 18 (Rev. Rul. 73-287, 1973-2 C.B. 321).

19. Regs. §25.2503-4(b)(1). The validity of this regulation was upheld in *J.T. Pettus*, 54 T.C. 112 (1970).

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).* [Emphasis supplied][20]

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

Another commentator offers the following warning:

> [For the exclusion to apply,] someone should have much the same control over the property and income for the minor's benefit as an adult over his own property. That control is lacking in the case of gifts for single or limited purposes. Therefore, if a grandfather wants to set up a trust for a grandson the income from which can be used only for educational purposes, . . . his transfer would not be excludable by reason of Section 2503(c). . . .[21]

Example In 1980 Client, who is unmarried, transfers $3,000 to a trust for the benefit of his nephew, age ten. The trust indenture permits income to be accumulated and distributed, along with the principal, to the nephew when the trust terminates ten years later. The $3,000 gift in 1980 is entirely excludible.

Only Unexpended Income Distributable at Age Twenty-one A donor may not consider twenty-one a suitable age for vesting complete control of property to a donee. Accordingly, a trust indenture may contain the following provisions:

- The principal is to be distributed at age twenty-five.

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20. Mertens, *Law of Federal Gift and Estate Taxation* (Chicago: Callaghan & Co.) §38.20. Mertens' Cum. Supp. (1971) also discusses *Pettus*, 54 T.C. 112 (1970). The Congressional explanation is as follows: "Your committee has amended the provisions of the House bill to provide that it is not necessary that the property or income therefrom be actually expended by or for the benefit of a minor during minority so long as all such amounts not so expended will pass to the donee upon attaining majority and, in the event of his prior death, will be payable to his estate or as he may appoint under a general power of appointment" (U.S., Congress, Senate, 83rd Cong., 2d sess., 1954, S.Rep. 1622, p.479).

21. Stephens et al., *Federal Estate and Gift Taxation*, 4th ed. (Warren, Gorham & Lamont), ¶9.04(5)(a); citations omitted.

- Income is to be expended during the donee's minority *at the trustee's unrestricted discretion.* Unexpended income is to be distributed at age twenty-one.
- Income earned after the donee attains age twenty-one is distributable annually.

Under these circumstances, a maximum exclusion of $3,000 is available with respect to the present actuarial value of the donee's right to the income, even though (1) the income may only be enjoyed in the future and (2) the underlying income-producing property (the corpus of the trust) is not distributed to the minor until after he reaches age twenty-one. The exclusion is available even if the corpus is not distributable to the donee at all. For example, the corpus could revert to the donor under a "ten-year trust" arrangement (described in 902).[22]

The actuarial values can be derived from tables in Gift Tax Regs. sec. 25.2512-9, which incorporate a 6 percent interest factor.[23]

Further Availability of the Gift Tax Exclusion Regulations section 25.2503-4(c) states the following:

> 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.

Income Tax Aspects Income Tax Regulations section 1.662(a)-4 contains two pertinent provisions:

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22. *Herr*, 303 F.2d 780 (3d Cir. 1962), aff'g 35 T.C. 732, acq. 1968-2 C.B. 2, withdrawing nonacq. 1962-2 C.B. 6; *Konner*, 35 T.C. 727, acq. 1968-2 C.B. 2, withdrawing nonacq. 1963-2 C.B. 2, 6; *Weller*, 38 T.C. 790, acq. 1968-2 C.B. 3, withdrawing nonacq. 1963-2 C.B. 6. *Est. of David Levine*, 526 F.2d 717 (2d Cir. 1975), rev'g 63 T.C. 136, nonacq. 1978-45 I.R.B. 5, refused to extend the *Herr* doctrine to post-age-21 income, holding that such income was a future interest. However, an exclusion was allowed where a minor's trust accumulated income and principal until a specified age but the beneficiary had the right to withdraw amounts under prescribed conditions (*Crummey*, 397 F.2d 82 (9th Cir. 1968), rev'g TCM 1966-144). Ltr. Rul. 7946007 required the beneficiary to have timely notice of his right to demand corpus in order for the exclusion to be obtained. This type of trust generally might be more desirable than one mandating the distribution of accumulated income and principal at age 21.

23. In Rev. Rul. 79-280, these tables were used to value a gift of non-income-producing property to a short-term trust.

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 obligation of any person is included in the gross income of such person . . ." (emphasis supplied). Under this regulation, a parent can be taxed on the income of a trust that a grandparent has established for a grandchild, even without the parent being named in the trust instrument."[24]
2. "The amount of trust income. . .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 for certain grantor trusts.[25]

901.4 Effect of the Unified Transfer Tax System

An individual should consider lifetime gifts as a means of avoiding transfer tax on postgift appreciation.

Post-1976 gifts are taxed at rates ranging from 18 percent (gifts up to $10,000) to 70 percent (gifts in excess of $5 million) under the unified rate schedule applicable to both gift and estate taxes. Under the unified transfer tax system introduced by the Tax Reform Act of 1976, donors are generally entitled to the full unified credit ($42,500 in 1980 and $47,000 thereafter), regardless of whether they made pre-1977 taxable gifts. (If a donor used the $30,000 prior law exemption against gifts made after September 8, 1976, and before January 1, 1977, there is a 20 percent reduction under sec. 2505(c) in the unified credit.)

A practitioner computes the gift tax on post-1976 taxable gifts by applying the unified rate schedule to cumulative lifetime taxable transfers, including pre-1977 taxable gifts, and then subtracting the tax payable on prior lifetime transfers and the unified credit. The subtraction for prior gift taxes is based on the unified rate schedule, even though the actual gift tax on pre-1977 taxable gifts may have been less.

Pre-1977 taxable gifts have no direct effect on the estate tax computation, although they may affect post-1976 gift taxes, which do enter into the estate tax computation. The estate tax is computed on the sum of the taxable estate and any post-1976 taxable

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24. See *Working With the Revenue Code* 1979, p.270.

25. See regs. §1.677(b)-1, as interpreted in *Brooke*, 300 F.Supp. 465 (D. Mont. 1969), amending 292 F.Supp. 571, aff'd 468 F.2d 1155 (9th Cir. 1972). See also Rev. Rul. 56-484, 1956-2 C.B. 23.

gifts (nontaxable gifts are excluded), other than gifts that are includible in the gross estate; the tax is then reduced by the unified credit and the gift tax payable on post-1976 gifts.[26]

Because pre-1977 taxable gifts affect the gift tax computation, the unified credit of a taxpayer with pre-1977 taxable gifts actually exempts a lesser amount from gift tax than the exemption equivalents.[27]

While lifetime gifts are included in the taxable gift category of the estate tax computation, their value is determined as of the time of the gift. *Thus, lifetime gifts have the advantage of avoiding transfer tax on postgift appreciation.* However, the time value of money (discussed in chapter 4) would have to be considered in weighing the relative advantages of lifetime versus deathtime transfers.

Example Client's sole surviving heir is his daughter. His estate at his death in 1985 totals $800,000. He made a taxable gift of land worth $200,000 ($203,000 less the $3,000 annual exclusion) to his daughter in 1980, on which he incurred a gift tax of $12,300 ($54,800 less $42,500 unified credit).[28] Client had not made prior taxable gifts, which would have affected the gift tax computation (although only post-1976 taxable gifts affect the estate tax computation). His estate tax is determined as follows.

Taxable estate	$ 800,000
Post-1976 taxable gifts	200,000
Sum of estate and post-1976 taxable gifts	1,000,000
Tentative tax	345,800
Less	
Gift tax payable on post-1976 gifts	12,300
Unified credit	47,000
Estate tax (ignoring state death tax credit)	$ 286,500

26. The unified credit "absorbed" in computing the gift tax does not reduce the unified credit in the estate tax computation. This is because the unified credit that was applied against lifetime gifts reduces the gift taxes that are subtracted in the estate tax computation. See U.S., Congress, House, 94th Cong., 2d sess., 1976, H.Rep. 1380, p.16; and the *General Explanation of the Tax Reform Act of 1976*, p.531.

27. For further discussion of this point, see *Working With the Revenue Code 1979*, p.407.

28. The client will incur gift tax if the gift is made in 1980 or 1981, but the gift tax would be reduced to $7,800 if the gift were postponed to 1981, when the unified credit is at its permanent level of $47,000.

If Client did not make the 1980 gift, his estate tax would be only moderately higher.

Taxable estate	$ 800,000
Land	203,000
Cash (used to pay gift tax above)	12,300
Taxable estate	1,015,300
Tentative tax	352,073
Less unified credit	47,000
Estate tax (ignoring state death tax credit)	$ 305,073

The $305,073 estate tax is $6,273 greater than the combined estate and gift tax of $298,800 ($12,300 + $286,500) shown in the first calculation; this reflects the savings attributable to the annual gift tax exclusion and the removal from the estate tax base of the cash used to pay the 1980 gift tax (see 3601). This comparison assumes no appreciation in the $203,000 land value between 1980 and 1985.

The transfer tax savings resulting from the 1980 gift would be considerably greater if the land appreciated by $100,000 from the time of the gift to the date of death.

Taxable estate	$1,015,300
Appreciation	100,000
Taxable estate	1,115,300
Tentative tax	393,073
Less unified credit	47,000
Estate tax (ignoring state death tax credit)	$ 346,073

The $346,073 estate tax is $47,273 greater than the combined estate and gift tax of $298,800 in the first calculation.

901.5 Ineffective Gifts

Donors should avoid making gifts that may not be recognized for estate tax purposes. These may include retained life estates, revocable transfers, gifts taking effect at death, and gifts within three years of death.

Postgift appreciation may not escape transfer tax if the gift is includible in the gross estate because the decedent retained certain rights, powers, or interests in the property. If such ineffective gifts are included in the gross estate, they are removed from the taxable gift component of the estate tax computation. "This is to preclude having the same lifetime transfers taken into account more than once for transfer tax purposes. However, the gift tax payable on these transfers is to be subtracted in determining the estate tax imposed. . . ."[29]

The estate tax implications of defective gifts are summarized in this section; their income tax implications are reviewed in 902.

Retained Life Estates

Section 2036(a) requires the inclusion of property for estate tax purposes, even if it previously was transferred as a lifetime gift, if the transferor retained 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."

Under sec. 2036(b), retention of the right to vote shares of a controlled corporation (whether directly or indirectly) is considered retention of enjoyment of the property; it thus causes the property to be included in the gross estate. Section 2036(b)(2) defines a *controlled corporation* as a corporation in which, during the three years prior to his death, the decedent either owned (using sec. 318 attribution) or had the right to vote (alone or in conjunction with any person) 20 percent of the voting stock.[30]

Revocable Transfers

Section 2038 likewise requires the inclusion in a donor's gross estate of any gifts if, at the time of the donor's death, enjoyment of the gifts could be changed "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 if such a power was relinquished during the three-year period prior to the decedent's death (emphasis supplied).

In regard to custodianships, Rev. Rul. 59-357 holds as follows:

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29. *General Explanation of the Tax Reform Act of 1976*, p.528.

30. For further discussion of this 20% voting-stock test, see U.S., Congress, Joint Committee on Taxation, *General Explanation of the Revenue Act of 1978*, 96th Cong., 1st sess., 1979, pp.434–35.

> 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][31]

The determining factor is whether the decedent was custodian at the time of death; thus, the same result occurs if the decedent was a *successor* custodian at the time of death.[32] It has been held, though, that the custodial property is not includible in the custodian's estate if he previously relinquished all beneficial interest in the funds used to establish the custodianship.[33] In all other circumstances, it appears that custodial property is includible only in the donee's gross estate.

A power held by the grantor as a trustee of the transferred property also may taint the gift as a revocable transfer. Administrative and management powers may cause a transfer to be includible in the donor's gross estate, even if the donor holds the powers as a trustee or in some other fiduciary capacity. In contrast are normal but broad management powers over reinvestment of trust properties in securities or properties not of a character prescribed by law.

The person who acts in conjunction with the settlor need not be someone other than the beneficiary, nor is the question of whether the person has an adverse interest of any importance. Thus, retention of a prohibited power exercisable jointly with a beneficiary is within the purview of sec. 2038.[34]

Gifts Taking Effect at Death

A gift can be effective at the time of the donor's death if the donor attaches conditions specifying that the donee's possession or enjoyment of the gift is held in abeyance until the donor dies. Section 2037 requires that such gifts be added back to the donor's estate

31. 1959-2 C.B. 212. The validity of Rev. Rul. 59-357 is on the I.R.S. Prime Issues List.

32. Rev. Rul. 70-348, 1970-2 C.B. 193.

33. *Chrysler*, 361 F.2d 508 (2d Cir. 1966), rev'g 44 T.C. 55.

34. See *Graham*, 46 T.C. 415 (1966), where a right to be consulted was not construed as a power to alter, amend, or revoke. Cf. Rev. Rul. 79-353, 1979-44 I.R.B. 27.

only if the donor had more than a 5 percent reversionary interest immediately before his death.

Gifts Within Three Years of Death

Usually, gifts made within three years of death are automatically included in the gross estate (see 3601); however, gift programs that are designed to take advantage of the $3,000 annual exclusion have the added advantage of excluding property from the gross estate even if the gifts are made within three years of death. Section 2035(b)(2) excludes gifts made within three years of the donor's death if no gift tax return is required—for instance, a gift of a present interest that does not exceed $3,000. On the other hand, "a gift of a present interest in property valued at $3,500 which is made within three years of death would be includible in the donor's gross estate even though the gift was fully excludible because the other spouse consented to be treated as the donor of one-half of the gift. . . ."[35]

The exception for gifts not shown on the gift tax return does not apply to life insurance, although it does apply generally to premium payments that are excludible under the annual exclusion.[36]

Deathbed gifts to family members that fall under the shelter of the annual exclusion may remove significant amounts from the gross estate. For example, gifts of $3,000 to each of six family members may remove $18,000 from the gross estate and save $12,600 in estate tax if the estate is in the 70 percent tax bracket.

901.6 Net Gifts

If the donee agrees to pay the gift tax prior to the transfer, the measure of the gift is reduced by the amount of the tax.[37] The IRS may impute taxable gain on such net gifts, but on the other hand, under certain conditions, the donor may avoid taxation on trust income used to pay the gift tax.

Net gifts may entail some computational difficulties, however, since the gift and the gift tax are interdependent. The IRS uses the

35. *General Explanation of the Revenue Act of 1978*, p.429.

36. *Ibid.*

37. Rev. Rul. 75-72, 1975-1 C.B. 310.

following formula in arriving at the gift tax to be deducted from the value of the gift:[38]

$$\frac{\text{Tentative tax}}{1 + \text{rate of tax}} = \text{Gift tax}$$

Example A client makes a taxable gift of $200,000 ($203,000 less $3,000 annual exclusion) to his daughter in 1980. There is no gift splitting, no prior taxable gifts have been made, and no state gift tax is imposed.

Taxable gift	$200,000 – Gift tax (T)
Unified rate schedule bracket below $200,000	150,000
Excess	50,000 – T
Unified rate schedule marginal rate	32%
	16,000 – .32 T
Tax on $150,000	38,800
Gross gift tax	54,800 – .32 T
Less unified credit	42,500
	$ 12,300 – .32 T
$T = \frac{\$12,300}{1 + .32}$	$ 9,318
Proof:	
Gross transfer	$203,000
Less	
Gift tax payable by donee	9,318
Annual exclusion	3,000
Taxable gift	190,682
Gift tax on $190,682	$ 9,318

The gift tax on a gross gift of $200,000 (where the donee does not assume the gift tax) is $12,300. Thus, a net gift in this situation saves $2,982 ($12,300 less $9,318).

38. Rev. Rul. 75-72, 1975-1 C.B. 310. See also Rev. Ruls. 76-57, 1976-1 C.B. 297; 76-104, 1976-1 C.B. 301; and 76-105, 1976-1, C.B. 304. See also I.R.S. Publication 904, *Computing the Interrelated Charitable, Marital, and Orphans' Deductions and Net Gifts.*

Income Tax Consequences of Net Gifts

If the donor's basis in the property is less than the gift tax, there is a possibility that the net gift will result in taxable gain to the donor.[39]

The donor should not borrow sufficient funds to pay the gift tax and then transfer the property subject to, or conditioned on the assumption of, the debt.[40] The service may nevertheless assert that there is taxable gain on the transfer, even in the case of the traditional net gift, with the donee merely assuming the gift tax.[41]

In a net gift transfer to a trust, the donor may also be taxed on trust income that is applied to the gift tax under the "grantor trust" concept (which holds that the trust income is being used to satisfy the grantor's obligation).[42] A sale by the trust to generate funds to pay the gift tax causes the transfer to be governed by sec. 644, which deals with sales by trusts within two years of the gift (a subject discussed in 902). The donor should *not* be taxed on trust income under the grantor trust rules if the trust pays the gift tax

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39. See and compare *J.W. Johnson, Jr.*, 495 F.2d 1079 (6th Cir. 1974), cert. den. 419 U.S. 1040; *Turner*, 49 T.C. 356 (1968), nonacq. 1971-2 C.B. 4, aff'd *per curium* 410 F.2d 952 (6th Cir. 1969); *Hirst*, 63 T.C. 307 (1974), aff'd *per curium* 572 F.2d 427 (4th Cir. 1978); *R.W. Davis*, T.C.M. 1971-318, aff'd *per curium* 469 F.2d 694 (5th Cir. 1972). For a summary of this controversy, see *Est. of Henry*, 69 T.C. 665 (1978), on appeal to 6th Cir. Also see *James C. Bradford, Sr.*, 70 T.C. 584 (1978); *Ralph Owen*, T.C.M. 1978-51; and *J.T. Benson*, T.C.M. 1978-231.

The service, in Ltr. Rul. 7752001, reaffirmed its position that a net gift of appreciated property results in taxable gain to the extent that gift taxes exceed adjusted basis. It held that basis must be determined under the "part-gift, part-sale" rules of regs. §1.1015-4 and that there was no "tacking" of the donor's holding period in a subsequent sale by the donee. Cf. *Citizen's National Bank of Waco*, 417 F.2d 675 (5th Cir. 1969). I.R.S. Ltr. Rul. 7752001 dealt with a transaction that preceded §644 (sales by trust within two years of gift), although it is not clear if §644 would alter that result. However, the *General Explanation of the Tax Reform Act of 1976*, p.162, states that the Tax Reform Act of 1976 treats such (trust) gains as if the transferor had realized the gain and then transferred the net proceeds from the sale after tax to the trust as corpus.

40. In *Johnson*, 495 F.2d 1079 (6th Cir. 1974), the donor borrowed $200,000 on a nonrecourse basis and used approximately $150,000 to pay the gift tax. The securities used as collateral were transferred to the trust, which assumed responsibility to pay the loan. The taxpayer was held to have realized gain to the extent that the $200,000 exceeded the basis in the securities. Also see *Evangelista*, 71 T.C. no. 95 (1979).

41. See n.39 supra.

42. *Est. of Staley*, 47 B.T.A. 260 (1942), aff'd 136 F.2d 368 (5th Cir. 1943), cert. den. 320 U.S. 786; *Sheaffer*, 37 T.C. 99 (1961), aff'd 313 F.2d 738 (8th Cir. 1963), cert. den. 375 U.S. 818; *Sheaffer*, T.C.M. 1966-126; *Krause*, 56 T.C. 1242 (1971). See also the discussion by the Tax Court in *Hirst*, 63 T.C. 307 (1974), at 310-11, particularly n.2 thereof, which states, "Where the gift tax is paid at the discretion of the trustee, the trust income thus used is chargeable to the grantor pursuant to sec. 677 only where the exercise of such discretion is not conditioned upon approval by an 'adverse' party. . . ."

with other assets on hand at the time of the transfer.[43] It has also been held that a donor could not be taxed on trust income after the trust borrowed funds to pay the gift tax.[44]

902 Effective Use of Trusts

The establishment of a trust enables an individual to create a new tax-paying entity with the following features:

1. **A new income tax bracket (although at the higher tax rates applicable to trusts and estates) into 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 and the tax on generation-skipping transfers).**

The price of these tax advantages is the individual's forfeiture of all beneficial interest in the 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. A possible solution is the ten-year-and-one-day (Clifford) trust, which permits income deflection if the grantor is willing to relinquish control for more than a ten-year period.

A trust cannot be used to divert taxable income to a donor's spouse. This practice is prevented by sec. 677, unless the income is taxed to the spouse under some other code section.

Extent of Tax-Free Investment Income to Dependent Children

Dependent children with no other investment income may receive up to $1,000 (the amount of the personal exemption) as beneficiaries of a trust without incurring income tax. A child who may be claimed as a dependent by his parents must file a return if his unearned income is $1,000 or more (sec. 6012). The amount of unearned income that may be received tax-free by dependent children is less than the sum of the personal exemption and the zero bracket amount because dependent children must increase

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43. *Est. of K.W. Davis*, T.C.M. 1971-318, aff'd 469 F.2d 694 (5th Cir. 1972).

44. *Morgan*, 37 T.C. 981 (1962), aff'd 316 F.2d 238 (6th Cir. 1963), cert. den. 375 U.S. 825; *Krause*, 56 T.C. 1242 (1971). The service's position is that trust income used to satisfy the donor's gift tax obligation is taxable to the donor under §677 (Rev. Rul. 57-564, 1957-2 C.B. 328).

their income by the "unused zero bracket amount" (sec. 63). (See the discussion in 2301.)

Accumulation of Income

The Tax Reform Act of 1976 significantly modified the rules affecting accumulation of income by trusts. The revised sec. 666(e) limits the manner of computing the tax to the beneficiary on accumulation distributions to a modified short-cut method, and it precludes any refund if the tax paid by the trust exceeds the beneficiary's tax.[45] The act also reinstated the exemption from the accumulation distribution (throwback) rules for income accumulated prior to the time the beneficiary attains age twenty-one (except in the case of certain multiple trusts). The act eliminated the character pass-through rules for accumulation distributions, except for tax-exempt interest; this eliminates such benefits to the beneficiary as the dividend exclusion and the maximum tax on personal service income. These changes increase the importance of planning in connection with the timing of trust distributions.[46]

Multiple Trusts

The Tax Reform Act of 1976 limited the credit to a beneficiary for taxes previously paid by multiple trusts. Now, when the beneficiary receives accumulation distributions from more than two trusts in the same taxable year, he only receives a credit for the taxes previously paid by the first two trusts. The result is analogous to the "double taxation" of corporate dividends, since there is no gross-up for the taxes that the trust pays on the accumulation distribution, but the trust income (net of tax) is again subject to tax at the beneficiary level. Section 667(c)(2) provides an exception if the sum of the accumulation distribution and all prior accumulation distributions is less than $1,000.[47]

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45. See J.D. McGaffey, "The Inexact Throwback Rule and Multiple Trusts," *U. of Miami Institute on Estate Planning* 13 (1979), chap. 13.

46. For discussion of the changes of the Tax Reform Act of 1976, see D.L. Cornfeld, "New Laws on Accumulation Trusts Require Practitioners to Take Prompt Action," *Journal of Taxation* 45 (December 1976): 331. For general discussion of trust taxation, which includes discussion of these changes, see B. Barnett, "The Taxation of Trust Distributions Revisited After the '76 Act," *Tax Adviser* 9 (January 1978): 22.

47. See, generally, the articles by McGaffey, n.45, herein, and Cornfeld, n.46, herein, at pp.332–33. Also see B. Barnett, "Multiple Trusts: The Code and the Regs," Tax Clinic, ed. S.R. Josephs, *Tax Adviser* 11 (May 1980): 287.

That the trusts may have been established by different grantors is irrelevant. If a third trust has the same grantor as either or both of the first two trusts, it may be possible for the beneficiary to preserve the credit for trust taxes by filing a "consolidated" fiduciary income tax return in accordance with regs. sec. 1.641(a)-0(c).[48]

Capital Gains

The Tax Reform Act of 1976 repealed the capital gain throwback provisions, an action that may increase the importance of planning the extent of trust distributions in a year in which the trust realizes substantial long-term capital gains.[49]

The Tax Reform Act of 1976 also added sec. 644, which restricts the ability to shift capital gains to a trust or its beneficiaries if the trust sells the property within two years of the transfer.[50] In essence, the gain is taxable to the trust, but the tax is computed as if the grantor realized the gain and then transferred the net after-tax proceeds from the sale to the trust as corpus.[51] The "includible gain" subject to this rule is the lesser of the gain recognized by the trust or the amount of gain that the trust would have realized had the property been sold immediately after the transfer.[52] Thus, appreciation after the transfer to the trust is subject to the normal rules for gains realized by the trust.[53] Section 644(e) specifies that the rule does not apply if the sale occurs after the death of the transferor or if the sale involves property that passes from a decedent. In regard to the determination of whether the trust's gain is capital or ordinary, another rule converts the trust's gain to ordinary income if the property would not have been a capital asset in the hands of the transferor.[54]

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48. See Barnett, n.46, herein, at p.34 and n.47 at p.288.

49. Cornfeld, n.46, herein, at pp.334–35.

50. The Revenue Act of 1978 clarified that §644 applies only to recognized gains of the trust and also provided for net operating loss situations. It also clarified the treatment of installment sales so that each installment is treated as a separate sale or exchange. See the *General Explanation of the Revenue Act of 1978*, p.362.

51. *General Explanation of the Tax Reform Act of 1976*, p.162.

52. Basis to the trust includes any increase in basis for gift tax under §1015(d). *General Explanation of the Tax Reform Act of 1976*, p.163, n.4.

53. *Ibid*, p.163.

54. *Ibid*, n.4.

902.1 Generation-Skipping Trusts

An individual should consider creating a trust for the benefit of a grandchild in order to take advantage of the $250,000 exemption from the generation-skipping transfer tax.

To avoid estate tax to their heirs, wealthy grantors created trusts in which younger generations received life interests, with remainder interests reserved for subsequent generations. Generation skipping resulted in inequities by enabling some families to pay transfer taxes only once every several generations; thus, it reduced the progressive effect of the transfer taxes.[55]

The transfer tax advantage to new generation-skipping trusts is now limited by the generation-skipping transfer tax introduced by the Tax Reform Act of 1976.[56] This tax is separate and distinct from the estate and gift taxes. The complexities of the generation-skipping transfer tax are well beyond the scope of this study.[57]

Basically, a generation-skipping transfer under a trust or similar arrangement provides for the splitting of benefits between two or more generations, all of which are younger than the grantor.[58] A grantor's spouse is considered to be of the same generation as the grantor; therefore, granting a spouse a life interest in a trust in order to minimize the estate tax that will be assessed at the time of the spouse's death (discussed in 3301.1) generally should not give rise to the generation-skipping transfer tax. The grantor's children are considered the first younger generation, the grandchildren the second younger generation, and so on.

An important exception provided by secs. 2613(a)(4) and 2613(b)(6) excludes up to $250,000 per deemed transferor from the

55. *General Explanation of the Tax Reform Act of 1976*, p.564.
56. Chapter 13 of the code, §§2601–2622. The Revenue Act of 1978 modified the effective date of the generation-skipping provisions. The *General Explanation of Revenue Act of 1978*, p.444, provides that the "new rules apply generally to generation-skipping transfers made after June 11, 1976. Irrevocable trusts in existence on June 11, 1976, are protected under a grandfather clause except for additions to corpus after that date. Also wills and revocable trusts in existence on June 11, 1976, which were not amended after that date (except in respects which do not affect generation-skipping), are protected in the case of decedents dying before January 1, 1982. . . ."
57. See, generally, the *General Explanation of the Tax Reform Act of 1976*, pp.564–83; *General Explanation of the Revenue Act of 1978*, pp.444–51; N. Shaw, "The Generation Gap," *N.Y.U. Institute on Federal Taxation* 36 (1978): 179; T.P. Sweeney and N.P. Wright, "New Tax on Generation-Skipping Transfers: A New Concept; Planning Implications," *Journal of Taxation* 46 (February 1977): 66.
58. §2611.

generation-skipping transfer tax if the property ultimately vests in a grandchild.[59] The maximum excludible amount is limited by the number of children, not the number of grandchildren: "Thus, if the grantor has two children, A and B, up to $500,000 could be transferred from the generation-skipping trust to the children of A and B ($250,000 to the children of each) without a tax being imposed upon the termination of A's or B's interest in the trust. . . ."[60]

If A's trust fund is worth $300,000 at the time of his death, the $50,000 difference will be taxed as a generation-skipping transfer. To minimize the generation-skipping tax on the $50,000, it may be advantageous for the parent to provide for discretionary distributions to the grandchildren during the child's lifetime.[61]

902.2 Ten-Year-Plus (Clifford) Trusts

An individual can temporarily divert income by limiting the duration of the trust to a specified term.

Section 673(a) provides that the specified term must exceed ten years.[62]

Because such trusts avoid permanent depletion of an estate, they may be particularly valuable planning tools for high-bracket executives and professionals who have not yet had time to accumulate a large estate.[63] They are often used to accumulate a college fund for a child or to shift income to an elderly parent supported by adult offspring,[64] although these are certainly not the only uses

59. "This $250,000 exclusion is to be available in any case where the property vests in the grandchild (i.e., the property interests will be taxable in the grandchild's estate) as of the time of the termination or distribution, even where the property continues to be held in trust for the grandchild's benefit, and regardless of whether the grandchild receives his interest under the express terms of the trust, or as the result of the exercise (or lapse) of a power of appointment with respect to the trust." *General Explanation of the Tax Reform Act of 1976*, p.572.

60. *Ibid.*

61. *Working With the Revenue Code 1979*, p.416.

62. Note that the more-than-ten-year requirement is measured from the date of transfer of property to the trust, not from the date of creation of the trust, so that the duration of the trust should provide time to transfer the trust corpus.

63. J. Marty, "Clifford Trusts for Young Executives and . . .," Tax Clinic, ed. S. Braun, *Tax Adviser* 9 (February 1978): 92.

64. Ten-year-plus trusts may provide for reversion to the grantor at the death of the income beneficiary, so the term of a trust may actually be less than ten years and still satisfy §673, a factor that is particularly important in the context of Clifford trusts to support elderly parents. §673(c), regs. §1.673(a)-1(b).

of ten-year trusts.[65] It also may be possible to obtain a tax-free step-up in basis if the Clifford trust is funded with appreciated assets (see 703).[66]

The creation of a short-term trust generates a taxable gift of a portion of the property, since the trust corpus eventually reverts to the grantor. The measure of the gift is approximately 44 percent of the value of the property, pursuant to Gift Tax Regs. sec. 25.2512-9(f), table B, if the trust is for a term that is certain and is not contingent on the beneficiary's earlier death. The regulation incorporates a 6 percent factor as the measure of the income interest, even though the actual yield of the assets used to fund the trust may be more or less than 6 percent.[67] For example, the measure of a gift of marketable securities with a current value of $100,000 to a ten-year-and-one-day trust would be $44,160, regardless of whether the actual yield is 4 percent or 8 percent. The taxable gift would be $41,160, assuming that income is required to be distributed currently, that the $3,000 annual exclusion is available, and that the donor is not married. At the donor's death, after reversion, his estate tax base may reflect both the value of the securities at that time and the $44,160 taxable gift.[68]

This effect should be noted in planning for ten-year trusts, but it is not necessarily a disincentive to the use of such trusts. Depending on the circumstances, the estate tax may not differ materially from the tax that would result if no Clifford trust were established and the property and related income were simply included in the gross estate. In addition, the double inclusion of the income interest in the estate tax base may be arguable, as explained in chapter 10.

The tax planner can mitigate the transfer tax consequences by structuring the transfer to the short-term trust so that it is eligible

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65. See, generally, S.D. Pinney, "Benefits Still Available From Short-Term Trusts Despite Recent Developments," *Estate Planning* 6 (September 1979): 266; J.F. Todd, "The Pros and Cons of Term Trusts and Some Alternatives," *Taxes: The Tax Magazine* 57 (January 1979): 10; and H.M. Esterces and I. Scherago, "Short-Term Trust Still Offers Substantial Opportunities for a Taxpayer to Shift Income," *Taxation for Accountants* 7 (August 1978): 68. Also see S.R. Josephs and M.H. Glicker, "The Short-Term Trust: How to Capitalize on This Often Overlooked Tax-Saving Tool," *Practical Accountant* 7 (May–June 1974): 34–41.

66. See also *Working With the Revenue Code 1979*, p.267.

67. In Rev. Rul. 79-280, the tables in the regulations were used to value a gift of non-income-producing property to a short-term trust.

68. *Working With the Revenue Code 1979*, pp.390–91; and A. Shapiro, "An Analysis of the Tax Savings Still Available Through the Creation of Short-Term Trusts," *Journal of Taxation* 50 (June 1979): 349.

for the $3,000 annual exclusion, even if it is a "sprinkling trust."[69] He should also consider the following advice:

> Consider maximizing the annual exclusions available by using a trust for a period greater than 10 years. Thus, if property is contributed in December of one year and January of the next, two annual exclusions apply and the trust can be for 10 years and one month or longer. However, note that the value of the gift is increased by the length of the trust.[70]

For the possibility of the donee amortizing the applicable gift tax, see 3603.

Ten-year-plus trusts have the advantage of statutory sanction, but the more controversial interest-free loan (discussed in chapter 10) should also be considered as an alternative.

902.3 Technical Observation: Triple Statutory Standards for Recognizing the Validity of Gifts

Internal Revenue Code secs. 671 to 679 set forth additional tests for determining whether a transfer in trust will be recognized as a valid gift for *income* tax purposes, thus countenancing an effective shift of income. Section 676 disregards revocable trusts as income-deflecting mechanisms.

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

Because of the asymmetrical statutory standards, inconsistent results frequently emerge. For example, Rev. Rul. 57-315 states

> It is well established that a gift is not considered as being incomplete for gift tax purposes merely because the income from the property

69. "Ordinarily, a gift to such a 'sprinkling trust' is a future interest, ineligible for the annual $3,000 exclusion, where the trustee has discretion to distribute to the beneficiaries amounts selected by him. See Example (3), Regs. Sec. 25.2503-3(c).

"The grantor may wish to consider a requirement, in a reversionary trust ending ten years and a day after its funding, of a minimum distribution to each beneficiary of $820 per year, with uncontrolled discretion in the trustee as to distribution of the remaining income. This annual amount, based upon the 6% Table B in Regs. Sec. 25.2512-9, will produce a $6,000 present value for the gift in trust, permitting full use of the annual exclusion by the grantor and his gift-splitting spouse . . ." (*Working With the Revenue Code 1979*, pp.401–02).

70. *Working With the Revenue Code 1979*, p.391. Also see the caveat at n.62, herein.

> 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.[71]

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

An income distribution to a beneficiary (other than the donor) subjects the donor to both income and gift taxes if a gift of the underlying income-producing property is incomplete for income and gift tax purposes.[72]

903 Joint Savings Accounts

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

Transfers of this nature can be effected in the following way:

> 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.[73]

Creation of the joint bank account would not involve a taxable gift; however, any income from the account generally is taxable to each co-owner in proportion to the income that each is entitled to receive under applicable local law.[74]

Of course, receipt of 50 percent of the interest may represent a gift under the rationale of regs. sec. 25.2511-2(f) (see conclusion of 902).

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71. 1957-2 C.B. 624. The income tax consequences of a gift-leaseback from a short-term trust, dealt with in the ruling and included in the I.R.S. Prime Issues List, have been the subject of considerable litigation. Cf., eg., *Quinlivan*, 79-1 U.S. Tax Cas. ¶9396 (8th Cir. 1979), aff'g T.C.M. 1978-70. See, generally, J.T. Schlenger and G.K. Reynolds, "Rental Payments to Clifford Trust Under a Gift-Leaseback Arrangement Held Deductible Under Section 162," *Estate Planning* 6 (September 1979): 302.

72. See §671 and Gift Tax Regs. §25.2511-2(f).

73. Gift Tax Regs. §25.2511-1(h)(4).

74. Rev. Rul. 76-97, 1976-1 C.B. 15. Also see 3502 of this study.

There is no need to split income in this fashion with a spouse if joint income tax returns are available. (This technique may be appropriate for state and local income taxation, assuming that state gift taxation, if any, follows the approach taken in regs. sec. 25.2511-1(h)(4).)

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

10

Deflected Income

Interest-Free or Low-Interest-Rate Loans

Interest-free or low-interest-rate loans to family members have several possible advantages: Earnings on the principal sum can be shifted to lower-bracket relatives; the value of the use of the money does not constitute a gift for gift tax purposes if the loan is a demand loan, and use of the money does not create taxable income for the lender or borrower. The service's position, however, is that interest-free and low-rate loans are subject to gift tax, whether they are demand or term loans.

Similarly, interest-free loans to employees may represent a nontaxable fringe benefit, although the issue is not free of doubt. Employer guarantees of loans to employees may represent nontaxable fringe benefits.

1001 Loans to Family Members

Gift Tax Aspects

The seventh circuit, in *Crown*, affirmed the Tax Court's holding that interest-free *demand* notes are not subject to gift tax.[1] The IRS takes the position that interest-free loans, whether payable on demand or at a specific time, are subject to gift tax.[2]

The Tax Court recently distinguished its ruling in *Crown* in *Est. of M. B. Berkman*,[3] which held that low-interest-rate *term loans* are subject to gift tax to the extent of the difference between the value of the transferred property and the fair market value of the notes received in exchange. The Tax Court considered the situation analogous to that in *Blackburn*, in which the court held that a transfer of property for a low-interest-bearing note whose face value is less than the value of the transferred property results

1. *Lester Crown*, 585 F.2d 234, aff'g 67 T.C. 1060 (1977), nonacq. 1978-1 C.B.2. See also *E.M. Johnson*, 254 F.Supp. 73 (D. Tex. 1966).

2. Rev. Rul. 73-61, 1973-1 C.B. 408. See also the I.R.S. nonacq. in *Crown*, 1978-1 C.B.2.

3. T.C.M. 1979-46.

in a gift equal to the difference between the value of the transferred property and the value of the note.[4]

While Rev. Rul. 73-61 dealt with a non-interest-bearing obligation, the IRS recently applied the same principle to low-interest loans. A private letter ruling held that a parent's loan to help finance a home acquisition is subject to gift tax when the interest rate is less than that charged for similar loans. The amount of the gift is the difference between the amount loaned and the fair market value of the notes received.[5]

A court has also held that cancellation of interest on an interest-bearing obligation results in a gift equal to the amount forgiven.[6]

From a planning standpoint, intrafamily loans that are interest-free or that carry a rate of interest less than would be charged on similar loans should be demand notes. Term loans are considered taxable gifts unless they are small enough to fall under the $3,000 annual exclusion of sec. 2503.[7] Open-account loans are particularly susceptible to being challenged as gifts in their entirety; so demand notes are preferable to open-account loans, although the latter may also escape gift tax.

The demand note should specifically provide that no interest is to be charged since "state statutes often create a legal obligation to pay interest on debts where the agreement is silent as to interest. The Service has announced that it recognizes that these state laws can create an obligation to pay interest."[8] The nonpayment of an interest obligation created by state law is considered a gift pursuant to *Republic Petroleum Corporation*.

To mitigate the prospect of constructive income to the lender, the lender should not retain any direct or indirect control over the loaned funds.

Income Tax Aspects

The seventh circuit, in *Crown*, expressed no opinion regarding the commissioner's contention (which was not part of the appeal or the

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4. *Blackburn*, 20 T.C. 204 (1953).
5. I.R.S. Ltr. Rul. 7905090.
6. *Republic Petroleum Corp.*, 397 F.Supp. 900 (D. La. 1975).
7. See Rev. Rul. 73-61.
8. M.A. Taicher, "How to Use Interest-Free Loans in Family Tax Planning," *Practical Accountant* 11 (September 1978): 25, citing I.T. 1720, II-2 C.B. 54 (1923), superseded by Rev. Rul. 73-322, 1973-2 C.B. 44.

Tax Court's decision) that there was constructive income to the partners of the partnership that made the loans.

The IRS issued a private letter ruling in 1977 holding that interest-free loans to an unrelated party in a business context do not result in interest income to the lender.[9] The ruling also states that the courts have held for many years that the maker of an interest-free loan does not recognize any gross income from the transaction even if the parties do not bargain on an arm's-length basis.[10] The ruling cites cases that deal with corporate loans to officers or shareholders. Also see the *Dean* case, discussed at 1002.

In originally holding split-dollar life insurance to be tax-free, Rev. Rul. 55-713 concluded that "*the mere making available of money does not result in realized income to the payee or a deduction to the payor*."[11] This ruling was revoked by Rev. Rul. 64-328 (see 501.2) 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." The practitioner may presume that the Rev. Rul. 55-713 conclusion remains untarnished.

Accordingly, unless the lender directly or indirectly maintains control of funds that are reinvested in a way that triggers the assignment-of-income doctrine,[12] interest-free or low-rate loans apparently do not result in income to the lender if the loans are not made in a business context.[13]

Planning Pointers

An individual may be assured that income from property placed in a ten-year trust will not be taxed during the term of the trust, even though the property eventually reverts back to him (see 902). While such arrangements have the advantage of the statutory protection afforded by sec. 673, the individual must also maintain a

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9. I.R.S. Ltr. Rul. 7731007.

10. *Ibid.*, citing *Brandtjen & Kluge, Inc.*, 34 T.C. 416 (1960), acq. 1960-2 C.B. 4; *Combs Lumber Co.*, 41 B.T.A. 339 (1940), acq. 1940-1 C.B. 2.

11. 1955-2 C.B. 23.

12. See, e.g., *Horst*, 311 U.S. 112 (1940); A.E. Hull and L.A. Kaster, "Interest-Free Loans Are Not Gifts, but Problems Remain in Their Use," *Estate Planning* 6 (March 1979): 66-69.

13. Such transfers should be outside the scope of §482 if they are made in a family context, although §482 may permit the IRS to impute interest in a business context. See, e.g., *Latham Park Manor, Inc.*, 69 T.C. 199 (1977); *Kerry Investment Co.*, 58 T.C. 479, 491 (1972), aff'd and rev'd by 500 F.2d 1086 (9th Cir. 1974).

hands-off policy during the term of the trust (usually a term of slightly more than ten years or the life of the beneficiary). Consequently, an interest-free loan may offer a more attractive alternative.

An interest-free loan may also have an estate tax advantage. Ordinarily, only the principal of the loan is subject to estate tax in the lender's estate; in contrast, transfers to a ten-year trust are subject to gift tax at the time of transfer (at approximately 44 percent of value) and are then subject to estate tax, with the result that 144 percent of the value may be subject to transfer tax.

Questions have arisen regarding the estate tax treatment of a gift of an income interest in a short-term trust (a ten-year-plus-one-day trust) under the unified transfer tax system. For example, in 1980 a widow transfers $100,000 of cash to a short-term trust for the benefit of her son. The value of the gift is $44,160.50. The cash reverts to the widow in 1990, and the widow dies in 1991. The $100,000 cash is includible in her gross estate. It is uncertain whether the $44,160.50 must also be included in her adjusted taxable gifts, which are added to her taxable estate in arriving at her estate tax base.

The November 1977 *Journal of Taxation* states the following:

> Adjusted taxable gifts may seriously erode the effectiveness of short-term trusts as tax savings devices. While the income tax shifting still exists, there may now be a major estate tax problem. When the donor dies after the property reverts to him, his estate tax base includes the full value of the property. It may also include the adjusted taxable gift resulting from the transfer. An adjusted taxable gift is erased when the gift is included in the gross estate (Section 2001(b)). *It is not clear whether the adjusted taxable gift is also erased when the property—but not the gift itself—is included in the gross estate.* [Emphasis supplied][14]

The definition of "adjusted taxable gifts" is contained in sec. 2001(b), which is further explained in the 1976 Joint Committee Report, as follows:

> Transfers included in the tax base as lifetime transfers (described as "adjusted taxable gifts" by the Act) are not to include transfers which are also included in the decedent's gross estate (i.e., transfers made within three years of the date of death and lifetime transfers where

14. L.C. Hodges, "Current Strategies for Using Lifetime Gifts to Reduce Total Estate and Gift Taxes," *Journal of Taxation* 48 (1977): 270.

the decedent had retained certain interests, rights, or powers in the property). This is to preclude having the same lifetime transfers taken into account more than once for transfer tax purposes. However, the gift tax payable on these transfers is to be subtracted in determining the estate tax imposed.[15]

An interest-free or low-rate loan to a family member may achieve income splitting by enabling the borrower to invest in high-income-producing properties, and there appears to be limited opportunity for the IRS to impute income to the lender unless the lender maintains control of the funds. However, the IRS contention in *Crown* that income should be imputed to the partners of the lending partnership may signal a change in IRS attitude. The borrower can minimize the possible risk by using the loan to purchase personal assets or to invest in non-income-producing properties.

1002 Loans to Employees

Gift Tax Aspects

Regulations section 25.2512-8 provides that "a sale, exchange, or *other transfer* of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth" (emphasis supplied).[16] Accordingly, gifts to employees should generally be immune from gift tax.

Income Tax Aspects

The conclusion reached in Rev. Rul. 55-713 was cited, with approval, in *J.S. Dean*, in which the Tax Court, in a reviewed decision, distinguished the situation in question from the line of cases taxing rent-free use of corporate property:

> 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

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15. U.S., Congress, Joint Committee on Taxation, *Joint Committee Report on the Revenue Act of 1976*, 94th Cong., 2d sess., 1976, p.528.

16. See also regs. §25.2511-1(g)(1).

the other hand, had petitioners borrowed the funds in question on interest-bearing notes, their payment of interest would have been fully deductible. . . .[17]

The *Dean* case involved the issue of whether there was income to the controlling shareholders from an interest-free loan of over $2 million that they received from their corporation. In 1973 the IRS nonacquiesced in *Dean.*[18] In 1978 the Tax Court reaffirmed its adherence to its *Dean* decision.[19] In a 1979 decision, the Tax Court may have retreated somewhat from *Dean,* saying that the uncharged interest would have been fully deductible. "That being so, whether or not we base our decision on *Dean,* the result will be the same."[20] The decision still held, consistent with *Dean,* that there was no income realized by the borrower in a low-rate business loan. The Tax Court later reaffirmed its adherence to *Dean* with the proviso that a different result may be obtained if the imputed interest is nondeductible under, for example, sec. 265(2) (relating to tax-exempt income).[21] See also *Combs Lumber Co.* and *Brandtjen & Kluge, Inc.* (note 10, herein), in which the courts held that there is no income to the corporate lender on interest-free loans to officers and shareholders.

While the Tax Court apparently takes a contrary position,[22] the IRS may attempt to impute income to the employees receiving an interest-free or low-rate loan from an employer.[23]

Employer-Guaranteed Loans

An employer may guarantee loans to an employee and thereby confer a benefit (in the form of reduced interest) that should be tax free. The IRS has apparently not contended that the mere guaranty of a loan creates taxable income.[24]

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17. *J.S. Dean,* 35 T.C. 1083 (1961).

18. 1973-2 C.B. 4.

19. A. *Suttle,* T.C.M. 1978-393.

20. *Greenspun,* 72 T.C. no. 78 (1979).

21. *Max Zager,* 72 T.C. no. 82 (1979).

22. Income can be imputed if §482 applies. See, e.g., *Latham Park Manor, Inc.,* 69 T.C. 199 (1977). §482 may apply in the context of an employee borrowing funds from a controlled corporation.

23. See also R. Callahan, "How to Use Interest-Free Loans in Business Tax Planning," *Practical Accountant* 11 (September 1978): 28.

24. There has been considerable discussion regarding the imputation of income under §482 (which might apply in the context of a controlled corporation guaranteeing loans to an

Nonrecourse Loans

Nonrecourse loans to employees to facilitate, for example, the purchase of the employer's stock may be considered options subject to sec. 83 (see the discussion in 1603).

1003 Imputed Interest

Section 483 bars certain interest-free transactions for tax purposes; however, sec. 483 *only* applies to sales or exchanges of property and thus does *not* apply to interest-free loans.[25]

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employee). The IRS issued technical advice in 1978 (I.R.S. Ltr. Rul. 7822005) holding that income could be imputed to the domestic parent guaranteeing loans to foreign subsidiaries; however, the measure of the allocation was limited to actual out-of-pocket costs incurred by the parent with respect to the guaranties, since rendering this type of service was not an integral part of the business of either the parent or its affiliates. See regs. §1.482-2(b)(3). For general discussion, see M. Tan and J.M.Pusey, "Selected Tax Planning Ideas for Savings and Loan Associations," *Tax Adviser* 10 (May 1979): 262, and *Working With the Revenue Code 1979*, ed. I.F. Diamond and M. Walker (New York: AICPA, 1979), p.241. Also see prop. regs. §1.385-11.

25. See the discussion in connection with installment sales in chap. 19, herein.

11

Long-Term Capital Gain

Distributions From Qualified Employee Trusts

The individual must carefully analyze the tax consequences of the various alternatives that may be available for distributions from qualified plans.

An employee is not taxed on contributions or accumulated benefits in a qualified retirement plan, whether or not he is vested, until the benefits are distributed or made available to him.[1] An employee is not currently taxed on contributions to a qualified cash or deferred profit-sharing (or stock-bonus) plan, even if he is given an option of accepting cash in lieu of the plan contribution.[2]

In general, a qualified plan must provide that benefit payments begin no later than the sixtieth day after the close of the plan year in which the latest of the following occurs:

- The date the participant reaches age sixty-five or, if earlier, the normal retirement age specified under the plan.
- The tenth anniversary of the year in which the individual commenced participation in the plan.
- The date the participant terminates service.[3]

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1. §401(a). An irrevocable election, exercised prior to the time that a distribution is payable, to receive benefits at a determinable future time is not "made available." See I.R.S. Ltr. Ruls. 7929050, 7928040, and 7927054, citing Rev. Ruls. 55-317, 1955-1 C.B. 329, 55-423, 1955-1 C.B. 41, and 67-213, 1967-2 C.B. 149. Cf. Rev. Rul. 54-265, 1954-2 C.B. 239. See, generally, T.R. Frantz and J.M. Peterson, "Constructive Receipt of Plan Distributions May Forfeit Tax Breaks of Qualified Plans," *Journal of Taxation* 49 (July 1978): 26; W.L. Sollee, "Shaping Qualified Plan Payout Provisions and Use of Rollovers Under New 2039(c)," *Journal of Taxation* 47 (July 1977): 4–5, and I. Goodman, "Rollovers and Constructive Receipt," *CCH Pension Plan Guide*, Issue 191, no. 183, part II (1978).
2. §402(a)(8), added by the Revenue Act of 1978.
3. §401(a)(14); regs. §1.401(a)-14.

The plan may permit the participant to elect to defer payments to a later date, in which case the employee can postpone the decision to pay tax on or roll over the distribution.[4] (Rollovers are discussed in chapter 17.)

When the employee approaches retirement, the plan may provide alternatives for the mode of distribution from the plan (an annuity or annuity-type distribution versus payment in full at retirement). Even if benefits are distributed to him, the employee may be eligible for tax deferral under the rollover provisions discussed in chapter 17.

1101 Lump-Sum Distributions

If it is desirable, the taxpayer should attempt to qualify distributions for lump-sum treatment.

A lump-sum distribution must be from a trust that is qualified under sec. 401(a) and that is exempt from tax under sec. 501. Distributions from IRAs do not qualify. The distribution must be made within *one* of the recipient's taxable years.[5]

The entire balance to the credit of the employee must be distributed. Under the aggregation rule of sec. 402(e)(4)(C)(i), all pension plans are treated as a single plan, as are all profit-sharing and stock-bonus plans.[6] All trusts that are part of a single plan are treated as a single trust.

The distribution must be attributable to the employee's death or separation from service, or it must occur after the employee attains age 59½. An employee's lifetime election to receive annuity-type distributions should not preclude a lump-sum distribution for his beneficiaries at his death.[7] Payment of the remaining benefits to an employee who has begun receiving annuity-type payments in a previous year does not constitute a lump-sum distribution.[8]

An employee may remain in active service and still be entitled

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4. Regs. §1.401(a)-14(b).

5. Miscalculations that result in an additional payment in a later year may not disturb the lump-sum character of the earlier distribution. I.R.S. Ltr. Rul. 7918085; Rev. Ruls. 69-190, 1969-1 C.B. 131, 67-164, 1967-1 C.B. 88, 56-558, 1956-2 C.B. 290. Cf. *Blyler*, 67 T.C. 878 (1977). See also prop. regs. §1.402(e)-2(d)(1)(ii)(B).

6. See, e.g., I.R.S. Ltr. Ruls. 7929065 and 7913075.

7. Rev. Rul. 69-495, 1969-2 C.B. 100; *Est. of Benjamin*, 465 F.2d 982 (7th Cir. 1972), aff'g 54 T.C. 953 (1970).

8. Regs. §1.402(a)-1(a)(6)(iii). See also I.R.S. Ltr. Rul. 7909020.

to lump-sum treatment on a distribution received after age 59½. However, because of the regs. sec. 1.401-1(b)(1)(i) requirement that a pension plan provide "definitely determinable benefits after retirement," the IRS has taken the position that an employee may not receive a lump-sum distribution from a qualified pension plan after age 59½ but prior to normal retirement age. Apparently, the IRS position is limited to pension plans, including money-purchase pension plans, since profit-sharing and stock-bonus plans are designed primarily to provide participation in profits.[9]

In the case of a self-employed individual, sec. 402(e)(4)(A) specifies that the distribution must be paid because of his death, after he has attained age 59½, or after he has become disabled.

Sections 402(a)(2) and 402(e)(4)(B) limit lump-sum treatment to an individual, trust, or estate.

1101.1 Capital Gain Treatment

A portion of a lump-sum distribution to a common-law employee, or to his beneficiaries in the case of distributions made after the employee's death, is taxed as long-term capital gain. This portion is computed as shown on p. 140.

The portion of the distribution attributable to post-1973 years of active plan participation is taxed as ordinary income, although the recipient may elect lump-sum treatment and the attendant ten-year averaging with respect to this portion.[10] The employee, unlike the self-employed individual, is entitled to capital gain treatment on the portion of the distribution attributable to pre-1974 participation whether or not lump-sum treatment for ten-year averaging is elected.[11]

The employee may also elect to treat all years of active participation as post-1973 years in order to qualify the entire distribu-

9. I.R.S. Announcement 75-110, based on T.I.R. 1334 (January 8, 1975) and T.I.R. 1403 (September 17, 1975) in Mertens, *Law of Federal Income Taxation–1975 Rulings* (Chicago: Callaghan & Co.) p.MA-485, as clarified by an October 29, 1976, special ruling, in *CCH Pension Plan Guide*, vol. 4, ¶17,348. The IRS position has been criticized. See, e.g., J.H. Boyd and M.J. Boyd, "Lump-Sum Distributions May Not Always Be Eligible for Ten-Year Averaging: An Analysis of Recent Decisions," *Taxes: The Tax Magazine* 56 (January 1978): 42, and J.R. Goldberg, "Lump-Sum Distributions: Rules: Planning to Avoid Adverse Consequences," *N.Y.U. Institute on Federal Taxation* 34, (1976): 1273–74.

10. §402(e)(1) and (4)(B).

11. §402(a)(2). See, e.g., I.R.S. Ltr. Ruls. 7928017, 7847010, and 7748053. While the recipient does not have to elect lump-sum treatment under §402(e)(4)(B), the distribution must nevertheless qualify as a lump sum.

Line			
1	Total distribution		$125,000
	Less		
2	Employee contributions	$20,000	
3	Previous nontaxable distributions	5,000	
4	Balance	15,000	
5	Net unrealized appreciation on employer's securities (1104)	10,000	25,000
6	Total taxable amount		$100,000
7	Pre-1974 calendar years of active plan participation		4
8	Total calendar years of active plan participation		10
9	Ratio of line 7 to line 8		40%
10	Capital gain portion (line 6 × line 9)		$ 40,000

NOTE As a result of the Technical Corrections Act of 1979, the §691(c) deduction for estate tax attributable to the distribution reduces the amount of the distribution eligible for ten-year averaging (but not the minimum distribution allowance) for decedents dying after April 1, 1980. See S. Rep. 96–498, pp. 28–29. The Revenue Act of 1978 provided a similar rule under which capital gain income in respect of a decedent is offset by the §691(c) deduction before computation of the capital gain deduction.

tion for ten-year averaging. The employee may make this election without making the election for ten-year averaging, in which case the entire distribution is taxed as ordinary income.

A self-employed individual may also elect ten-year averaging with respect to the portion of the distribution attributable to post-1973 years of active participation, in which case the pre-1974 portion of the distribution must be taxed as long-term capital gain. The self-employed individual is not entitled to capital gain treatment on the pre-1974 portion of the distribution unless ten-year averaging is elected with respect to the post-1973 portion of the distribution.[12] Otherwise, for a self-employed individual who does not elect ten-year averaging, the entire distribution is taxed as ordinary income. The self-employed individual may also elect to subject the entire lump-sum distribution to ten-year averaging by electing to treat all years of active participation as post-1973 years.

12. §402(a)(2) and (e)(4)(B); U.S., Congress, *Conference Committee Report on ERISA*, 93d Cong., 2d sess., 1974, H.Rep. 1280, p.351.

1101.2 Ten-Year Averaging

The ten-year averaging rules treat the ordinary income portion of the distribution as if it were received and taxed evenly at single-taxpayer (not head-of-household) rates over a ten-year period. The tax is computed separately from the regular income tax, so that, for example, electing ten-year averaging may not be advisable if the taxpayer has a net operating loss carryover. The ordinary income portion of the distribution, which is subject to ten-year averaging, is deductible "above the line" in computing the regular income tax to the extent that it is included in gross income.[13] Ten-year averaging does not preclude the use of regular income averaging.[14]

Five-Year Participation Requirement

Under sec. 402(e)(4)(H), to qualify for ten-year averaging an employee must have been a participant in a plan for at least five taxable years prior to the taxable year in which the distribution is received.

> If an amount, which would otherwise be a lump sum distribution, is distributed to A, an employee who has completed only 4 of his taxable years of participation in the plan before the first day of the taxable year in which the amount is distributed, A is not entitled to use the provisions of section 402(e) to compute the tax on the ordinary income portion of the amount distributed. If the amount were distributed to A's beneficiary on account of A's death, however, A's beneficiary could treat the distribution as a lump sum distribution. . . .[15]

The five-years-of-participation requirement does not apply for purposes of eligibility for capital gain treatment on the pre-1974 portion of the distribution. However, it *might* apply in order for the self-employed to obtain capital gain treatment on the pre-1974 portion of a lump-sum distribution.

The Revenue Act of 1978 deleted the five-year participation requirement for purposes of rolling over a distribution from a qualified plan to an IRA or another qualified plan.[16]

If the taxpayer chooses to roll over part of a plan distribution,

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13. §§62(11) and 402(e)(3).

14. §1304(b); *Conference Report on ERISA*, p.351.

15. Prop. regs. §1.402(e)-2(e)(3).

16. §402(a)(5)(D)(i)(II); U.S., Congress, Joint Committee on Taxation, *General Explanation of the Revenue Act of 1978*, 96th Cong., 1st sess., 1979, p.114.

ten-year averaging may not be elected.[17] Also, capital gain with respect to the portion of the distribution attributable to pre-1974 participation does not apply. (See the discussion of rollovers in chapter 17 regarding ten-year averaging for distributions from a qualified plan that previously received assets in a rollover.)

The ten-year averaging tax may not be offset by the investment credit (sec. 46(a)(4)), the foreign tax credit (sec. 901(a)), the WIN credit (sec. 50A(a)(3)), or the targeted jobs credit (sec. 53(a)).

An analysis of the intricacies of the ten-year averaging computation is beyond the scope of this study. Figure 11-1, though, shows the basic elements of the ten-year averaging computation.

The Look-Back Rule

The practitioner should also be aware of the "look-back" rule of sec. 402(e)(2), which requires consideration of other lump-sum distributions received in the current year or during the five preceding years. The look-back rule subjects the lump-sum distribution to the ten-year averaging tax at a higher rate than would otherwise be the case. Since the election of lump-sum treatment is a one-time election for any employee beyond age 59½, the look-back rule may affect such taxpayers as a widow electing ten-year averaging for lump-sum distributions received from her own plan and her deceased husband's plan.[18]

If possible, the taxpayer should delay distributions that may otherwise be subject to the look-back rule. For example, it may be desirable to postpone a planned early retirement to avoid the impact of the look-back rule.

Electing Ten-Year Averaging

Temporary regs. sec. 11.402(e)(4)(B)-1 prescribes the mechanics of electing ten-year averaging. The taxpayer must make the election for each taxable year for which it is to apply by filing Form 4972 (the ten-year averaging form) with the return or amended return. When there is a distribution to more than one recipient (except for certain trusts) on behalf of the same employee, the taxpayer should file Form 5544. The election must be made before the expiration of the period (including extensions) prescribed by sec. 6511 for claiming a credit or a refund for the year. Within the same time period,

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17. §402(a)(6)(C).

18. §402(e)(4)(B) and temp. regs. §11.402(e)(4)(B)-1(a).

the taxpayer may revoke the election by filing an amended return that includes a statement revoking the election and payment of any tax resulting from the revocation.

Figure 11-1

Ten-Year Averaging Computation

The employee receives a lump-sum cash distribution of $200,000 from the employer's calendar-year plan. The employee had participated in the plan for twenty years when he retired at the end of 1983.

Step 1.	Determine the total taxable amount (the total lump-sum distribution, including capital gain portion, less net employee contributions and unrealized appreciation on employer securities).		$200,000
Step 2.	Subtract the minimum distribution allowance, which is		
	a. The lesser of (i) $10,000 or (ii) 50% of the total taxable amount,	$10,000	
	b. Less 20% of the amount by which the total taxable amount exceeds $20,000.	36,000	
	(The result cannot be less than zero.)	–0–	–0–
			$200,000
Step 3.	Compute the initial separate tax.		
	a. Add $2,300 to 1/10 of the result of step 2. 1/10 × 200,000 = $20,000 + 2,300 =	$22,300	
	b. Calculate the tax, using single-taxpayer rates.	4,959	
	c. Multiply by 10.	×10	
	Initial tax	$49,590	
Step 4.	Compute the ordinary income portion (sec. 402(e)(4)(E)) by multiplying the total taxable amount (step 1) by the following fraction: Calendar years of active participation after 1973 ÷ calendar years of active participation* $\$200,000 \times \frac{10}{20}$		$100,000

Figure 11-1 (cont.)

Step 5. Compute the ordinary income tax by dividing the ordinary income portion (step 4) by the total taxable amount (step 1) and multiplying the result by the initial separate tax (step 3).	
$\$49,590 \times \frac{\$100,000}{\$200,000}$	$ 24,795
The individual is married and has no taxable income except his $100,000 long-term capital gain resulting from the distribution. The taxpayer does not itemize.	
Long-term capital gain	$100,000
Capital gain deduction	60,000
Adjusted gross income	40,000
Exemptions	2,000
Taxable income	$ 38,000
Regular tax	$ 9,366
Alternative minimum tax	
Taxable income (net of zero bracket amount)	$ 34,600
Long-term capital gain deduction	60,000
Alternative minimum taxable income	$ 94,600
Tax on first $20,000	-0-
10% of next $40,000	4,000
20% of next $34,600	6,920
	$ 10,920
Total tax liability	
Ten-year averaging tax	$ 24,795
Greater of regular income tax or alternative minimum tax	10,920
Total tax on distribution	$ 35,715

NOTE The total tax liability is still less than it would be had the taxpayer not elected ten-year averaging. While the 50 percent maximum tax on personal service income may be available, ten-year averaging is still advantageous. Moreover, if the taxpayer had elected to treat all years of participation as post-1973 years, his tax liability would be $49,590 (step 3).

*The Treasury may prescribe regulations using plan years instead of calendar years (§402(a)(2)).

1101.3 Other Tax Breaks for Lump-Sum Distributions

Maximum Tax Rate

It is not entirely clear whether the 50 percent maximum tax rate on personal service income (discussed in chapter 3) applies to the ordinary income portion of a lump-sum distribution if ten-year averaging is not elected. The Tax Reform Act of 1976 extended the maximum tax rate to deferred compensation, including pensions and annuities. The IRS has ruled that installment distributions that a trust beneficiary of a qualified profit-sharing plan received in 1977 as income in respect of a decedent were eligible for the maximum tax rate.[19] The IRS has also issued a private ruling that a one-time distribution from a nonqualified plan for highly paid executives is eligible for the maximum tax rate.[20] It would appear to be anomalous for the IRS to accord less favorable treatment to a distribution just because it is from a qualified plan and meets the definition of a lump-sum distribution.

There is a problem of statutory construction, however, since the sec. 1348(b) definition of "personal service income" subject to the maximum tax specifically excludes amounts to which sec. 402(a)(2) (capital gain) and sec. 402(e) (ten-year averaging) apply. The IRS letter ruling dealing with the nonqualified plan pointed out that these exceptions do not apply to a nonqualified plan.[21]

For a lump-sum distribution defined in sec. 402(e)(4)(A), the recipient elects lump-sum treatment under sec. 402(e)(4)(B) and thereby becomes subject to the ten-year-averaging tax imposed by sec. 402(e)(1). If the sec. 402(e)(4)(B) election is not made, sec. 402(e) may not "apply," even though the distribution is still a lump-sum distribution defined in sec. 402(e). Thus, the maximum

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19. I.R.S. Ltr. Rul. 7913046. None of the distribution consisted of interest accrued after the employee's death. However, the benefit of the maximum tax may be lost for distributions from trusts, because the Tax Reform Act of 1976 (P.L. 94-455) repealed the character pass-through rule for accumulation distributions. See D.L. Cornfeld, "New Laws on Accumulation Trusts Require Practitioners to Take Prompt Action," *Journal of Taxation* 45 (December 1976): 334.

20. I.R.S. Ltr. Rul. 7839130.

21. I.R.S. Ltr. Rul. 7839130 cites U.S., Congress, Senate, 94th Cong., 2d sess., 1976, S. Rep. 938, pp.114–116, which states that lump-sum distributions and penalty distributions are ineligible for the maximum tax.

tax appears to be available, consistent with apparent legislative intent; however, opinions vary on this question.[22]

Legislative history expressly sanctions the availability of the maximum tax on the retained portion of a partial rollover, and it has been suggested that a taxpayer roll over a nominal amount to take advantage of this legislative intent.[23] It is not clear, however, that this is necessary to assure access to the maximum tax rate. A partial rollover also eliminates the capital gain treatment for the portion of the distribution attributable to pre-1974 participation.[24]

Regular Income Averaging

The ordinary income portion of a lump-sum distribution is eligible for regular income averaging (discussed in chapter 2) if ten-year averaging is not elected. (Regular averaging would always be available for the capital gain portion.)

Death Benefits

Lump-sum distributions from a qualified plan qualify for the $5,000 death benefit exclusion of sec. 101(b) (discussed in 502), despite the fact that the employee may have had a nonforfeitable right to the benefit while living.

1101.4 Distributions From More Than One Plan

In order to utilize ten-year averaging, the recipient must elect lump-sum treatment for all such amounts received during the year.[25] The employee's capital gain treatment does not depend on electing lump-sum treatment, nor is it necessary to elect lump-sum

22. P.I. Elinsky and J. Jones, "Maxi-Tax: Qualifications of Lump-Sum Distribution," in Tax Clinic, ed. P. Elder, *Tax Adviser* 10 (April 1979): 234, states, "Based on discussions with the Joint Committee on Taxation, the intent of Congress was to allow the portion of a lump sum distribution that is not taxed under the favorable capital-gains or ten-year average provisions to be taxed as personal service income." Also see U.S., Congress, Joint Committee on Taxation, *Joint Committee Report on the 1976 Tax Reform Act*, 94th Cong., 2d sess., 1976, p.110, which states, "Lump sum distributions which are taxed under special rules . . . do not qualify for the maximum tax." But Elinsky and Jones opine that it appears that the maximum tax may not be available. Cf. J.F. Nasuti, "How to Coordinate Income and Estate Tax Planning for Qualified Plan Distributions," *Journal of Taxation* 49 (October 1978): 195, n.10, and 198, n.25.

23. Elinsky and Jones, "Maxi-Tax: Qualification of Lump-Sum Distribution," pp.234–35.

24. §402(a)(6)(C).

25. §402(e)(4)(B).

treatment to have a "qualifying rollover distribution."[26] (Rollovers are the subject of chapter 17.) The requirement that the taxpayer elect lump-sum treatment for all such amounts received during the year—and the sec. 402(e)(1) imposition of the ten-year-averaging tax once such an election has been made—may, however, effectively preclude the employee from electing ten-year averaging with respect to a pension distribution and rollover treatment for a profit-sharing distribution when the distributions are received in the same year.[27]

It seems clear that the alternative of rolling over one distribution and applying ten-year averaging with respect to another distribution is not available if the distributions are from plans of the same employer and of the same type (for example, two profit-sharing plans). This is because the definition of a lump-sum distribution includes distribution of the "balance to the credit of the employee" within one taxable year, and the aggregation rule requires that all pension plans maintained by an employer be treated as a single plan for this purpose. The same rule applies to profit-sharing plans and stock-bonus plans. The IRS has ruled that the rollover of a distribution from one type of plan precludes ten-year averaging with respect to a distribution received in the same year from another type of plan.[28] The IRS indicated, however, that the rollover does not preclude capital gain treatment with respect to the lump-sum distribution that is not rolled over.[29]

Lump-sum distributions from different plans should be received in different taxable years to avoid the result of these rulings.

1102 Electing to Treat All Years as Post-1973 Years of Participation

The tax planner should consider the advisability of the election to treat all years as post-1973 years of participation in the plan.

A taxpayer receiving a lump-sum distribution may irrevocably elect to treat all years of active participation as post-1973 years.[30] The

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26. §402(a)(2) and §402(a)(5)(D)(i)(II).

27. See I.R.S. Ltr. Rul. 7928017.

28. I.R.S. Ltr. Ruls, 7842049 (where the §402(e)(4)(L) election was also made) and 7928017.

29. I.R.S. Ltr. Rul. 7928017.

30. §402(e)(4)(L). See J.O. Everett and C.A. Geddeis, "Lump Sum Distributions and the Special 10-Year Averaging Election: '78 Act May Alter the Decision," *Tax Adviser* 10 (October 1979): 594.

election applies to all the recipient's lump-sum distributions with respect to the same employee. The election is not available if a previous post-1975 lump-sum distribution received long-term capital gain treatment.

The election is designed to alleviate situations in which "capital gains treatment creates a burden instead of relief."[31] (Large capital gains may be subject to the alternative minimum tax discussed in chapter 1.)

For employees and self-employed individuals, the election eliminates capital gain treatment on the portion of the distribution attributable to pre-1974 participation, and it allows the taxpayer to elect ten-year averaging for the entire lump-sum distribution. This irrevocable election can be disastrous for an employee who makes the election with the understanding that ten-year averaging is available but who then fails to satisfy the five-year participation requirement.

The tax planner should consider the potential adverse effect on any lump-sum distribution before he elects to treat all years of participation as post-1973 years. Because the election applies to all the recipient's lump-sum distributions with respect to the same employee, it effectively removes the possibility of capital gain treatment on a lump-sum distribution from another plan. If a 59½-year-old recipient made this election and also elected ten-year averaging with respect to an earlier distribution, a distribution in a later year will be ordinary income, without benefit of capital gain treatment or ten-year averaging (unless rolled over).[32]

Making the Election

The taxpayer must make the election by the due date of the return, including extensions.[33] The taxpayer does so, if ten-year averaging is also elected, by checking the appropriate box on Form 4972, or Form 5544 in the case of a recipient (except certain trusts) of a lump-sum distribution made to more than one recipient on behalf of the same employee. A taxpayer who does not elect ten-

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31. U.S., Congress, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976*, 94th Cong., 2d sess., 1976, p.442.

32. See I.R.S. Ltr. Rul. 7748053.

33. Temp. regs. §7.0(b)(1), reproduced in *CCH Standard Federal Tax Reporter*, ¶407.

year averaging makes the election by attaching a statement to his income tax return indicating that the election is being made under sec. 402(e)(4)(L) and identifying the election, the period for which it applies, and the taxpayer's basis or entitlement for making the election.[34]

1103 Estate Tax Exclusion

The lump-sum recipient should consider waiving favorable income tax treatment in return for estate tax exclusion.

Certain benefits received from a qualified plan, other than benefits receivable by the executor, may escape estate tax under the sec. 2039(c) exclusion for annuities or payments other than lump-sum distributions.[35] The Revenue Act of 1978 allows lump-sum distributions to qualify for this exclusion if the beneficiary *irrevocably* elects, under sec. 2039(f), to forego capital gain treatment and ten-year averaging.[36]

Proposed Estate Tax Regs. sec. 20.2039-4(d) provides that the sec. 2039(f) election is made by determining income on the return (or amended return) without capital gain and ten-year averaging treatment. The proposed regulations also provide that no estate tax exclusion may be claimed prior to submission to the district director of evidence that the recipient has made the election; this apparently necessitates allowing the executor to have access to the recipient's income tax returns.

A beneficiary with no estate tax burden may have little incentive to elect to forego the income tax benefits, even though the estate tax savings may outweigh the income tax advantage.[37]

The code generally permits *either* the income tax advantages of ten-year averaging and capital gain treatment *or* estate tax exemption, but not both. In comparing the estate and income tax consequences, the practitioner should not forget the sec. 691(c)

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34. Temp. regs. §7.0(d).

35. Defined in §402(e)(4).

36. *General Explanation of the Revenue Act of 1978*, p.92.

37. In connection with this problem, see N.P. Damico, 370 *Tax Management, Qualified Plans–Taxation of Distributions*," p.A-37.

deduction for estate taxes attributable to income in respect of a decedent.[38]

1104 Distribution of an Employer's Securities

The taxable portion of a lump-sum distribution can be reduced by the amount of any net unrealized appreciation attributable to securities of an employer corporation that are included in the distribution to an employee.

Distributions of appreciated employer securities are taxed more favorably than other lump-sum distributions. There is no immediate taxation on the portion of the distribution representing net unrealized appreciation in employer securities. The five-year participation requirement does not apply for this purpose. Also, the recipient can obtain capital gain taxation on his subsequent sale of these securities.[39] If the employee's heirs sell the securities, stepped-up basis is not available, because the net unrealized appreciation constitutes income in respect of a decedent.[40]

A non-lump-sum distribution of employer securities can only be reduced by the net unrealized appreciation deemed acquired through employee contributions. (Compare secs. 402(a)(1) and 402(e)(4)(J).) Furthermore, regs. sec. 1.402(a)-1(b)(3) prohibits exclusion of any appreciation in securities acquired with earnings on employee contributions.

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38. For general discussion of this and other considerations, see M.A. Mead, "Optimum Timing for Qualified Plan Distributions," Tax Clinic, ed. S.R. Josephs, *Tax Adviser* 9 (May 1978): 279, and J.F. Nasuti, "How to Coordinate Income and Estate Tax Planning for Qualified Plan Distributions," *Journal of Taxation* 49 (October 1978): 194. U.S., Congress, House, 96th Cong., 1st sess., 1979, H.Rep. 250, p.21, indicates that "the Revenue Act of 1978 added a provision which coordinated the (Sec. 691(c)) deduction for estate taxes with the capital gain deduction so that the amount of any capital gain which is income in respect of a decedent is offset by the deduction for estate taxes before the capital gain deduction is computed. . . . The bill provides that the amount of a death benefit distribution subject to 10-year averaging will be reduced by the amount of the death tax deduction attributable to the distribution" (explanation of the Technical Corrections Act of 1979). The Crude Oil Windfall Profit Tax Act of 1980 repealed the changes made by the Tax Reform Act of 1976, so that the §691(c) deduction will continue to be allowed for only the *federal* estate tax attributable to income in respect of a decedent. This deduction will also continue to be computed at the highest marginal estate tax rate.

39. Rev. Rul. 71-394, 1971-2 C.B. 211.

40. Rev. Rul. 75-125, 1975-1 C.B. 254.

1105 Annuities

A plan can provide that its covered employees may elect to receive payments over an extended period (an annuity) in lieu of a lump-sum settlement.

If an employee elects, *within sixty days* after the lump sum becomes payable, to receive a nontransferable annuity from the plan, the employee is taxed only on the actual cash receipts.[41]

If the employee merely elects to receive from the plan payments over more than one taxable year or under an annuity, the receipts are simply ordinary taxable income when received if the employee has no investment in the contract. If the employee has such an investment, each distribution consists of a pro rata portion of taxable income and a nontaxable cost recovery, usually measured by the life expectancy of the annuitant or joint annuitant. If the employee's entire cost will be recovered in three years, none of the distributions are included in income until his cost is recovered.[42]

Electing to take deferred (annuity-type) distributions, if permitted by the plan, may be advantageous, even though the benefits do not qualify for capital gain or ten-year-averaging treatment. Taxation of the benefits is deferred over a period of years; income is not concentrated in a single year. Distributions qualify for regular income averaging (discussed in chapter 2), as well as the 50 percent maximum tax on personal service income (discussed in chapter 3).[43] If there are undistributed benefits at the employee's death, tax may be shifted to beneficiaries whose tax brackets may be lower than that of the employee.

The decision to take annuity-type payments generally precludes lump-sum treatment of a later distribution of the account balance. A later distribution ordinarily will not be eligible for capital gain treatment, ten-year averaging, or rollover;[44] however, a distribution to beneficiaries at the employee's death may qualify as a lump-sum distribution despite earlier annuity-type payments

41. Rev. Rul. 59-94, 1959-1 C.B. 25, which applies §72(h), dealing with annuity options in general, to qualified employees' profit-sharing trusts. See also regs. §1.402(a)-1(a)(2).

42. §72(d).

43. §1348(b)(1)(A).

44. See regs. §1.402(a)–1(a)(6)(iii) and I.R.S. Ltr. Rul. 7909020.

to the employee.[45] Also, rollover may be possible despite earlier annuity payments if a distribution is the result of the plan's termination.[46]

In addition, any balance unpaid at the employee's death is not subject to estate tax unless the balance is payable to the executor.[47]

45. See Rev. Rul. 69-495, 1969-2 C.B. 100, and *Est. of Benjamin*, 465 F.2d 982 (7th Cir. 1972), aff'g 54 T.C. 953 (1970).

46. See I.R.S. Ltr. Rul. 7930178.

47. See §2039(c).

12

Long-Term Capital Gain

Real Estate and Business Properties

There is significant capital gain potential associated with real estate, including rental real estate and other business properties. (The ability to convert ordinary income into capital gain through depreciable realty is discussed in 2601 in connection with the use of real estate as a tax shelter.)

1201 Subdividing Real Estate

An individual can obtain capital gain treatment on subdivided property by meeting the requirements of sec. 1237. If such compliance is not possible or desirable, the individual may still avoid ordinary income in certain circumstances.

1201.1 Real Estate Subdivision: A Case Study

A client owns a fairly substantial tract of real property that he currently uses as his residence. He has been offered alternative inducements to vacate the premises: $250,000 if the property is sold as is or $400,000 if the property is subdivided and sold as individual parcels.

He consults his CPA about whether subdividing would be worthwhile. The CPA offers the following advice.

Sale of the Property as a Whole

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 can be treated as a long-term capital gain. Such treatment may be available if the property is a personal residence at the time of sale or if it has been converted to rental property.

In the event that a new residence is acquired within eighteen months of the sale, or construction of a new residence is started within eighteen months of the sale and completed within two years 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 currently taxed gain is determined on the amount by which the selling price of the old residence exceeds the cost of the new residence. This means that the entire sales proceeds of $250,000 must be reinvested in a new residence if all federal income tax on the gain is to be postponed. If a new residence is purchased, for example, at a cost of $200,000, only $50,000 of the $178,000 total gain will be taxable. 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* 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)). In one case, for example, a garden, orchard, and chicken yard, which provided products for a taxpayer's *own* use, were categorized by the IRS as residential property.[1]

Since it is understood that the client may rent an apartment, these nonrecognition-of-gain provisions may not be available.[2] 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 aged fifty-five or older.[3]

Sale of Property After It Has Been Subdivided

All of the acreage can be sold for $400,000 if it is first subdivided. The cost of subdivision is unknown; but if it is assumed to be $50,000, the following gain would be realized.

1. Rev. Rul. 56-420, 1956-2 C.B. 519.
2. These provisions, authorized by § 1034, are discussed further in 1501, herein.
3. See the discussion of § 121 at 601, herein.

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. A comparison between the cash yield in this situation and the cash yield on a sale of the property without subdividing is shown in figure 12-1.

Figure 12-1

	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 tax (1980 rate)†	—	49,840	
Total federal income tax	194,600	49,840	144,760
Net gain (cash yield)	$ 83,400	$128,160	$(44,760)

*Presumes joint return and other income of over $225,000.

†28% (100% − 60% capital gain deduction = 40% × 70%). This capital gain is not subject to the 15% add-on minimum tax (chapter 1) or, to the extent that it qualifies as gain from the sale of a principal residence, to the alternative minimum tax (chapter 1).

This computation assumes that all gains will be realized during one year. Of course, the income tax could be decreased if the sale or sales are made on the installment basis so that income is reportable over a period of years rather than in one year.

The computation discloses a net cash reduction of $44,760 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 by meeting either the requirements expressly prescribed by sec. 1237 or the general rules for differentiating capital assets.

Internal Revenue Code Provisions

Under sec. 1237 gain from the sale of subdivided property is entitled to capital gain treatment if *all* of the following tests are satisfied:

- The lot has been held for five years (unless acquired by inheritance).
- 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.
- No substantial improvement that substantially enhances the value of the lots is 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 on the particular circumstances. However, the income tax regulations provide that if improvements increase values by no more than 10 percent the increase is not 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 that 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.[4]

Further, the benefits of sec. 1237 can be obtained even

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4. Regs. § 1.1237-1(c)(4).

though substantial improvements have been made if the following conditions are met:

- The client has held the property for ten years.
- The improvement consists of the building or installation of water, sewer, or drainage facilities (surface, subsurface, or both) or roads, including paved roads, curbs, and gutters.
- The client shows, to the satisfaction of the IRS, that without the improvement the lot would not have brought the prevailing local price for similar building sites.
- The 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 depends on the amount of improvement cost involved and the difference between the ordinary income rates and capital gain rates. Based on the facts in this situation, this election can increase the client's after-tax gain on the subdivided property by $102,760, as shown in figure 12-2.

Figure 12-2

	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 (1980 rate)*	91,840	—	
Total tax	91,840	194,600	$(102,760)
Gain less tax	236,160	83,400	
Cost of improvements not deducted above	50,000	—	
Net gain (cash yield)	$186,160	$ 83,400	$ 102,760

*Alternative minimum tax is ignored.

In comparison with the capital gain on the property without subdividing, the election produces the following additional after-tax gain:

Net gain on subdivided property, with election in effect	$186,160
Net gain on property, without subdividing	128,160
Benefit from subdividing and election	$ 58,000

Section 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 in which the sixth lot is sold to be considered ordinary income (to the extent that this amount represents a gain). The balance of any gain is considered capital gain. 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. The effect of this special rule can be mitigated if sales can be controlled, as shown in figure 12-3.

Figure 12-3

	Taxpayer	
	A	B
Lots sold:		
1980	5	6
1981	2	1
Tax treatment:		
1980	All capital gain	5% rule applies
1981	5% rule applies	5% rule applies

Furthermore, if the client does not sell any lots for five years after the sale of at least one lot, the remainder of the tract is deemed a new tract in determining when more than five lots have been sold (for purposes of this 5 percent rule). (This special 5 percent rule applies even though all the other requirements of sec. 1237 are met.)

1201.2 Sale of Subdivided Property Not Covered by Section 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."[5] By the same token, sec. 1237 does not apply, even though its conditions are met, if the real property sold would be entitled to capital gain treatment (or sec. 1231 treatment) without regard to sec. 1237.[6] "Thus, the district director may at all times conclude from convincing evidence that the taxpayer held the real property solely as an investment. . . ."[7]

Regardless of whether or not its conditions are met, sec. 1237 is inapplicable to losses realized on the sale of subdivided realty.

1201.3 Qualifying Realty as Investment Property Eligible for Capital Gain Treatment

The real estate investor must realize that he runs the risk of being considered a real estate dealer. The *Gault* case was one forum in which the courts described the factors that may give rise to dealer status.

> 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 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."[8]

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5. Regs. § 1.1237-1(a)(4).
6. See 1203, herein.
7. Regs. § 1.1237-1(a)(4).
8. Excerpt from *Howard W. Gault et al.*, 332 F.2d 94 (2d Cir. 1964), aff'g 22 T.C.M. 847. The Mertens observation is from Mertens, *Law of Federal Income Taxation* (Chicago: Callaghan & Co.), § 22.138, n.69.

Installment Reporting

Reporting on the installment method may not only defer gain but may also reduce the effective tax rate on capital gains by spreading the gain over a period of years. (This method is discussed in chapter 19). Elective installment reporting may also minimize the alternative minimum tax that might otherwise apply if the client has capital gains that are significant in relation to his other income. (The alternative minimum tax is discussed in chapter 1).

Maximum Tax Rate on Personal Service Income

The practitioner might consider advising a client to engage in sufficient subdividing and selling activities to be classified as a dealer; as a dealer, the client would avoid sec. 1237 treatment.[9] This procedure is desirable only if the increased after-tax profit resulting from the client's activities exceeds the additional taxes generated by conversion of capital gain into ordinary income. In making this determination, the following factors are pertinent:

1. A reasonable allowance for personal services rendered in real estate activities can be personal service income. Therefore, part of the resulting ordinary income appears to be eligible for the 50 percent maximum tax rate on personal service income.[10] The balance of ordinary income is subject to regular rates.
2. The maximum capital gains tax rate is 28 percent. The alternative minimum tax may also apply, as indicated in chapter 1.
3. Capital gains are eligible for income averaging, which can lower their effective tax rate. Under sec. 1304(b)(3) income averaging and the maximum tax rate on personal service income are mutually exclusive. This conflict may necessitate further computations.

Note The maximum tax rate on personal service income is discussed in chapter 3. Income averaging is discussed in chapter 2.

1201.4 Infrequent Sales of Real Property

Sales to Related Parties

If sec. 1237 benefits are unavailable, the practitioner should consider the following points in any transaction between a taxpayer

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9. See regs. § 1.1237-1(a)(1), (2), (3).
10. § 1348(b)(1).

and his controlled corporation or the members of his family.

1. Controlled Corporations. Thinness: A sale to a newly created corporation usually cannot be consummated for full and immediate cash payment. Using the "thin corporation" doctrine, the taxing authorities may construe the incorporator-seller's notes receivable as representing an equity interest (see prop. sec. 385 regulations), with the following undesirable results:
   - The corporation is denied a stepped-up basis for the property, causing it to realize greater gains (generally taxed at ordinary rates) when it disposes of the property.
   - Double ordinary income taxation is generated, since principal and interest payments on the notes are classed as nondeductible dividends, taxable as ordinary income to the payee.
2. Controlled Corporations. Collapsibility: Premature sales of the corporation's stock, either to avoid the thin corporation problem or to liquify investments, precipitate ordinary income if the corporation is a "collapsible corporation" as defined by sec. 341. (See 1302.2 for a discussion of the sec. 341(f) special relief election.)
3. Controlled Corporations. Sham: In appropriate cases, the revenue service may argue *substance* over *form* and disregard the corporation's existence. This would undo the entire transaction and place a client in his original position of being unable to avoid ordinary income on the sale of his land.
4. Family Members. A sale to a child, or a trust for the child's benefit, may produce capital gain for the parent. The buyer, who originally is not a dealer, also stands a better chance of avoiding ordinary income on subsequent sales. (As one alternative, sec. 1237—which is unavailable to dealers—would be within easier reach.)

   Furthermore, if and when the buyer recognizes ordinary income, it may be taxed in a lower bracket than that of the parent and the substance-over-form danger may apply.

Sales to Unrelated Parties

A dealer may avoid ordinary income, 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 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 disposition of the property after he has improved, subdivided, or otherwise acted with respect to it. . . ."[11]

1201.5 Sales of Inherited Real Property

Mertens states, "In the absence of extensive development and sales activity, the liquidation of inherited property has been held to result in capital gain even though the process of liquidation involved frequent and continuous sales."[12]

1202 Reducing Ordinary Income From Depreciation Recapture

The practice of transforming ordinary income into capital gain received a severe setback in 1962 and further setbacks in 1964, 1969, and 1976 with the enactment and subsequent amendments of two new code sections. These statutory provisions seek to recapture gains on sales of property, to the extent that the gains result from tainted depreciation, and deem them noncapital gains. The two code sections are the following:

- Section 1250, which relates to depreciable real property.
- Section 1245, which relates to 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.

Section 1250 can be described as a milder version of sec. 1245—"milder" because of two factors that are unique to sec. 1250:

1. Only "additional" depreciation is recapturable. Section 1250(b) defines *additional depreciation* as the amount by which actual depreciation exceeds a hypothetical straight-line computation for the same period. This definition applies to actual depreciation allowed or allowable after December 31, 1963.
2. Only a constantly decreasing percentage of this additional depreciation is taken into account in determining the amount to be recaptured. (This sliding scale is known as the "applicable

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11. Mertens, *Law of Federal Income Taxation* (Chicago: Callaghan & Co.), §22.146, n.71.
12. *Ibid*, §22.142.

percentage.") This particular attribute, however, only applies in particular circumstances.

These provisions affect all code sections concerned with depreciable property dispositions that are not excepted by the express terms of sec. 1245 or 1250.

1202.1 Avoiding Recapture on Section 1250 Property

The taxpayer should consider using only the straight-line method of depreciation on sec. 1250 real estate, and he should hold the property for at least one year. For certain sec. 1250 properties, he can select another permissible method of depreciation, but he must hold the property for at least the particular period that is necessary to avoid recapture.

Permissible methods of depreciation are summarized in figure 12-4. These are the fastest methods permitted for the various property categories; they do not preclude slower methods, such as straight-line, when those are appropriate.

Figure 12-4

Permissible Depreciation Methods

New (sec. 167(j)):	
Residential rental property	200%-declining-balance or sum-of-the-years-digits
Other new sec. 1250 property	150%-declining-balance or any generally comparable method
Used (sec. 167(j)):	
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 1982 for low-income rental housing (sec. 167(k))	Straight-line over 60-month period
Certain expenditures for child care facilities (sec. 188)	Straight-line over 60-month period
Certain rehabilitation expenditures for certified historic structures (sec. 191)	Straight-line over 60-month period

Necessary Holding Periods

The Tax Reform Act of 1976 provided for the complete recapture of all post-1975 depreciation in excess of straight-line in the case of residential real property, a provision that already applied to nonresidential property. The exceptions permitted by the Tax Reform Act of 1976 pertain to certain low-income rental housing; they include the rapid amortization of expenditures to rehabilitate low-income rental housing under sec. 167(k).[13] Consequently, the length of the holding period is immaterial in reducing recapture of post-1975 depreciation on property other than low-income rental housing.

The holding period necessary to avoid recapture of pre-1976 depreciation in excess of straight-line depreciation is shown in figure 12-5.

Priority for recapture is based on the year of excess depreciation. First to be recaptured is gain resulting from post-1975 excess depreciation, followed by gain resulting from depreciation in the period from 1970 to 1975, which is followed by gain attributable to excess depreciation in the years 1964 through 1969.[14]

Changing Depreciation Methods

In determining the desirability of changing from an accelerated method to the straight-line method to minimize anticipated future recapture, the practitioner may want to use projections. The practitioner should also keep in mind that the excess of accelerated depreciation over straight-line is a tax preference (sec. 57(a)(2))for purposes of the 15 percent add-on minimum tax (discussed in chapter 1).

A change from the 200 percent or 150 percent declining-balance method to the straight-line method can be made without IRS consent unless the change is prohibited by a sec. 167(d) agreement.[15] A change from the sum-of-the-years-digits method to the straight-line method can likewise be made; however, the application for change must be filed (with the service center director) within 180 days of the *beginning* of the year for which the change

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13. § 1250(a)(1)(B).

14. U.S., Congress, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976*, 94th Cong., 2d sess., 1976, p.31.

15. Regs. § 1.167(e)-1(b); Rev. Rul. 74-324, 1974-2 C.B. 66.

Figure 12-5

Required Holding Periods

Type of property	Applicable percentage	Holding period required for no recapture
	Post-1975 Depreciation	
Low-income rental housing (sec. 1250(a)(1)(B)(i)-(iv))	100% less 1% for each full month after 100 months	200 months (16 years and 8 months)
Other sec. 1250 property (sec. 1250(a)(1)(B)(v))	100%	Not applicable (there is recapture regardless of the holding period)
	1970–1975 Depreciation	
Property disposed of, pursuant to a written contract binding on the owner, on or after July 24, 1969 (sec. 1250(a)(2)(B)(i))	100% less 1% for each full month after 20 months	120 months (10 years) (post-1979 dispositions should avoid recapture)
Certain low-income rental housing (sec. 1250(a)(2)(B)(ii))	100% less 1% for each full month after 20 months	120 months (10 years)
Other residential property, as defined in sec. 167(j)(2)(B) (sec. 1250(a)(2)(B)(iii))	100% less 1% for each full month after 100 months	200 months (16 years and 8 months)
Rehabilitation expenditures for low-cost rental housing under sec. 167(k) (sec. 1250(a)(2)(B)(iv))	100% less 1% for each full month after 100 months	200 months (16 years and 8 months)
Other sec. 1250 property (sec. 1250(a)(2)(B)(v))	100%	Not applicable (there is recapture regardless of the holding period)
	Pre-1970 Depreciation	
All sec. 1250 property (sec. 1250(a)(3)(B))	100% less 1% for each full month after 20 months	120 months (10 years) (post-1979 dispositions avoid recapture)

is sought.[16] Conversely, the taxpayer can change from straight-line to accelerated depreciation for otherwise eligible property.[17]

Computation of Recapture for Section 1250 Property

An apartment building that was constructed for $100,000 and completed on December 31, 1971, is sold for $100,000 on December 31, 1980. (Land values are excluded.) The actual accelerated depreciation claimed and the hypothetical straight-line depreciation for the period are shown in figure 12-6. A forty-year life is assumed. Although 200 percent declining-balance depreciation could have been used for this residential property, 150 percent declining-balance is shown for illustrative purposes.

Figure 12-6

	Depreciation		
Year	Accelerated	Straight-line	Additional
1972	$ 3,750	$ 2,500	
1973	3,609	2,500	
1974	3,474	2,500	
1975	3,344	2,500	
Post-1969 to pre-1976	14,177	10,000	4,177
1976	3,218	2,500	
1977	3,097	2,500	
1978	2,982	2,500	
1979	2,870	2,500	
1980	2,762	2,500	
Post-1975	14,929	12,500	2,429
	$29,106	$22,500	$6,606

Note Because post-1969 additional depreciation on commercial property is subject to 100 percent recapture, the separate computations of additional depreciation from 1970 to 1975 and from 1976 to 1980 would not be necessary if the property were a commercial building. The sec. 1250 depreciation recapture would simply be $6,606 (100 percent of the lesser of the additional depreciation or the recognized gain).

16. Rev. Proc. 74-11, 1974-1 C.B. 420.
17. *Ibid.*

Recapture is computed as shown in figure 12-7.

Figure 12-7

Line			
1.	Proceeds of sale		$100,000
	Less adjusted basis		
2.	Original cost	$100,000	
3.	Less allowed or allowable depreciation	29,106	
4.	Adjusted basis		70,894
5.	Total gain recognized		29,106
6.	Post-1975 additional depreciation		$ 2,429
	Recapture of post-1975 depreciation		
7.	100% of lesser of lines 5 or 6		$ 2,429
	Recapture of depreciation after 1969 and before 1976		
8.	Line 5	$ 29,106	
9.	Less line 7	2,429	
10.	Remaining gain	$ 26,677	
11.	Post-1969 and pre-1976 additional depreciation	$ 4,177	
12.	Applicable percentage*	92%	
13.	92% of lesser of lines 10 or 11		3,843
14.	Total recapture (lines 7 and 13) treated as ordinary income		6,272
15.	Sec. 1231 gain** (line 5 less line 14)		$ 22,834
16.	Total gain recognized (per line 5)		$ 29,106

*Property has been held 108 months. The applicable percentage is 100% less 1% for each full month over 100 months = 92%.

**See the discussion of sec. 1231 at 1203.

1202.2 Avoiding or Mitigating Recapture on Section 1245 or Section 1250 Property

Several techniques are available to the taxpayer: He should consider using multiple-asset accounts whenever possible, should consider installment sales, should sell stock rather than corporate assets, and should be aware of relevant statutory exceptions.

Since sec. 1245's impact on capital gain taxation is so much more devastating than that of sec. 1250, these techniques are primarily attuned to sec. 1245; however, they may also be applicable in a sec. 1250 situation, especially if the ordinary income potential is material.

Multiple-Asset Accounting for Depreciable Property

Certain individual owners of depreciable properties—such as the owner of an apartment house providing furnished rooms or the sole proprietor of a professional practice or a commercial enterprise—can use multiple-asset accounting.

Partners' taxable incomes derived from their partnership operations are also affected by recapture at the company level. Consequently, this discussion also applies to depreciable property owned by partnerships.

Regulations section 1.167(a)-7(a) provides that a taxpayer can account for depreciable property by treating each individual item as an account or by combining two or more assets in a single account. Regulations section 1.167(a)-8(e)(2), dealing with the accounting treatment for asset retirements, permits the nonrecognition of gains under the following circumstances:

- Multiple asset accounts are used, and acquisitions and retirements are numerous.
- To avoid unnecessarily detailed accounting for individual retirements, a taxpayer consistently charges the reserve with the full cost or other basis of assets retired and credits the reserve with all receipts from salvage.

This practice may be continued as long as, in the commissioner's opinion, it clearly reflects income.

By crediting salvage proceeds to the depreciation reserve in this manner, an individual can avoid tax on gains from asset retirements (that is, dispositions) as long as the reserve account does not exceed the amount of the multiple-asset account. Thus, continued acquisitions will prolong the deferment process.

On the other hand, increasing the reserve account hastens the recovery of asset cost (or other basis) and thus reduces the amount of allowable depreciation deductions.

Effect Upon Recapture What does this have to do with such broad and far-reaching provisions as secs. 1245(d) and 1250(i), which proclaim, "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 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*]

For multiple-asset accounts under the class life asset depreciation range (ADR) system, "ordinary retirements" correspond to "normal retirements" under the general rules (regs. sec. 1.167(a)-11(d)(3)(iii)). Accordingly, the possibility of avoiding depreciation recapture also exists under the class life ADR system. However, buildings are not subject to ADR depreciation and, therefore, must be depreciated under the general rules. On the other hand, Pub. L. 93-625 allows a taxpayer electing ADR to elect to determine the class life of certain sec. 1250 property either under Rev. Proc. 62-21 (as amended and supplemented), as in effect on December 31, 1970, or under the particular facts and circumstances. (Also see Rev. Proc. 77-3.)

Installment Sales of Recapturable Property

Section 1245 treats gains attributable to depreciation as ordinary income because 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 at the same tax rates as the original deductions. This possibility becomes more probable the longer sec. 1245 remains in effect.

Income averaging may provide some tax *rate* relief for this pile-up of ordinary income (chapter 2); however, another means of regulating a client's ordinary income bracket is through installment sales. (Naturally, anyone considering installment sales must also heed the interest requirements of sec. 483, discussed in chapter 19.) Regulations section 1.1245-6(d) provides that if the installment method of reporting gain applies to a sale or other disposition of sec. 1245 property, the taxpayer may also report any recognized recapturable depreciation gain on the installment method. *The income (other than interest) on each installment payment is deemed to consist of recapturable depreciation gain until all such recognized gain has been reported.*

Example Client sells an item of sec. 1245 property for $10,000, payable in ten $1,000 installments, plus 9 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 figure 12-8.

The same treatment would apply to recapture of depreciation under sec. 1250 in the case of a building sold on the installment method.[18]

Sales of Stock vs. Sales of Corporate Property

Selling stock instead of corporate property solves a seller's recapture problems but may create such problems for the buyer; negotiations should not overlook any adverse effects that this may cause. If recapturable properties are owned in corporate form, a sale of the corporate owner's stock, instead of the properties themselves, bypasses the depreciation recapture provisions as far as the seller is concerned. A sale of stock rather than corporate assets also obviates investment credit recapture.

If stock is purchased in lieu of property, however, the buyer will find himself in the unenviable position of having acquired potential tax headaches. Of course, the longer assets are held by the original corporate owner (even though under new ownership), the greater the likelihood that investment credit recapture can be permanently forestalled. The minimum holding period for elimination of this particular type of recapture is generally seven years.

On the other hand, a buyer may want to liquidate the corporation whose stock he has acquired in order to obtain a stepped-up basis for its assets. If 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 sec. 334(b)(2).[19] Briefly, this section applies if (1) at least 80 percent of

18. Regs. § 1.1250-1(c)(6).

19. The Court of Claims has held that §334(b)(2) is not the sole authority permitting such stepped-up basis by a corporate vendee (*American Potash & Chemical Corp.*, 399 F.2d 194 (Ct. Cl. 1968)). Other courts have held to the contrary. See the discussion in *International State Bank*, 70 T.C. 173 (1978).

Figure 12-8

Installments	Recapturable depreciation taxable as ordinary income	Sec. 1231 gain
1st	$ 300	$ —
2d	300	—
3d	300	—
4th	300	—
5th	300	—
6th	300	—
7th	200	100
8th	—	300
9th	—	300
10th	—	300
Totals	$2,000	$1,000

the stock (except nonvoting preferred) is purchased during a period of not more than twelve months and (2) a plan of liquidation is adopted within two years after the purchase.

Early liquidations 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 a client, regardless of which role he plays, be armed with this knowledge and be able to negotiate accordingly. A major decision involves the sales medium (stock or assets). If the asset vehicle is chosen, much dealing can be done in connection with the arm's-length bargaining to allocate the total selling price among the properties to be sold; here again, the parties' interests are diametrically opposed.

Example On December 31, 1980, Client is on the verge of selling the properties shown in figure 12-9, p. 172.

Before the sale is consummated, Client consults his CPA, who advises him of the potential tax consequences. Thereupon, hard bargaining occurs between Client, in conjunction with his lawyer, and the buyer's negotiating team. The following results emerge:

1. The sale is to be transacted on January 2, 1981, in order to provide additional time for the seller to pay tax.
2. The selling price is reduced by $5,000 and reallocated as shown in figure 12-10, p. 173.

Figure 12-9

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	$59,000	
3.	Less capital gain deduction (at 60%)	8,400	
4.	Taxable income (it is assumed that other income is exactly offset by deductions and exemptions)	$50,600	
5.	Tax on line 4 (joint rates to nearest thousand) assuming no investment credit recapture		15,000
6.	After-tax proceeds		$ 85,000

*Including net sec. 1231 gain.
†Resulting from depreciation recapture.

Client is able to clear an additional $3,000 on this transaction as a result of arm's-length determinations of fair market values, arrived at through negotiations with an adverse, unrelated 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 (ignoring alternative minimum tax)	$3,000

When are contractual allocations conclusive for federal income tax purposes?[20] If contractual allocations are later disputed, the "strong

20. See, generally, R.T. Standsbury, "Advising Clients on Tax Treatment of Goodwill v. Covenant-not-to-Compete Issue," *Journal of Taxation* 45 (October 1976): 208.

Figure 12-10

Asset	Adjusted basis	Final selling price	Actual gain Capital	Actual gain 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	$54,000	
3.	Less capital gain deduction (at 60%)	22,800	
4.	Taxable income	$31,200	
5.	Tax on line 4 (nearest thousand)		7,000
6.	After-tax proceeds		88,000
7.	After-tax proceeds (per figure 12-9)		85,000
8.	Increase in retained proceeds		$ 3,000

proof" rule and "substance over form" usually take 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 covenant 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. . . . [21]

There is also the stricter *Danielson* rule, which provides that a party to an agreement may not attack the values in the agreement without proof of mistake, undue influence, fraud, and so forth.[22] In a subsequent consolidated case involving a buyer and a seller, with the IRS as a stakeholder, the Tax Court, in a reviewed decision with three dissents, declined to follow the *Danielson* doctrine. Instead, it reiterated the strong proof rule of *Ullman.*[23] It might be advisable to suggest that buy-sell agreements specifically provide for damages resulting from one party's failure to adhere to the agreement's valuations for tax purposes.

Statutory Exceptions

Sections 1245(b) and 1250(d) provide various degrees of relief from recapture in the following situations.

Gifts The deduction for charitable gifts is reduced, however, by the depreciation that would have been recaptured had the property been sold at its fair market value at the time of the gift.[24]

Death This event completely eradicates all traces of depreciation recapture, except for income in respect of a decedent attributable to a predeath sale.

Certain Tax-Free Transactions Relief is possible in tax-free transactions in which the transferred property's basis is carried over. Ordinary income is nevertheless precipitated to the extent of any

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21. *Schulz et al.*, 294 F.2d 52 (9th Cir. 1961) (emphasis supplied). See also *Hamlin Trust et al.*, 209 F.2d 761 (10th Cir. 1954).

22. *Danielson et al.*, 378 F.2d 771 (3rd Cir. 1967), rev'g and rem'g 44 T.C. 549; cert. denied 389 U.S. 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 the construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc. . . ." (emphasis supplied).

23. *J.L. Schmitz*, 51 T.C. 306 (1968), aff'd sub. nom. *Throndson*, 457 F.2d 1022 (9th Cir. 1972). The Tax Court recently reiterated its preference for the "strong proof" rule in *M.F. McKinney*, T.C.M. 1978-448, and *Resler*, T.C.M. 1979-40. See also *Fedders Corp.*, T.C.M. 1979-350.

24. See § 170(e).

gain recognized from the receipt of boot (money or its equivalent). The gain is limited to recapturable depreciation (post-1961 depreciation for sec. 1245 property and post-1963 depreciation for sec. 1250 property).

Seven kinds of tax-free transactions are spelled out in secs. 1245(b)(3) and 1250(d)(3). The following two are particularly relevant to individual taxpayers:

1. Incorporation of, or additional investment in, a corporation that is generally at least 80 percent owned by the incorporators or investors involved in the transaction.
2. Contribution of property to a partnership in exchange for a partnership interest. (In circumstances specified in sec. 751, a partnership, unlike a corporation, can distribute property to its owners without precipitating recapture.)

In these tax-free situations, the new owner generally obtains the transferor's tainted depreciation.

Example Jones, 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's taxable gain is limited to the $1,000 cash receipt (the "boot"), which is taxed as ordinary income in accordance with 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).[25]

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* that the partnership would have recognized if the property had been sold at fair market value immediately before the distribution.

Either amount is further reduced by any ordinary gain recognized

25. Based on regs. § 1.1245-2(c)(2)(iii). See R. Steinman, *Tax Guide for Incorporating a Closely Held Business*, Federal Tax Study 1, rev. ed. (New York: AICPA, 1978), pp. 116–17, for situations in which § 351 would not apply in the case of transfers to an investment company.

to the partnership under sec. 751(b), dealing with disproportionate distribution to a partner.[26]

Example A, B, and C are equal partners in a partnership whose assets consist of the following three pieces of sec. 1245 property.

		Asset		
Line		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.[27]

Like-Kind Exchanges and Involuntary Conversions Like-kind exchanges (sec. 1031) and involuntary conversions (sec. 1033) result in ordinary income to the extent of recognized gain plus the fair market value of nondepreciable or non-sec. 1245 property received that 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 sec. 1031 or 1033 and is also beyond the purview of sec. 1245. An example of 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). There is a catch, however, regarding the holding period for sec. 1250 property acquired in like-kind exchanges or involuntary conversions. Section 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* the property is acquired in transactions that are specified in sec. 1250(e)(2). Since like-kind exchanges and involuntary conversions are *not* referred to in sec. 1250(e)(2), regs.

26. §§1245(b)(6) and 1250(d)(6).

27. Based on an illustration contained in U.S., Congress, Senate, 87th Cong., 2d sess., 1962. S. Rep. 1881, pp.284–85, accompanying the Revenue Act of 1962.

sec. 1.1250-3(d)(1)(i), relating to the limitation on sec. 1250 gain in cases of like-kind exchanges and involuntary conversions, states, "The holding period of the acquired property for purposes of computing applicable percentage . . . does not include the holding period of the property disposed of."

Disposition of Principal Residence Recapture exceptions also exist for dispositions of certain principal residences on which depreciation has been claimed for partial business use. (See sec. 1250(d)(7) and the regulations thereunder.)

1203 Net Gain or Loss Under Section 1231 (Including Involuntary Conversions)

If practicable, the tax planner should avoid matching sec. 1231 gains and losses.

Section 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. Mertens' *Code Commentary* explains the approach 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 . . . one year . . .), 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 . . . one year. . . . 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][28]

1203.1 Treatment of Involuntary Conversions

Casualty Losses

Casualty or theft gains and losses on enumerated properties 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

28. Mertens, *Code Commentary* (Chicago: Callaghan & Co.), § 1231.

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:

- All business properties.
- Capital assets held more than one year, including such personal assets as a residence and a nonbusiness automobile.

Under sec. 1231(a), it is immaterial whether these properties are uninsured, partially insured, or totally insured.

Other Involuntary Conversions

Gains or losses from the compulsory or involuntary conversion of business and personal assets, 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).

An ideal situation is one in which the taxpayer annually alternates sec. 1231 gains and losses. In this way, *all* gains qualify for capital gain treatment in any given year while *all* losses are fully deductible in some other year.

Of course, this ideal is difficult to achieve—causing its 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).

The benefits of sec. 1231 have been severely curtailed and will eventually be eliminated for most depreciable personal property as a result of the depreciation recapture prescribed by sec. 1245. Depreciation recapture is also required for depreciable real property under sec. 1250; however, as more fully explained in 1202, sec. 1250 only recaptures the excess of accelerated over straight-line depreciation.

1204 Natural Resources

Capital gain opportunities are available for dispositions of oil and gas property interests, cut timber, and timber, coal, and domestic iron ore royalties.

1204.1 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 oil and gas. A complex body of tax law has grown around these three elements, partly due to the bewildering variety of economic relationships which have been 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. . . .[29]

In view of these obstacles to a comprehensive review of the subject, only a brief summary is possible within the limits of this study.

> The variety of methods of disposing of oil and gas properties and of providing for participation in their production and earnings is so great that it is difficult to make a useful summary of the types of such transfers so as to make a reasonably conclusive statement as to the application of the capital gain and loss provisions.[30]

The taxpayer may find it advantageous, when disposing of his interest in oil and gas properties, to structure the transaction to qualify for capital gain treatment or to permit subsequent income to qualify for depletion (see 2602). For example, the taxpayer may dispose of his interest and retain an overriding royalty, which may be subject to percentage depletion; or he may effect a sale of his interest for cash and/or debt, including retention of a production payment, which will be treated as a purchase money mortgage pursuant to sec. 636(b).

Capital gain potential with respect to certain oil and gas prop-

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29. J. Rabkin and M.H. Johnson, *Federal Income, Gift and Estate Taxation*, vol. 3 (New York: Matthew Bender), §47.01. For further income tax aspects of this subject, see F.M. Burke *et al.*, *Income Taxation of Natural Resources* (Englewood Cliffs, N.J.: Prentice-Hall, 1980); *Miller's Oil and Gas Federal Income Taxation*, ed. J.L. Houghton *et al.* (Chicago: Commerce Clearing House, 1979); F.M. Burke, "Current Developments in Oil and Gas Taxation," *Tulane Tax Institute* 27 (1977).

30. Mertens, *Law of Federal Income Taxation*, §22.37.

erties is now limited by the intangible drilling cost (IDC) recapture rules of sec. 1254. This provision generally converts the gain recognized on disposition of oil, gas, or geothermal properties into ordinary income to the extent that the deductions for IDC exceed the amount that would have been deductible had these intangible costs been capitalized and deducted through cost depletion.[31] Also, depletion and IDC are preferences subject to the 15 percent add-on minimum tax.

1204.2 Cut Timber

The tax planner should weigh the merits of the election to treat the cutting of timber as a hypothetical sale.[32] Section 1231(b)(2) includes timber (with respect to which sec. 631 applies) among the properties eligible for favorable sec. 1231 treatment. Section 631(a) provides an election for specified taxpayers to treat the *cutting* of certain timber as equivalent to its sale or exchange and thus to qualify for sec. 1231 coverage. Figure 12-11 illustrates the merits of this election.

The nature of this gain or loss (capital, ordinary, etc.) is

Figure 12-11

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	100
Ordinary gain (loss)	$ 50
Computation without election	
Actual selling price	$150
Less actual cost or other basis	60
Gain (loss)	$ 90

SOURCE Regs. sec. 631-1(a)(1) and (e).

31. See the *General Explanation of the Tax Reform Act of 1976*, pp.64–67.

32. See, generally, H.C. Lowenhaupt, "Tax Advantages of Investing in Timber," in *Tax Ideas* (Englewood Cliffs, N.J.: Prentice-Hall), ¶17,009.

determined under the usual rules, which consider such factors as whether the cut timber was held primarily for sale to customers in the ordinary course of trade or business.[33]

	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.

The election is made by a descriptive computation in the first applicable tax return (presumably, including extensions); however, according to regs. sec. 1.631-1(c), it cannot be made in an amended return. The election is binding for all future years unless the commissioner permits revocation because of undue hardship. In accordance with regs. sec. 1.631-1(a)(3), a revocation precludes further elections without the commissioner's consent.

1204.3 Timber, Coal, and Domestic Iron Ore Royalties

Timber Royalties

A special code provision (sec. 631(b)) enables timber royalties, which normally would be ordinary income, to qualify, on a mandatory basis under sec. 1231, for long-term capital gain or ordinary loss treatment, provided the taxpayer has held the underlying timber property for more than one year prior to the "disposal" for which the royalties are received.

33. See §§ 1221(1) and 1231(b)(1)(A) and (B).

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	$

*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.)

The date of mining is deemed to be the date of disposal.

Domestic Iron Ore Royalties

The IRS treats royalties from iron ore in the same way that it treats coal royalties. Unlike coal, the iron ore must be mined in the U.S., and its royalties are subject to these limitations:

1. Section 631(c)(1) excludes 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).
2. Section 631(c)(2) excludes a disposal "to a person owned or controlled directly or indirectly by the same interests which own or control the person disposing of such iron ore."

1205 Sales or Exchanges of Patents

The tax planner should attempt to qualify transfers of patent rights, other than gifts or bequests, for automatic capital gain treatment under sec. 1235. If this is not possible or desirable, the tax planner should consider other means of obtaining the same favorable treatment.

1205.1 Requirements of Section 1235

If the transfer of a patent meets the requirements of sec. 1235, capital gain treatment can be obtained. Section 1235 provides

> 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 [one year], 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. [Emphasis supplied][34]

Regulations section 1.1235-1(b) states: "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. . . ."[35]

Revenue Ruling 59-210, 1959-1 C.B. 217, provides that if a holder transfers all substantial rights in a patent 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.[36]

1205.2 Definitions

Related Persons

The related persons to whom transfers are taboo under sec. 1235 are those described in sec. 267(b) (for the purpose of disallowing losses, expenses, and interest between tax relatives), with the following modifications prescribed by sec. 1235(d):

- 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.

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34. Regs. § 1.1235-1(a).

35. See also Rev. Rul. 69-482, 1969-2 C.B. 164, which held that the contrary Tax Court decision in *Myron C. Poole*, 46 T.C. 392 (1966), acq. 1966-2 C.B. 6, will not be followed. Rev. Rul. 69-482 states that this acquiescence concerns a deduction for royalty payments made by the corporation.

36. See also, e.g., *W.F. Stahl*, 442 F.2d 324 (7th Cir. 1971), and *R. Kershaw*, 34 T.C. 453 (1960).

- A holder cannot obtain capital gain treatment under sec. 1235 on royalties received from a corporation in which he owns 25 percent or more *in value* of the outstanding stock.

Thus, a transfer would not be disqualified, *per se,* if made to the following corporation:[37]

	Percent of value owned
Mr. Keeper (the holder)	24%
Mr. Keeper's brother	76%

Regulations section 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.

Holder

Section 1235(b) defines a holder as follows:

> 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][38]

Regulations section 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, whether amateur or professional, regardless of how often they may have sold their patents.[39]

In addition, the Senate Finance Committee was "desirous of extending the scope of this section to cover (in addition to inven-

37. See regs. § 1.1235-2(f)(3).

38. U.S., Congress, Senate, 83d Cong., 2d sess., 1954, S.Rep. 1622, p.440. Of course, a corporation is not necessarily ineligible for capital gain treatment on the sale of a patent merely because § 1235 does not apply to corporations. See, e.g., Rev. Rul. 78-328, 1978-2 C.B. 215.

39. S.Rep. 1622, p.440.

tors) those individuals who contribute financially toward the development of the invention.[40]

Financial backers who 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.[41]

Exception to the Imputed Interest Rule

Transfers described in sec. 1235(a) are also exempt from the imputed interest rule that might otherwise convert part of the gain into ordinary income.[42]

Other Terms

The following terms are defined in the indicated 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).

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40. *Ibid.* See § 1235(b)(2) and regs. § 1.1235-2(e) for requirements in regard to this matter.

41. S.Rep. 1622, p.440.

42. § 483(f)(4). Other patent sales are subject to § 483. See Rev. Rul. 78-124, 1978-1 C.B. 147; *Ransburg Corp.*, 72 T.C. no. 23 (1979), and citations therein.

13

Long-Term Capital Gain

Securities

1301 Sales

If gain will be recognized on the sale or exchange of securities or other investments, they should be held for more than one year to qualify for long-term capital gain treatment. As discussed in chapter 14, securities on which a loss will be realized should ordinarily be sold within the one-year holding period to avoid the impact of the rule that limits the deductibility of long-term capital losses to 50 percent of the loss (except to the extent they offset short-term or long-term capital gains).

A seller should time transactions with a view to the "ex-dividend" date, which is a specified number of days prior to the record date for payment of the dividend. After the ex-dividend date, a listed stock may trade at a lesser value than would otherwise be the case because the seller has reserved the dividend to himself. Accordingly, the seller may want to sell securities prior to the time they trade ex-dividend in order to receive maximum capital gain advantage, rather than a dividend and a lesser capital gain. Of course, postponing the sale so that the seller receives the dividend may be advantageous if the dividend will be sheltered by the dividend exclusion (see 701.2).

An individual should consider the reverse strategy when buying stocks: buying stocks after they trade ex-dividend to minimize ordinary dividend income and maximize future capital gain potential.

In the case of securities that were purchased at different times or at different prices, the taxpayer is assumed to have sold the acquired securities at the earliest time—that is, first in, first out. The taxpayer can avoid this FIFO assumption by making an adequate identification of the securities sold, preferably by delivering the particular securities that are to be sold or by instructing the broker, preferably in writing, of the particular securities to be sold.[1]

1301.1 Restricted Stock and Stock Options

The capital gain potential with respect to compensation received in the form of restricted securities and stock options is discussed in 1603 and 1604.

1301.2 Technical Observations

The holding period for securities is determined by the *trade date*, excluding the day of purchase and including the day of sale.[2] Thus, stocks acquired on March 11, 1980, result in short-term gain or loss if sold on or before March 11, 1981, and long-term gain or loss if sold on or after March 12, 1981.

The *settlement date* ordinarily determines the time for recognizing a gain on a sale of stocks or bonds. Unless the sale is made as a *cash sale* under stock exchange rules, investors can establish profits in trades through their broker in the last few days of a taxable year and have the gain taxed in the following year if the settlement date falls in the following year. On the other hand, a loss is recognized in the year of sale, even if the settlement date falls in the succeeding year.[3]

1302 Stock Redemptions and Distributions in Liquidation

Qualified shareholder redemptions or corporate liquidations permit complete or partial reductions of shareholder equity to be taxed as capital gains instead of ordinary dividends. This requires the corporation to avoid collapsible status or else to consider applying relief provisions. Such consideration should include the advisability of a special election. The planner should also consider the feasibility of disposing of sec. 306 stock without generating ordinary income.

A shareholder's receipt of corporate property, representing accumulated earnings and profits, is not always taxed as ordinary divi-

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1. See regs. §1.1012-1(c)(1)-(4); Rev. Ruls. 72-415, 1972-2 C.B. 463, 67-436, 1967-2 C.B. 266, 61-97, 1961-1 C.B. 394; *Klugar Associates, Inc.*, 69 T.C. 925 (1978), aff'd by 2d Cir.
2. Rev. Ruls, 70-598, 1970-2 C.B. 168; 66-97, 1966-1 C.B. 190. See also Rev. Rul. 66-7, 1966-1 C.B. 188.
3. Rev. Rul. 70-344, 1970-2 C.B. 50.

dend income. Certain transactions, involving either a complete or partial diminution of shareholder 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, under sec. 303 dividend treatment can be avoided, for federal income tax purposes, on the redemption of certain stock included in a decedent's gross estate. 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 administrative expenses allowable as estate tax deductions. Administrative expenses can be included in determining the amount of a sec. 303 redemption, even though they are actually deducted for income tax purposes.[4] (The treatment of administrative expenses, as either estate or income tax deductions, is discussed in 3202.)

Such redemptions must generally occur within a time period ending on one of the following dates:

- Four years after death: the nine-month due date for the estate tax return, plus the three-year assessment period, plus ninety days (sec. 303(b)(1)(A)).
- Ten years after the estate tax return due date if maximum deferred tax payments are elected under sec. 6166A (sec. 303(b)(1)(C)).
- Fifteen years after the estate tax return due date if maximum deferred tax payments are elected under sec. 6166 (sec. 303(b)(1)(C)).

4. Rev. Rul. 56-449, 1956-2 C.B. 180.

- Sixty days after a Tax Court decision becomes final if a timely petition for redetermining an estate tax deficiency was filed (sec. 303(b)(1)(B)).

The value of all the redeeming corporation's stock included in the decedent's gross estate must exceed 50 percent of the gross estate, less deductions for funeral and administrative expenses, debts, taxes, and losses.[5]

1302.1 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]."[6]

Partial Liquidation "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."[7] "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."[8]

1302.2 Planning Implications

Maintaining a Shareholder's Capital Gain

Redemptions may fail to qualify for capital gain treatment because of attribution rules; there are no such attribution rules in the case of partial liquidations under sec. 346.[9] Similarly, unlike liquidations, the redemption of sec. 306 stock may precipitate ordinary income.

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5. §303(b)(2). For discusson of §303 planning, see the pre-Revenue Act of 1978 articles: J.J. Bruce, "Financing the Payment of Federal Estate Taxes," *Univ. of S. Calif. Institute on Federal Taxation* 29 (1977): 349; F.G. Acker, "Deferred Estate Tax Payments and the Tax Reform Act," *N.Y.U. Institute on Federal Taxation* 36 (1978): 301; L. Newman and A. Kalter, "Coping with TRA-Created Problems Affecting Postmortem Stock Redemptions," *Journal of Taxation* 46 (April 1977): 226.

6. U.S., Congress, Senate, 83d Cong., 2d sess., 1954, S.Rep. 1622, p.49.

7. *Ibid.*

8. *Ibid.*, p.262.

9. See §302(c), which invokes the rules set forth in §318.

Section 306 stock is stock issued as a tax-free stock dividend, except common stock issued with respect to common stock, at a time when the issuing corporation has earnings and profits.[10] Section 306 prevents so-called preferred stock "bail-outs" by taxing the entire proceeds of certain dispositions of sec. 306 stock as ordinary income. Some dispositions, such as those completely terminating the shareholder's interest in the corporation and those arising through corporate liquidations, are not subject to this stringent treatment.[11]

Certain redemptions (but not partial liquidations) may be able to avoid the ordinary income that may flow from a collapsible corporation.[12] Under sec. 341(f) selling shareholders can avoid their collapsible corporation's taint if the following is done:

1. The corporation consents to recognize gain on any future disposition of its subsection (f) assets (that is, 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 a Shareholder's Losses

Under sec. 267(b)(2) redemption losses are not deductible by a more-than-50 percent shareholder; however, sec. 267 does not apply to "losses in cases of distributions in corporate liquidations."[13]

Effect Upon a Corporation

If appreciated property is distributed in partial or complete redemption of stock, gain is generally recognized to the extent of the

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10. 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 §306 stock, and (2) stock whose basis is determined by reference to §306 stock. As explained in regs. §1.306-3(e), this particular definition can cause common stock to be tainted as §306 stock.

11. Exceptions are also permitted if the IRS can be satisfied that the distribution and disposition were not part of a plan that had federal income tax avoidance as one of its principal purposes (§306(b)(4)).

12. §341. See regs. §1.341-1; B.I. Bittker and J.S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, 4th ed. (Boston: Warren, Gorham & Lamont, 1979), p.12–5, n.9.

13. §267(a)(1).

appreciation (sec. 311(d)(1)). Section 311(d)(2) contains the following exceptions to this rule:

- Redemptions completely terminating the interest of a shareholder who owned at least 10 percent of the corporation's stock during the prior twelve-month period.
- Redemptions under sec. 303.
- Distributions of the stock of a 50 percent-or-more-owned subsidiary.
- Distributions pursuant to an antitrust decree or the Bank Holding Company Act.
- Certain redemption distributions to private foundations.
- Distributions by regulated investment companies.

It is obvious that the first two exceptions are most significant for closely held corporations and their individual shareholders.

If sec. 311(d) does not apply, ordinary income or capital gain 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)). These gains need not be recognized if the distribution can be classified as a partial liquidation.[14]

Distributions in *either* redemption or partial liquidation can be included in the dividends-paid deduction for accumulated earnings tax purposes.[15] The deductible portion is limited, however, to the amount properly chargeable to earnings and profits in accordance with 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.)

Pursuant to sec. 537 the accumulated earnings tax cannot be asserted merely because of redemptions under sec. 303 or redemptions from private foundations to comply with the sec. 4943 excess business holdings requirements.

14. Cf. §§311 and 336.

15. See §§346(a) and 562(b)(1)(A).

14

Long-Term Capital Gain

Converse Effect of Capital Losses

Capital losses are, of course, the antithesis of capital gains—in both a financial and a tax sense. Since capital losses are only deductible against ordinary income to the extent of $3,000 per year, and since only 50 percent of net long-term losses can be used for this purpose, taxpayers, if they are able to obtain ordinary losses instead, shun capital losses.

Capital loss planning has its place in the following situations:

- **It is the only type of loss available.**
- **The lifetime carryover can be used against future capital gains and ordinary income.**
- **The differences between long-term and short-term considerations can be used effectively.**
- **Capital losses can be converted into ordinary losses.**

Individuals and fiduciaries can deduct capital losses against capital gains, and they are permitted a limited deduction for these losses against ordinary income. A taxpayer computes this ordinary income deduction, which is subject to an annual maximum limitation of $3,000 ($1,500 for married persons filing separate returns), as shown in figure 14-1, p. 194. Short-term losses are deducted first.[1]

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. Short-term and long-term losses retain their respective character when carried to a future year.

1. Regs. § 1.1211-1(b)(4).

Figure 14-1

Short-term	100%
Long-term	50%
Example	
1980 salary	$8,000
Net long-term capital loss — $1,800	
Amount deductible against salary	900
Adjusted gross income	$7,100

The carryover of noncorporate net long-term capital losses sustained in years beginning after 1969 is also reduced by the 50 percent portion of the losses that are *not* allowed as a deduction against ordinary income (up to the maximum of $3,000, or $1,500 for married couples filing separately). This treatment is shown in figure 14-2.

Figure 14-2

1980 return	
Salary	$8,000
Net short-term capital loss — $200	
Net long-term capital loss — $6,000	
Maximum deduction against ordinary income	3,000
Adjusted gross income	$5,000
Computation of carryovers to 1981	
Short-term:	
1980 net short-term loss	$ 200
Less amount deductible against ordinary income	200
Carryover to 1981	None
Long-term:	
1980 net long-term loss	$6,000
Less amounts consumed in 1980	
Balance of amount deductible against ordinary income ($3,000 less $200) — $2,800	
Remaining 50% nondeductible amount (always equal to deductible balance) — $2,800	
Total amounts consumed	5,600
Carryover to 1981	$ 400

If there are no other 1981 capital gains or losses, ordinary income can be reduced by $200—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.

Capital loss carryovers from a separate return year can be combined on a joint return for a later year. 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 the individual losses that gave rise to the carryover.[2]

1401 Only Type of Loss Available

A client may own capital assets (defined in sec. 1221) that have deteriorated in value and whose disposition, therefore, may be prompted by any of the following considerations:

1. From an investment standpoint, the owner should dispose of the property to prevent further deterioration of value or to improve the financial yield on the invested funds.
2. The owner has realized capital gains, which can be offset by realizing paper losses on the otherwise undesirable property. In many cases, however, it may be more desirable to avoid offsetting gains and losses.
3. The owner, in anticipation of his death, should sell property in order to recognize losses that would otherwise be eliminated by stepped-down basis at the time of death. (See the discussion of declined-in-value properties in 704.)

Revenue Ruling 74-175 and regs. sec. 1.1212-1(c) indicate that a decedent's unused capital losses cannot be carried over by his surviving spouse—even though joint returns were filed prior to his death.

1402 Lifetime Carryover Against Future Capital Gains and Ordinary Income

Section 1212(b)(1) enables individuals to carry over unused capital losses against future capital gains or future ordinary income (subject to the $3,000 annual limitation). The taxpayer can carry over

2. See examples (1) and (2), regs. § 1.1212-1(c)(2).

the unused losses indefinitely; that is, they are good for his lifetime. This carryover expires at his death.[3]

The Revenue Act of 1964, which introduced the lifetime carryover for noncorporate taxpayers, also required carryovers to retain the short- or long-term character of the original loss. However, under the pre-1969 TRA transitional rule set forth in the former (but still effective) sec. 1212(b)(2), an unused prior loss that was available as a capital loss carryover in the first year subject to the 1964 act (1964 for calendar-year individuals) can be carried over indefinitely as a short-term capital loss carryover (irrespective of whether the originating loss was short- or long-term).[4] The transitional rule reaches back into 1959-through-1963 years (for calendar-year taxpayers) and perpetuates losses from those years as short-term capital loss carryovers.

In computing carryovers to subsequent years, the taxpayer first subtracts capital losses (including prior carryovers) that are applied against the current year's ordinary income (up to the $3,000 maximum) from any short-term losses; any remaining ordinary income reduction is offset against long-term capital losses.[5]

1403 Long-Term vs. Short-Term Considerations

Prior to the 1969 Tax Reform Act, an individual who had an excess of net long-term capital losses over net short-term gains could deduct the losses against ordinary income on a dollar-for-dollar basis. Taxpayers are still entitled to deduct carryovers of pre-1970 losses on a dollar-for-dollar basis. If the taxpayer has pre-1970 capital losses, the carryovers from pre-1970 years are deducted prior to later losses.[6]

For years beginning after 1969, only 50 percent of an individual's net long-term capital losses may be used to offset ordinary

3. See Rev. Rul. 74-175, which holds, "In the absence of any express statutory language, only the taxpayer who sustains a loss is entitled to take the deduction. See *Calvin v. United States*, 354 F.2d 202 (10th Cir. 1965). . . ."

4. Regs. § 1.1212-1(b)(3).

5. § 1212(b)(2).

6. § 1212(b)(3); regs. §§ 1.1211-1(b)(3) and (4) and 1.1212-1(b)(4); Rev. Rul. 71-195, 1971-1 C.B. 225. A taxpayer with a carryover of pre-1970 capital losses files Form 4798 with his return.

income (up to the $3,000 limit). Thus, $2 of long-term losses are necessary to obtain a $1 deduction. Furthermore, under sec. 1212(b) the unused 50 percent cannot be carried over to future years; it is lost forever. The Revenue Act of 1978 increased the long-term capital gain deduction from 50 to 60 percent, but the reduction in the long-term capital loss deduction remains at 50 percent.[7]

Because of the 50 percent shrinkage in the long-term capital loss deduction, it is important to review all new investment positions prior to the expiration of the one-year short-term holding period. When there is little possibility for gain in the immediate future, clients might be advised to take a short-term loss.

Recognized Long-Term Capital Gains

The current rules provide some incentive to recognize long-term capital gains and long-term capital losses in different years. Long-term capital losses recognized in the same year as long-term capital gains reduce income at a rate of only 40 percent, whereas 50 percent of long-term capital losses are deductible against ordinary income if *not* offset against capital gains.

Example The taxpayer realized a $10,000 long-term capital gain in 1980 and is contemplating whether to recognize a $10,000 loss on declined-in-value securities in 1980 or 1981. If the loss is recognized in 1980, the taxpayer obviously has no taxable income or loss in either year, assuming no other securities transactions. If the loss is recognized in 1981, the taxpayer has taxable income of $4,000 in 1980 ($10,000 less the 60 percent capital gain deduction) and offsets against ordinary income of $5,000 in 1981 and later years (as a result of the $10,000 long-term capital loss). Because of the $3,000 annual limitation for capital loss deductions, the $5,000 deduction is available to the extent of $3,000 in 1981 and $2,000 in 1982. Thus, over the three-year period, the taxpayer gains a $1,000 deduction as a result of postponing recognition of the capital losses.

This example illustrates one of the major hazards of recognizing significant capital gains in years prior to recognition of signifi-

7. The Revenue Act of 1978 "does not change the present law treatment of a noncorporate taxpayer's capital losses" (U.S., Congress, Joint Committee on Taxation, *General Explanation of the Revenue Act of 1978*, 96th Cong., 1st sess., 1979, p.253).

cant capital losses. The absence of any provision for the carryback of an individual's capital losses, combined with the $3,000 annual limitation on capital loss deductions, limits the benefit of future capital losses, despite the fact that the taxpayer paid tax on capital gain in an earlier year. A taxpayer's capital loss carryover expires at his death and does not carry over to his estate or heirs.

Recognized Short-Term Capital Gains

Since such gains are taxable in full without benefit of the long-term capital gain deduction, the tax planner should consider offsetting the gains with capital losses. Ideally, long-term capital losses that may be deductible only on a two-for-one basis in future years should be recognized to offset short-term capital gains. As with long-term capital gains, the tax planner should remember the hazards of recognizing sizeable capital gains in one year and recognizing capital losses in a later year. (There may be an advantage to shifting potential short-term gains to a corporation. See chapter 8.)

Recognized Long-Term Capital Losses

The tax planner should consider offsetting long-term capital losses with short-term capital gains, which effectively makes such losses fully deductible. Long-term capital losses are otherwise deductible on a two-for-one basis. However, because the long-term capital loss may offset ordinary income in the current year (up to $3,000) or in later years due to the loss's indefinite carryover, it may be advantageous not to offset such losses with long-term capital gains. This is because of the 10 percent disadvantage of using long-term capital losses to offset long-term capital gains eligible for the 60 percent capital gain deduction, rather than deducting 50 percent of such losses against ordinary income, up to $3,000 annually, to the extent that they do not offset capital gains.

Recognized Short-Term Capital Losses

Since such losses are deductible in full against ordinary income, to the extent of $3,000 annually, and the balance is carried over indefinitely, it may be advantageous to postpone the recognition of gains until a later year. The 60 percent long-term capital gain deduction is lost to the extent that long-term capital gains offset such losses. While unrealized short-term capital gains may be recognized to offset short-term capital losses, it may be preferable to wait until the gains become long-term and, thus, eligible for the 60 percent long-term capital gain deduction in a later year.

1404 Converting Capital Losses Into Ordinary Losses

Congress has enacted several provisions that transform capital losses into ordinary losses. Two provisions of particular interest to individuals are sec. 1244, dealing with losses on small business stock, and sec. 1242, dealing with losses on small business investment company (SBIC) stock.[8] Unlike sec. 1244, there are presently no monetary limits to the sec. 1242 transmutation. (In other words, *all* losses on stock of a company operating under the Small Business Investment Act of 1958 are treated as ordinary losses.) In common with sec. 1244 ordinary losses, sec. 1242 losses are eligible for inclusion in net *operating* loss carrybacks or carryovers (under sec. 172).

8. § 1244 losses are discussed in R. Steinman, *Tax Guide for Incorporating a Closely Held Business*, Federal Tax Study 1, rev. ed. (New York: AICPA, 1978), § 505.5.

15

Deferred Income

Sale or Exchange of Residence

Homeowners are allowed a tax postponement on the proceeds of the sale or exchange of a principal residence to the extent that the proceeds are reinvested in a new principal residence within the time limits specified in sec. 1034.

Replacement of a residence should be timely in order to prevent unwanted tax; conversely, only untimely replacement precludes mandatory nonrecognition of gain and carryover of basis. In the case of certain involuntary conversions, the tax planner should weigh the merits of electing sec. 1033 or sec. 1034 treatment.

The ensuing discussion is based on the following assumptions:

1. The homeowner has sold, or has decided to sell, his present home.
2. He desires, or is willing, to invest the proceeds in a new home.
3. He is financially able to make such an investment.

1501 Section 1034

"The provisions of Sec. 1034 are mandatory, so that the taxpayer cannot elect to have gain recognized under circumstances where this section is applicable."[1] Thus, if sec. 1034 applies, the basis of the new residence must be reduced by the gain that is not recognized on the old home's disposition. Consequently, the unrecognized gain will be taxed when the new house is disposed of, except to the extent that any of the following apply:

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1. Regs. § 1.1034-1(a).

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 and used as a principal residence within eighteen months after the original residence is sold, only the last property qualifies as a new residence under sec. 1034, unless the sale relates to a move to a new principal place of work.[2]
2. The new residence is sold or exchanged in a sec. 121 transaction (discussed at 601).
3. Death intervenes to give the new residence a stepped-up basis (discussed in 704).

1501.1 Time Limits

The new residence must be purchased or constructed within specific time limits. These limits are prescribed by sec. 1034(a) and (c)(5) and can be charted as follows.

	Eighteen months before	Date of old residence's disposal	Eighteen months after	Two years after
New residence:				
Purchased	←	———	→	
Constructed	←	———	———	→

Physical occupancy within these time limits is required, notwithstanding unavoidable delays, and actual construction must begin by the end of the eighteen-month-after period.

Revenue Ruling 68-594 considered construction to have been timely in the case of a taxpayer who, 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.[3]

On the other hand, untimely replacement can avoid the mandatory operation of sec. 1034. Such a taxable transaction can be desirable as a means of income acceleration (see chapter 4).

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2. § 1034(c)(4) and (d).
3. Rev. Rul. 68-594, 1968-2 C.B. 339.

1501.2 Business Use of Home

Regulations section 1.1034-1(c)(3)(ii) provides that, if a taxpayer uses part of a property as a principal residence and part for other purposes, an allocation is necessary to determine the extent to which the taxpayer is eligible to defer gain through a qualifying replacement.

The IRS national office has issued a technical advice memorandum (Ltr. Rul. 7935003, May 14, 1979) holding that this regulation applied even though the taxpayer was not entitled to any deduction for business use of the home in the year of sale because the requirements of sec. 280A were not satisfied. A 35 percent business use was allowed for 1971 through 1975 and claimed (but disallowed) for 1976. The service held that only 65 percent of the gain could be deferred.

Accordingly, nonresidential use should be curtailed if the sec. 280A deductibility tests (see 2503) cannot be met and if undiminished nonrecognition of gain is desired.

1501.3 Advisability of Filing Form 2119

Section 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 the gain can be assessed during this otherwise closed period.

The notice must inform the IRS of 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 the time limits.

The taxpayer can comply with this statutory requirement by attaching IRS Form 2119, "Statement Concerning Sale or Exchange of Residence," to an appropriate original or amended income tax return. Form 2119 contains provision for a husband and wife to execute the consents that may be necessary in order for them to be treated as one taxpayer for sec. 1034 purposes.[4]

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 re-

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4. See § 1034(g) and regs. § 1.1034-1(f).

ductions of the selling price (along with expenses of sale, such as 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, that is unrecognized with respect to the old residence. Unlike expenses of sale, fixing-up expenses do *not* enter into the computation of the gain realized on the old residence's disposition. These intricacies are outlined on Form 2119.

1501.4 Definitions

The following terms are defined in the indicated 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).

1502 Other Code Sections

1502.1 Election of Either Section 1033 or Section 1034 Treatment for Certain Involuntary Conversions

Section 1034(i) grants a homeowner the option of using either sec. 1033 or sec. 1034 if his principal residence is converted involuntarily through seizure, requisition, condemnation, or the threat or imminence of any of these. (The destruction or theft of a principal residence (such as the theft of a houseboat or house trailer) *must* be treated under sec. 1033.) The taxpayer exercises this option by filing an *irrevocable* election in the manner prescribed by regs. sec. 1.1034-l(h)(2)(iii). (See 2103 for further discussion of involuntary conversions.)

The CPA is 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 his client's involuntary conversion predicament. However, the following general observations should be considered:

1. Section 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 fifty-five and older) is equally available in conjunction with either sec. 1033 or sec. 1034.

1502.2 Repossession and Resale of a Principal Residence

Section 1038 contains special rules for determining gain on the repossession of real property previously sold on credit. Under sec. 1038(e) *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.[5]

1503 Specialized Types of Homeowners

1503.1 Cooperative Tenant-Stockholders

Section 1034(f) enables this type of homeowner to be covered by sec. 1034 if the apartment or house is occupied as his principal residence.

1503.2 Members of the Armed Forces

Section 1034(h) suspends the rigid time limits for replacing property under sec. 1034 for members of the armed forces. Thus, the eighteen-month-after-sale period for new purchases, or the corresponding two-year 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. . . ."[6]

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5. See regs. § 1.1038-2.
6. Regs. § 1.1034-1(g)(1).

16

Deferred Income

Deferred Compensation Plans

Deferred compensation plans are discussed extensively in chapter 2 of Tax Study no. 1, rev. ed., *Guide to Incorporating a Closely Held Business*.

1601 Qualified Plans

In specified circumstances, the tax planner should consider the establishment of qualified retirement plans.

Employer contributions to qualified pension, profit-sharing, and stock-bonus plans are not currently taxable, even if the employees' rights are fully vested. Under a qualified cash or deferred profit-sharing (or stock-bonus) plan, this is true even if the employee is given a choice of either cash or a plan contribution.[1] The tax on earnings from employer and employee contributions is also deferred.[2]

The capital gain and ten-year averaging potential for distributions from qualified plans is discussed in chapter 11. The ability to further defer tax via rollover of distributions from qualified plans is discussed in the following chapter. Qualified plans are also discussed extensively in chapter 2 of R. Steinman, Federal Tax Study 1, *Tax Guide for Incorporating a Closely Held Business*, rev. ed. (New York: AICPA, 1978). Consequently, it suffices at this point to summarize the various tax attributes of these plans in the juxtapositions shown in figure 16-1.

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1. §402(a)(8).

2. See R.A. Sugar, "Employee Contributions to Qualified Plans—A Frontier for Tax Planning," *Taxes: The Tax Magazine* 57 (August 1979): 547.

Figure 16-1

Type of plan	Immediate employer deduction	Deferral of employee's tax attributable to: Employer's contribution	Deferral of employee's tax attributable to: Earnings on contributions[1]	Lump-sum distributions[2]: Capital gain[3]	Lump-sum distributions[2]: Special averaging[3]	Exemption from estate and gift taxation[4]
I. Qualified						
(a) Pension, profit-sharing, or stock-bonus	Yes	Yes	Yes	Yes	Yes	Yes
(b) "Principal" shareholder-employees of subchapter S corporation[5]	Yes	Yes[6]	Yes	Yes	Yes	Yes
(c) Self-employed retirement plans:						
(1) Owner-employee (more than 10% capital or profits interest; sec. 401(c)(3))	[7]	Yes	Yes	Yes	Yes	Yes
(2) Other self-employed "employees"(partners whose capital *and* profits interest are 10% or less)	[7]	Yes	Yes	Yes	Yes	Yes
(3) Common-law employees	Yes	Yes	Yes	Yes	Yes	Yes
II. Nonqualified	No	Contribution deferred[8]	No	No	No	No

Figure 16-1 (cont.)

NOTES

1. This includes both employer and employee contributions within allowable limitations.
2. See the definition in chapter 11.
3. Capital gain treatment is available for the taxable portion of a lump-sum distribution attributable to pre-1974 participation in the plan. Ten-year averaging may be available for the balance of the distribution, or ten-year averaging may apply to the entire distribution if this treatment is elected (as explained in chapter 11).
4. This is 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, for amounts attributable to employee contributions, or for certain lump-sum distributions. (See the discussion in chapter 11.)
5. These are "principal" shareholder-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. The employee's tax is not deferred on an employer's contributions that exceed the *lesser* of (*a*) 15 percent of reportable compensation from the corporation during its taxable year or (*b*) $7,500 (sec. 1379(b)). This does not apply in the case of defined benefit plans qualifying under sec. 401(j) (sec. 401(j)(6)).
7. For each self-employed person, the deduction is limited to the *lesser* of $7,500 or 15 percent of earned income. Only the first $100,000 of compensation may be considered in applying this limitation, which may be exceeded for defined benefit plans (see chapter 29).
8. Under nonqualified plans, generally, employer contributions are made, and the employee is taxed on them during the employee's retirement years. A nonqualified plan constitutes a contractual guarantee of compensation to an employee at some future time when his income tax bracket is likely to shrink. The employer's *actual* contribution customarily is deferred in order to avoid immediate taxation to the employee.

See also the discussion of individual retirement plans (2801) and simplified employee pensions (1606).

1602 Nonqualified Deferred Compensation Plans

In specified circumstances, the tax planner should consider the establishment of nonqualified retirement plans.

If an employer contributes cash to a nonqualified trust or a nonqualified annuity plan, and if the employee's rights are not substantially vested when the contribution is made but subsequently become substantially vested, the employee is taxed on the contribution when he becomes substantially vested, not when the contribution is actually distributed to him.[3] In such cases, the amount subject to tax when the employee's interest becomes substantially vested equals the value at that time of his interest in the trust (or the value of the annuity contract), not the fair market value of the accumulated employer contributions or premium payments.[4] The value of amounts subsequently contributed by the employer (or of premiums subsequently paid) is included in the employee's income when the amounts are contributed to the trust (or paid to the insurer) if the employee's interest in the amounts is substantially vested.[5]

On the other hand, income earned by nonqualified trusts is not taxed to the beneficiaries prior to its distribution.[6] Of course, the income is taxable currently to the nonexempt trusts.

Employers are allowed deductions for contributions to nonexempt trusts at the time employees recognize income (if separate accounts are maintained for each employee).[7] Employers can obtain ordinary deductions by vesting an employee's interest in a nonqualified trust. Of course, the employer must consider the effect that vesting will have on the employee's continued services, as well as the resultant increases in the employee's compensation income and income tax.

3. Regs. §§1.402(b)-1(b), 1.403(c)-1(b), 1.83-3(e), and 1.83-8(a).
4. *Ibid.*
5. Regs. §§1.402(b)-1(a) and 1.403(c)-1(a).
6. §402(b). U.S., Congress, House, 91st Cong., 1st sess., 1969, H.Rep. 413, part 2, p.64.
7. §404(a)(5).

1603 Restricted Property and Phantom Stock

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 in 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 on the property, and these restrictions may affect the property's 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 the services are performed). The rule covers the following categories of taxpayers:[8]

- Employees.[9]
- Independent contractors, such as promoters and real estate developers.
- Third parties who receive property without performing any services.

The rule also covers transfers by corporate and individual shareholders of the employer.[10]

Definition of Restricted Property

Regulations section 1.83-3(e) defines property subject to sec. 83 as

> real and personal property other than money or an unfunded and unsecured promise to pay money in the future.[11] The term also includes a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account.[12] See, however, Sec.

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8. See regs. § 1.83-1(a).

9. Although, for convenience, this discussion refers to "employees," self-employed individuals are also included.

10. See regs. § 1.83-6(d)(1). For a discussion of transfers by shareholders under §83, see W.L. Sollee, "Final Section 83 Regs. Endanger Employee Deductions, Premium on Employee Election," *Journal of Taxation* 49 (December 1978): 342–46.

11. See the discussion of the constructive receipt and economic benefit doctrines in chap. 18, herein.

12. The example of the signing bonus paid a football player, in Rev. Rul. 60-31, 1960-1 C.B. 1976, would appear to be an example of such a transfer. See the discussion at p.245.

> 1.83-8(a) with respect to employee trusts and annuity plans subject to section 402(b) and section 403(c). . . .[13]

Transfers to qualified employee trusts are not subject to sec. 83.

1603.1 Taxation of Restricted Property

The tax planner should consider the use of restricted property to control the recognition of compensatory income and deductions.

Under sec. 83(a) the receipt of a beneficial interest in property in return for the performance of services is taxable currently unless the recipient's interest is subject to a "substantial risk of forfeiture." In the latter situation, taxation occurs when the risk is extinguished.

Regulations section 1.83-3(c)(1) provides that the particular facts and circumstances determine whether a risk of forfeiture is substantial:

> A substantial risk of forefeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied.

For example, a transfer of stock that is forfeitable upon failure to attain an increased level of earnings is subject to substantial risk of forfeiture.

Property is not subject to substantial risk of forfeiture to the extent that the employer is required to pay the employee the fair market value of a portion of the property upon its return. A nonlapse restriction by itself does not result in substantial risk of forfeiture.

A requirement that property be returned if the employee is discharged for cause or for committing a crime is not considered a substantial risk of forfeiture. A prohibition against accepting a job with a competing firm is not ordinarily considered a substantial risk; however, regs. sec. 1.83-3(c)(2) lists factors to be considered in determining whether a covenant not to compete constitutes a substantial risk of forfeiture. Regulations section 1.83-3(c)(3) lists factors for determining whether the possibility of forfeiture is substantial if an employee owns a significant stock interest in a corporate employer or its parent corporation.

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13. Nonqualified trusts and annuity plans subject to §§402(b) and 403(c) are discussed in 1602, herein.

Section 83(a) also taxes the receipt of restricted property that is transferable without subjecting the transferee to the forfeitability conditions. This can occur, for example, when 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.[14]

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.[15] When such gifts are made, the *employee* would first be taxable when the *donee's* rights become nonforfeitable.[16]

Section 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.[17]

The statutory determination of when property is transferable and taxable may not always coincide with the actual restrictions placed on the property's financial transferability. For example, if the rights to full enjoyment of property were no longer conditioned upon the future performance of substantial services, substantial risk of forfeiture would cease and the property would be deemed transferable; however, actual transfer may still be precluded because the property is unregistered stock of a public corporation or because its sale is barred during a designated time.

This pitfall can cause liquidity problems by creating taxable income in the form of property that cannot be converted to cash in order to pay the resulting tax. The problems are increased by the requirement that the income must be measured without consideration of any restrictions that may eventually lapse. Even if the financial restrictions permit a sale, their very existence may cause a substantial discount to be realized, which may be reflected only as a capital loss. Such a loss has limited tax value and may be unable to offset the ordinary income initially precipitated by the financially restricted property. (See the discussion of capital losses in chapter 14.)

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14. U.S., Congress, Senate, 91st Cong., 1st sess., 1969, S.Rep. 552, p.122.
15. See regs. § 1.83-3(d).
16. S.Rep. 91-552, p.122.
17. See also the regs. § 1.83-3(d) definition of "transferability."

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 that by its terms will never lapse	$
Less any amounts paid for the property	______
Compensatory income	$

The fair market value of the property, at the time it is to be taxed, is used in the foregoing computation. Although the AICPA Federal Taxation Division suggested that only contractual restrictions should be ignored in valuing property, the final regulations do not take this position. For example, regs. sec. 1.83-3(h) provides that state or federal securities registration laws are not "nonlapse" restrictions and thus must be ignored in valuing securities. Stock subject to an investment letter may sell at a discount significantly below the selling price of stock not subject to such a letter, with the result that a sec. 83(b) election to be currently taxed on the stock may require recognition of taxable income considerably in excess of current value.[18]

Restrictions That Will Never Lapse

Regulations section 1.83-3(h) defines a *nonlapse restriction* as a permanent limitation on the property that will (*a*) require the transferee to sell, or offer to sell, at a price determined under a formula and (*b*) continue to apply to the transferee or any subsequent holder. A formula price normally determines the property's fair market value.[19]

If a nonlapse restriction is cancelled, there is additional compensation in the year of cancellation, calculated as follows.

18. See *Pledger*, 71 T.C. 618 (1979), holding that investment letter restrictions cannot be taken into account in valuing stock. See also *P.N. Cassetta*, T.C.M. 1979-384. It has been argued, though, that this issue is still unsettled; see A.F. Kaufman, "Valuation of Stock Under Secs. 83 and 57: Securities Law Restrictions," Tax Clinic, ed. D. Broenen, *Tax Adviser* 10 (November 1979): 661.

19. Regs. § 1.83-5(a).

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		$

Additional compensation is not recognized if the owner of the property establishes that (1) the cancellation was not compensatory and (2) the employer, who would be entitled to a deduction for a compensatory cancellation, will not treat the transactions as compensatory (as prescribed by regs. sec. 1.83-5(b)(2)).

Eligibility for Maximum Tax on Personal Service Income

Income treated as compensation either under sec. 83(a) or pursuant to the sec. 83(b) election is eligible for the 50 percent maximum tax rate on personal service income.[20]

1603.2 Election to Be Taxed Immediately

The tax planner should consider whether immediate taxation is advantageous.

Section 83(b) grants an election whereby the restricted property rules can be bypassed, even though restricted property is received and is nontransferable or subject to a substantial risk of forfeiture. The election has the following effects:

- Compensation is recognized when the property is received; it is based on the property's current fair market value and is computed in the usual manner.
- Any future appreciation in value will not be treated as compensation but will permit capital gain treatment—if otherwise available—when the appreciation is realized upon a sale or other taxable disposition of the property.
- If the property is later forfeited, no deduction or refund is allowable in respect of the forfeiture.

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20. For example, U.S., Congress, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976*, 94th Cong., 2d sess., 1976, p.154, states, in connection with the repeal of qualified stock options, "Income recognized by the employee under these rules would generally constitute earned income for purposes of the maximum tax on earned income (Sec. 1348)."

The regulations confine the denial of deduction or refund to amounts previously taxed under the original election; the regulations permit tax relief for any forfeited cash or other consideration previously paid to acquire the property. For example, regs. sec. 1.83-2(a) provides that the excess of any amount paid for the property over the amount realized on forfeiture is a capital loss. In contrast, a loss realized by an employee (but not his beneficiary) upon forfeiture of substantially vested property is an ordinary loss to the extent that income was previously recognized under the general rules of sec. 83(a).[21] If the property is subsequently sold, its basis is the amount paid for it plus the amount included in income under the sec. 83(b) election.

According to regs. sec. 1.83-2(b), the sec. 83(b) election must be made by the person performing the services not later than thirty days after the date of the transfer. A copy of the election must be filed with the IRS within the required time and must be submitted with the individual's tax return for the taxable year of the transfer. Other copies must be filed with the employer and, if the employee and transferee are not the same, with the transferee. The regulations prescribe the content of the election, which may be revoked only with the commissioner's consent.[22]

1603.3 Tax Planning Implications

To use restricted property effectively, the tax planner should consider the following questions:

- **Should the employer restrict property with a substantial risk of forfeiture?**
- **Should the employer cancel a restriction that will never lapse? If so, should it treat the cancellation as compensatory?**
- **Should an employee exercise the sec. 83(b) election?**
- **What are the opportunities for limited income shifting?**

Should the 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 rather than capital gain. In essence, the tax

21. Regs. § 1.83-1(e).

22. Regs. § 1.83-2(f).

burden is shifted from employer to employee, a fact that both parties should consider in determining the net after-tax impact of this compensatory device. In some cases, additional before-tax compensation might be considered because of this shift in tax burden.

The net combined tax expense of both parties depends on their tax brackets and on whether the employee makes the sec. 83(b) election. Compare lines 6 and 9 of figure 16-2, p. 218. There is a $22,000 net tax savings when the employee is in the 24 percent tax bracket, compared with a $4,000 net tax expense when the employee is in the 50 percent tax bracket. A 24 percent employee tax rate on $100,000 of income may be realistic if, for example, the risk of forfeiture expires over a period of years after retirement.

The business reasons for imposing such restrictions, such as retention of the employee's services, must also be considered.

Should the Employer Cancel a Restriction That Will Never Lapse? (If So, Should It Treat the Cancellation as Compensatory?)

The effects of such an action should be weighed along the same lines as the previous question. The business consequences of the cancellation must also be examined. For example, if the employer's stock is involved, it may not be desirable to forego control over its subsequent disposition.

Should an Employee Exercise the Section 83(b) Election?

The opportunity to convert ordinary income into capital gain may be enticing; however, the employee will then be compelled to bear the risk of subsequent forfeiture—without any tax relief if the forfeiture materalizes. The smaller the bargain element in the year of transfer, the smaller is the risk in this regard.

The sec. 83(b) election may be an important planning consideration even when there is no bargain element in the transfer. For example, a corporate employer permitted an employee to purchase 1,000 shares of stock at its fair market value of $1 per share, with the stipulation that the employer had the right to purchase the stock for $1 per share if the employee terminated employment within five years. The employee quit almost five years later, when the stock was worth $10 per share, at which time the employer waived the restriction and let the employee keep the stock. The IRS held that the employee had ordinary income equal to the $9

Figure 16-2

Operation of Section 83(b)

Line			
	Fair market value of property*		
1.	At date of transfer	$ 50,000	
2.	At date no longer subject to substantial risk of forefeiture	$100,000	
3.	Appreciation since transfer (line 2 less line 1)	$ 50,000	
	Treatment under sec. 83(a) (50% employee tax bracket)		
4.	Tax on individual (50% of line 2)	$ 50,000	
5.	Less tax benefit to employer corporation (46% of line 2)	46,000	
6.	Net tax expense		$ 4,000
	Treatment under sec. 83(a) (24% employee tax bracket)		
7.	Tax on individual (24% of line 2)	$ 24,000	
8.	Less tax benefit to employer corporation (46% of line 2)	46,000	
9.	Net tax expense (savings)		($22,000)
	Treatment under sec. 83(b) (50% employee tax bracket)		
10.	Tax on individual		
	(50% of line 1)	$ 25,000	
	(20%† of line 3)	10,000	
		35,000	
11.	Less tax benefit to employer corporation (46% of line 1)	23,000	
12.	Net tax expense		$12,000

*Net of employee's purchase price.

†50% × 40% (100% − 60% capital gain deduction). The employee is assumed to sell the stock immediately when it is no longer subject to substantial risk of forfeiture. The holding period for property that is subject to the sec. 83(b) election begins just after the date of the transfer (regs. sec. 1.83-4(a), I.R.S. Ltr. Rul. 7829007) and is here assumed to be in excess of one year.

difference between the value of the stock and the amount the employee paid.[23] The service indicated that the sec. 83(b) election was available in the year of the original transfer, even though there was no bargain element present. If the sec. 83(b) election had been made, the $9,000 would have been taxed as a long-term capital gain.

Another important consideration in evaluating the sec. 83(b) election is that if the property is not *financially* transferable it is

23. I.R.S. Ltr. Rul. 7829007.

not available as a liquid source for payment of the resulting tax.

Also, the employee's current tax bracket should be compared with his projected bracket for the future year in which income will be recognized (without the election). This comparison may reflect actual or estimated effective rates for ordinary income and capital gain. (See figure 16-2.)

The tax planner should also consider the effect on the employer, who effectively foregoes any tax deduction for post-election appreciation. The individual may prefer to negotiate for additional compensation in consideration for foregoing the election. Compare lines 6 and 12 of figure 16-2. While the sec. 83(b) election saved the employee \$15,000 in tax, there was an \$8,000 increase in net combined tax expense because the employer's tax liability increased by \$23,000. The possible adverse effect on the employer is obviously reduced when the employer is in a low tax bracket or in a net operating loss situation.

What Are the Opportunities for Limited Income Shifting?

Section 83 provides the employee with a certain flexibility for shifting income between taxable years. One characteristic of the sec. 83(b) election is that it accelerates income into the year of transfer unless the employee pays fair market value at that time.

There are also opportunities for shifting income between years when the sec. 83(b) election is not made. The rules vary significantly, depending on whether such a transfer is at arm's length. An arm's-length disposition after the property was transferred but prior to the time it becomes substantially vested results in income equal to the excess of the amount realized upon the disposition over the amount paid for the property.[24] Income is reported in accordance with the employee's method of accounting; therefore, installment reporting may be available for such a disposition. Thereafter, sec. 83(a) ceases to apply to the property, so the employee is no longer subject to ordinary compensation income on future increases in value.

While transfers to related parties may be at arm's length, it may be preferable to dispose of the property to an unrelated third party if arm's-length treatment is desired. In any case, appraisals may be desirable.

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24. Regs. § 1.83-1(b)(1).

Regulations section 1.83-1(c) provides that a disposition of substantially nonvested property not at arm's length results in compensation income equal to the amount of money or the fair market value of any substantially vested property received in the exchange. This provides the employee with the opportunity to shift future income to family members. The regulations confine the extent of such income shifting by limiting the amount of compensation to the fair market value of the property (determined without regard to any lapse restrictions), less the amount paid for the property. Also, a disposition not at arm's length does not terminate the applicability of sec. 83; so the employee will still recognize income when the property becomes substantially vested.

Example In 1981 an employee pays $50 for a share of stock, which has a fair market value of $100 and is substantially nonvested at the time. Later in 1981 (at a time when the property still has a fair market value of $100 and is still substantially nonvested) the employee, in a transaction not at arm's length, sells the share of stock to his wife for $10. The employee realizes compensation of $10 in 1981. In 1982, when it has a fair market value of $120, the stock becomes substantially vested; the employee realizes additional compensation in the amount of $60 (the $120 fair market value of the stock less both the $50 paid for the stock and the $10 taxed as compensation in 1981).[25]

1603.4 Phantom Stock Plans

The tax planner should consider phantom stock plans as a means of compensation.

In a phantom stock plan, stock is not actually issued; instead, units are awarded to represent shares of the employer's stock. The units are credited with amounts equal to dividends paid on stock that is actually outstanding and the increase in market value of that stock. If the market value is difficult to ascertain, book value can be substituted (as, for example, in the case of a closely held employer).

The employee's income and the employer's deduction are postponed until the employee receives cash equal to the value of the original units and subsequent credits. This form of compensa-

25. Regs. § 1.83-1(c).

tion is entirely ordinary (that is, noncapital) in nature and, therefore, is not usually received until after the employee retires.[26]

The tax planner should consider the following economic factors:

1. The employee is able to enjoy all benefits of ownership (with the possible exception of voting) without risking the 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 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 may prove too low for the employee or too high for the employer.

1604 Stock Options

Stock options whose value can be readily ascertained may offer capital gain opportunities; however, such options must overcome their own regulatory obstacles. Stock options with no readily ascertainable fair market value have less capital gain potential but are often more practical compensatory vehicles. All types of options, unlike restricted property, usually require employee investment.

The provisions of sec. 83 (discussed in 1603) apply at the time the option is granted if a stock option has a readily ascertainable value at that time; otherwise, sec. 83 applies at the time the option is exercised or otherwise disposed of, even if the fair market value of the property becomes readily ascertainable before then. Thus, if a stock option has a readily ascertainable market value when granted, its value constitutes ordinary income to the employee at that time, but any later gain realized by the employee upon sale of the stock will be capital gain. If an option does not have a readily ascertainable market value when granted, it does not generate income at that time; but if the option is exercised, the excess of the fair market value of the stock over the option price will produce ordinary income.

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26. It appears that such plans may not be subject to §83, so that, e.g., the employee may not be entitled to make the §83(b) election. See W.L. Sollee, "Final Section 83 Regs. Will Have Major Impact on Compensatory Property Payments," *Journal of Taxation* 49 (November 1978): 260–61.

The taxation of stock options is shown in figure 16-3.

Figure 16-3

		Fair market value of stock	
Year	Event	Option 1	Option 2
1980	Option granted	$100*	$100
1981	Option exercised	300	300
1983	Stock sold	800	800
Tax treatment			
1980:			Not applicable
Fair market value of option		$ 50	
Less amount paid for option		0	
Ordinary income		$ 50	
1981:		Not applicable	
Fair market value of stock			$300
Less purchase price			100
Ordinary income			$200
1983:			
Proceeds		$800	$800
Less			
Purchase price		100	100
Prior ordinary income		50†	200**
Total basis		150	300
Long-term capital gain		$650	$500

*Only option 1 has a readily ascertainable fair market value, which is $50.
†$50 included in basis pursuant to regs. sec. 1.421-6(e)(4).
**$200 included in basis pursuant to regs. sec. 1.421-6(e)(1).

1604.1 Readily Ascertainable Fair Market Value

The capital gains potential of stock options can be considerably enhanced if the option has a readily ascertainable fair market value. Of course, the value of the option at the date of its grant precipitates some degree of ordinary income.

Since qualified stock options have been repealed, the search for capital gains compensation has turned to nonqualified options. In regard to nonqualified options, the phrase "readily ascertainable fair market value" assumes crucial importance. This key term has been defined in regs. secs. 1.83-7(b) and 1.421-6(c). The option must be actively traded on an established market, or all of the following conditions must 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) that has a significant effect on its fair market value.
4. The fair market value of the option privilege is readily ascertainable, considering the following factors:
   a. Whether the value of the property subject to the option can be ascertained.
   b. The probability that the ascertainable value will increase or decrease.
   c. The length of time during which the option can be exercised.

Congress, however, intended that the IRS

> will make every reasonable effort to determine a fair market value for an option (i.e., in cases where similar property would be valued for estate tax purposes) where the employee irrevocably elects (by reporting the option as income on his tax return or in some other manner to be specified in regulations) to have the option valued at the time it is granted (particularly in the case of an option granted for a new business venture).[27]

The service requested the public to submit written comments (by July 5, 1979) on the issue of how a nonqualified stock option can be valued with reasonable accuracy if it is not actively traded on an established market. Comments addressing the problem of how to value options on the stock of new or small companies were especially appreciated. New regulations have not been proposed.

1604.2 Planning Implications

In the absence of public markets for the option or its underlying property, a readily ascertainable fair market value is at present practically beyond reach. If the option is not publicly traded but its underlying property can be valued, the additional requirements set forth in regs. secs. 1.83-7(b) and 1.421-6(c) may be undesirable,

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27. *General Explanation of the Tax Reform Act of 1976*, p.154. Cf. prop. regs. §§1.83-6(e) and (f) and 1.83-7(c), Nov. 20, 1977.

from a business standpoint, for the following reasons.

Requirement	Possible adverse business consequence
Option is transferable.	Employer intention that particular employee become a stockholder may be thwarted.
Option is 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 cannot, usually, have a right of first refusal to prevent outsiders from owning its stock.

As a result, the capital gain opportunities offered by stock options may be subject to formidable practical limitations.

As an alternative, the tax planner should consider a sale of convertible debentures to the employee. If necessary, the purchase of these debentures can be financed with employer-guaranteed loans, which should not produce sec. 482 income (as discussed in 1002).[28]

Depending on the circumstances, arrangements designed to provide benefits similar to stock options may be considered options. For example, regs. sec. 1.83-3(a)(2) provides that if the amount paid for the transfer of property is an indebtedness secured by the transferred property, on which there is no personal liability to pay all or a substantial part of the indebtedness, the transaction may be substantially the same as the grant of an option.[29]

A convertible debenture should, apparently, be considered property rather than an option. For example, Rev. Rul. 71-420 held that gain on stock sold for cash and convertible debentures may be reported on the installment method, since the debentures are considered evidences of the purchaser's indebtedness and the conversion feature is not valued separately.[30]

28. See Lefevre, "Nonrestricted Stock Options," *N.Y.U. Institute on Federal Taxation* 20 (1962): 365.

29. See also regs. § 1.83-3(a)(7), example 2.

30. See also S.R. Field, "Payments in Restricted Property: Recent Developments," *N.Y.U. Institute on Federal Taxation* 30 (1972): 391. Cf. Rev. Rul. 70-108, 1970-1 C.B. 78.

1605 Individual Retirement Accounts

In order to defer tax on a portion of their compensation and the earnings thereon, eligible individuals should consider establishing individual retirement accounts.

Prior to the Tax Reform Act of 1976, deferred compensation plans were employer-financed. The 1976 act introduced individual retirement accounts (IRAs, discussed in 2801), which enable employees and the self-employed to fund their own personal retirement plans. In essence, IRAs are a form of deferred compensation, since they postpone taxation on a portion of compensation that would otherwise be currently taxable.

Distributions from an IRA or annuity are included in gross income in the year in which they are paid or distributed (sec. 408(d)(1)). The proceeds of an IRA retirement bond are included in gross income upon redemption (sec. 409(b)).

Section 408(f) places restrictions on the use of these funds before age 59½. Distributions from an IRA prior to age 59½ may subject the individual to a 10 percent tax on premature distribution (secs. 408(f) and 409(c)). There is also a requirement that distributions begin by age 70½; distributions delayed beyond age 70½ may trigger the 50 percent excise tax on IRA accumulations (sec. 4974).

Within these limitations, the individual has considerable flexibility to withdraw from an IRA in any year that is most advantageous. This may be in a retirement year, when the individual's tax bracket usually is lower than during his active employment years.

Distributions from an IRA (or redemptions in the case of IRA retirement bonds) are fully taxable as ordinary income. The basis of an IRA, IRA annuity, or IRA retirement bond is always zero (secs. 408(d)(1) and 409(b)(2)). Capital gains and ten-year averaging, which may be available for distributions from qualified plans (as discussed in 1101), are not available for IRA distributions or redemptions of IRA retirement bonds. Amounts received from individual retirement accounts, annuities, and bonds qualify for the 50 percent maximum tax rate.[31] Income from an IRA is also eligible for regular income averaging (discussed in chapter 2) unless the maximum tax rate is used.

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31. U.S., Congress, Joint Committee on Taxation, *General Explanation of the Revenue Act of 1978*, 96th Cong., 1st sess., 1979, p.391.

1605.1 Estate Tax Exclusion

Section 2039(e) specifically excludes from the gross estate the value of an annuity payable to any beneficiary, other than the executor, under an IRA. The exclusion does not apply, or is limited, if all or part of the contributions to the IRA were nondeductible. Rollovers from other IRAs or qualified plans (discussed in chapter 17) are eligible for the exclusion.[32] The exclusion applies to both regular and spousal IRAs.

The annuity must be an annuity contract or other arrangement providing for a series of substantially equal payments for the beneficiary's life or for a period extending at least thirty-six months after the decedent's death. The Joint Committee Report on the Tax Reform Act of 1976 states the following:

> For this purpose, payments under an annuity contract are to be considered to be "substantially equal" under a variable annuity if the variance in payments is not solely attributable to tax avoidance motives. Of course, the annuity or other arrangement need not provide payments for the life of the beneficiary. Generally, satisfaction of the 3-year payment standard will be based on the payment provisions of the account or the settlement option, if any, elected no later than the earlier of the date the estate tax return is filed or the date on which the return is required to be filed (including extensions of time to file).[33]

Moreover, Prop. Estate Tax Regs. sec. 20.2039-5(b) provides this warning:

> Payments shall not be considered substantially equal, however, if the amounts payable to the beneficiary during any 12-month period may exceed 40% of the total amount payable to the beneficiary, determined as of the date of the decedent's death.

The employee or self-employed individual can control the method of payment from the IRA or can allow this option to his beneficiary.[34]

If a beneficiary withdraws the funds within thirty-six months of the decedent's death, the IRA is subject to estate tax.[35]

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32. Rev. Rul. 77-222, 1977-1 C.B. 281.

33. U.S., Congress, Joint Committee on Taxation, *Joint Committee Rep. on the Tax Reform Act of 1976*, 94th Cong., 2d sess., 1976, p.594.

34. Prop. Estate Tax Regs. §20.2039-5(b) and (e).

35. See W.L. Sollee, "Shaping Qualified Plan Payout Provisions and Use of Rollovers Under New 2039(c)," *Journal of Taxation* 47 (July 1977): 3.

1606 Simplified Employee Pensions

The tax planner should consider the comparative advantages and disadvantages of simplified employee pensions and other forms of deferred compensation.

The "simplified employee pension" concept, introduced by the Revenue Act of 1978, is essentially an employer plan funded by contributions to employees' IRAs. A simplified employee pension must meet certain participation and other requirements, such as not discriminating in favor of officers, shareholders, self-employed individuals, or highly compensated persons.[36]

An advantage of simplified employee pensions is that deductible contributions on behalf of employees may be as high as $7,500. The 15 percent-of-compensation limitation generally applicable to IRAs applies to simplified employee pensions.[37]

The IRS has prescribed Form 5305-SEP, which may be used as an agreement between the parties. (This form is not to be filed with the IRS.) The form sets forth guidelines plus questions and answers pertaining to simplified employee pensions.[38]

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36. § 408(k)(3).

37. § 219(b)(7).

38. The 1979 Technical Corrections Act contains a number of amendments relating to simplified employee pensions. See U.S., Congress, Senate, 96th Cong., 1st sess., 1979, S.Rep. 498, pp.31–37. Among the amendments are further limitations on self-employed retirement plans and subchapter S corporate plans (pp.33–34). If an employer maintains a defined contribution H.R. 10 plan for a self-employed individual and contributes to a simplified employee pension for that individual, the limitation on the employer's deduction for the contribution to the H.R. 10 plan is reduced by the deduction allowed for the contribution to the simplified employee pension, so that the limitation on the total deductible amount for that individual is not increased.

Under the act, the limitation on the amount that may be set aside tax-free in a defined contribution plan by a subchapter S corporation on behalf of a shareholder-employee is reduced by the amount deducted by the employer for contributions to that employee's simplified employee pension. Also, the act does not allow an employer who maintains a defined benefit plan for self-employed individuals or shareholder-employees to contribute to simplified employee pensions.

17

Deferred Income

Rollovers From Qualified Retirement Plans and Individual Retirement Accounts

The taxation of distributions from qualified retirement plans is discussed in chapter 11. This chapter discusses the deferral of tax on distributions from qualified plans by means of rollovers.

In evaluating rollovers, the tax planner should consider the advantage of income tax deferral and possible estate tax exclusion. The tax planner should also consider whether the income tax burden may ultimately be increased or decreased as a result of the rollover.

1701 Effect of Rollovers

An employee or self-employed individual may be eligible to roll over a distribution from a qualified plan to an IRA or to another qualified plan and, thus, to achieve tax deferral and possible tax savings.[1] A distribution that is completely rolled over is currently excluded from gross income by secs. 402(a)(5)(A) and 403(a)(4)(A). Partial rollovers are also permitted.

1701.1 Character of the Post-Rollover Distribution

Distribution from an IRA or an IRA annuity or the proceeds of redeeming an IRA retirement bond are taxable in full as ordinary

1. Rollovers from a qualified trust or annuity plan are permitted, but there is no provision for rollovers of §405 bonds to an IRA (I.R.S. Ltr. Rul. 7916072).

income. Thus, in a rollover to an IRA plan (other than a *conduit IRA*, in which the assets are again rolled over into a qualified trust or sec. 403(a) annuity plan), the individual gains tax deferral but sacrifices the capital gain and/or ten-year averaging benefit that might otherwise be available. Except in premature distribution situations, the distribution from the IRA should be eligible for the 50 percent maximum tax rate, whether it is distributed to the individual or to his beneficiaries after his death. (See the discussion of taxation of IRA distributions in 1605.) The income will also be eligible for regular income averaging (discussed in chapter 2).

If the rollover is to a qualified trust or sec. 403(a) annuity plan (including a self-employed retirement trust or plan), it seems reasonably clear that it may be possible for a subsequent distribution to qualify as a lump-sum distribution that will be subject to ten-year averaging or further rollover.[2] The IRS has indicated that there is no requirement in the definition of a lump-sum distribution that the distribution originate with the distributing plan. "Amounts transferred from one plan to another, by means of a rollover, merger or direct transfer, would be included in the balance to the credit of an employee in the transferee plan."[3] Thus, subsequent distributions may be subject to ten-year averaging.

A further question is whether it is permissible to consider participation in other than the distributing plan in determining whether the individual has satisfied the five-year participation requirement. Section 402(e)(4)(H) requires that the individual have been a participant in "the plan" for five or more years prior to the taxable year in which the amount is distributed in order to be eligible for ten-year averaging. The statute may well be interpreted to mean that the five-year participation requirement must be satisfied with respect to only the distributing plan, without benefit of tacking on years of service in the plan that distributed the rolled over assets. It seems even less likely that the period the assets are in a conduit IRA can be tacked on for this purpose.

While five years or more of participation is not a requirement for further rollover or for capital gain purposes, the tacking-on issue affects whether capital gain potential is eliminated by

2. A distribution from a qualified plan may be eligible for rollover either as a lump-sum distribution or as a result of termination of the plan. The requirements for rollover are discussed later in this chapter.

3. I.R.S. Ltr. Rul. 7927054.

rollovers. Section 402(a)(2) accords capital gain treatment for the portion of the distribution attributable to pre-1974 active participation in "such plan." Unless it is permissible to tack on years of service in the plan that distributed the rolled over assets, a post-1973 rollover may eliminate any prospect of capital gain on any portion of the ultimate distribution.

Authority on this question is limited. The previously cited letter ruling discusses years of participation in "the plan" without benefit of any tacking-on for years of service in other plans.[4] Commentators seem to agree that the issue is uncertain.[5] From a planning standpoint, it should be assumed that, pending further clarification, rollovers may eliminate capital gain potential.

1701.2 Estate Tax Exclusion

One significant advantage to rollovers is that they preserve the possibility of estate tax exclusion. This is true of rollovers to qualified plans and IRA plans.

Benefits in a qualified plan at the death of an employee or self-employed individual may be eligible for exclusion from estate tax under sec. 2039(c) (discussed in 1103). The IRS has indicated that the sec. 2039(c) exclusion is available whether the distributing plan received the assets by contribution or by means of a rollover, merger, or direct transfer.[6] Accordingly, it would appear that the sec. 2039(c) exclusion is possible for distributions payable from qualified plans, whether resulting from assets previously received through a direct rollover or a rollover from a conduit IRA.

Benefits due from an IRA are also eligible for exclusion from estate tax under sec. 2039(e) (discussed in 1605.1), unless they are receivable by the executor. The sec. 2039(e) exclusion for IRA plans is also available when the IRA received the assets as a result of a rollover from a qualified plan.[7]

With respect to employee contributions, a rollover to an IRA may have an advantage over a rollover to a qualified plan. This is

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4. See also I.R.S. Ltr. Rul. 7929065, citing prop. regs. §1.402(e)-2(d)(3)(ii), and regs. §1.219-2.

5. See J.F. Goldberg, "Lump-sum Distribution Rules: Planning to Avoid Adverse Consequences," *N.Y.U. Institute on Federal Taxation* 34 (1976): 1280–81; R.L. Fischer and M.H. Berger, "A New Tax Benefit—Individual Retirement Plans Under the '74 Act," *Tax Adviser* 6 (April 1975): 218.

6. I.R.S. Ltr. Rul. 7927054.

7. Rev. Rul. 77-222, 1977-1 C.B. 281.

because the earnings attributable to the employee's contributions are not subject to exclusion under sec. 2039(c),[8] whereas the entire distribution from an IRA may be eligible for exclusion.[9]

The sec. 2039(c) exclusion may be preserved even for lump-sum distributions from a qualified plan if the recipient elects to forego capital gain and ten-year averaging pursuant to sec. 2039(f). A surviving spouse is not permitted to roll over to another qualified plan, but the Revenue Act of 1978 permits partial or total rollovers to IRA plans. The sec. 2039(c) exclusion may be available for a lump-sum distribution pursuant to sec. 2039(f) even if the spouse elects to roll over to an IRA. The staff of the joint committee, however, may propose legislation to require the surviving spouse to forego rollover in order for a lump-sum distribution to be eligible for the estate tax exclusion, although the 1979 Technical Corrections Act does not contain such a provision.[10]

1702 Permissible Recipients of Rollovers

Section 402(a)(5) provides that certain distributions from qualified plans are not includible in gross income if they are rolled over into eligible retirement plans. Section 402(a)(5)(D)(iv) defines *eligible retirement plans* as any of the following:

- An individual retirement account described in sec. 408(a).
- An individual retirement annuity described in sec. 408(b).
- A retirement bond described in sec. 409.
- A qualified trust.
- An annuity plan described in sec. 403(a).

In addition, secs. 408(d)(3) and 409(b)(3)(C) permit rollovers between various forms of IRA plans. Transfers between plans may also be accomplished by means of direct transfers that are not includible in income unless distributed or made available to the individual.[11] These are usually trustee-to-trustee transfers, al-

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8. Estate Tax Regs. §20.2039-2(c).

9. *Working With the Revenue Code* 1979, ed. I.F. Diamond and M. Walker (New York: AICPA, 1979), p.397.

10. P.I. Elinsky, "Spousal Rollover of Lump Sum Distributions: Income and Estate Tax Benefits," Tax Clinic, ed. P. Elder, *Tax Adviser* 10 (April 1979): 225–26.

11. §402(a)(1). See, generally, the articles by I. Goodman, "Rollovers and Constructive Receipt," *CCH Pension Plan Guide*, Issue 191, no. 183, part II (1978); and T.R. Frantz and J.M. Peterson, "Constructive Receipt of Plan Distributions May Forfeit Tax Breaks of Qualified Plans," *Journal of Taxation* 49 (July 1978): 26.

though it is also possible to have a tax-free direct transfer involving a nontrusted annuity plan. Placing a portion of the rollover in an IRA and a portion in a qualified plan is also permissible under sec. 402(a)(5).[12]

A transfer to a qualified trust must be under a plan that provides for acceptance of the rollover contributions.[13]

1702.1 Rules for Rollovers to IRA Plans

The IRS permits rollovers, but not contributions, to an IRA if the individual is an active participant in another plan.[14] Rollovers to more than one IRA are permissible.[15]

If the employee or self-employed individual receives a distribution from a qualified plan and elects to roll over into an IRA plan, he must roll over to his separate IRA plan; he cannot roll over half of the distribution to his spouse's IRA plan.[16] In the case of a single IRA with subaccounts for both spouses, the individual is allowed to roll over his distribution into his separate subaccount.[17] It may be inadvisable, however, to roll over into an IRA to which the individual makes, or has made, contributions, as discussed in 1703.

Despite some earlier contradictory private rulings, the IRS has apparently settled on the position that rollovers to IRAs are permitted even after the recipient attains age 70½.[18] A recent private ruling adopts this position but provides that distributions must commence in the same taxable year as the rollovers.[19] It also sets forth a procedure for calculating distributions.[20]

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12. I.R.S. Ltr. Rul. 7927054.

13. Prop. regs. §1.402(a)-3(c)(2), issued 2/21/75, withdrawn 8/8/80 for future reproposal.

14. I.R.S. Ltr. Ruls. 7813106 and 7815016.

15. Rev. Rul. 79-265, 1979-36 I.R.B. 14.

16. I.R. 1809 (May 9, 1977), ques. 17.

17. *Ibid.*

18. See and cf. I.R.S. Ltr. Ruls. 7826117, 7847031, and 7915016. See also P.I. Elinsky, "I.R.A. Rollover After Age 70½," Tax Clinic, ed. P. Elder, *Tax Adviser* 10 (April 1979): 227.

19. I.R.S. Ltr. Rul. 7932072. See also I.R.S. Ltr. Ruls. 7932038, 7930178, and 7927059.

20. However, the initial distribution from the IRA must be at least equal to the amount of the distribution that was rolled over from the qualified plan, divided by the participant's life expectancy at age 70½ reduced by the number of whole years elapsed from age 70½ until the first day of the taxable year in which the rollover occurred. For each succeeding year, the required distribution must be at least equal to the remaining account balance at the beginning of the taxable year, divided by the applicable life expectancy at age 70½ reduced by the number of whole years elapsed since the taxpayer attained the age of 70½.

1703 Conduit IRAs

Unless any part of the earlier rollover to the IRA or IRA annuity is attributable to contributions from a self-employed retirement plan, an individual may roll over contributions from an IRA or IRA annuity to a qualified plan, including a self-employed retirement plan. The requirements are the following:

- The entire amount in the IRA, or the entire value of the IRA annuity, must be distributed (sec. 408(d)(3)(A)(ii)).[21]
- The amount must be entirely attributable to rollover contributions and earnings thereon.
- The entire distribution must be rolled over. Apparently, the partial rollovers permitted by Pub.L. 95-458 do not apply in the case of distributions from conduit IRAs (sec. 408(d)(3)(A)(ii)).
- The rollover must occur within sixty days.

It is also possible to roll over a distribution from a qualified plan into an IRA retirement bond, then to redeem the bond and roll the proceeds over into another qualified plan.[22]

A rollover from a qualified plan should be placed in an IRA separate from any other IRA to which the individual makes, or has made, contributions. This preserves the option to subsequently roll over the amounts to another qualified plan.

1704 Basic Rollover Requirements

A rollover from a qualified plan is a transfer of all or part of a *qualifying rollover distribution* (defined in sec. 402(a)(5)(D)(i)) to an *eligible retirement plan* (defined in sec. 402(a)(5)(D)(iv)).

To be eligible for rollover, the balance to the credit of the employee must be distributed from a qualified trust or annuity plan in a lump-sum distribution (as defined in chapter 11).[23] Distributions from IRAs do not qualify (except in the case of rollovers to other IRAs or conduit IRAs). A distribution is still eligible for rollover if it is attributable to the termination of a qualified plan or

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21. As discussed in 1708, in a mere transfer from one IRA to another, it is not necessary that the entire balance be distributed (§408(d)(3)(A)(i)).

22. §409(b)(3)(C).

23. See, e.g., Rev. Rul. 77-222, 1977-1 C.B. 281.

to the complete discontinuance of contributions to a profit-sharing or stock-bonus plan.[24]

The individual is not required to be a participant in the plan for five years. The Revenue Act of 1978 eliminated this requirement for taxable years beginning after 1977; and it permitted individuals who, because of the five-year participation requirement, were denied the opportunity for a rollover during 1978 to complete their rollovers at any time before 1979. The Technical Corrections Act of 1979 permits individuals who received distributions during 1978 until the end of 1980 to make the rollovers.[25]

As a general rule, only an employee or self-employed individual is permitted the rollover privilege.[26] Although beneficiaries are generally excluded, the Revenue Act of 1978 provided an important exception that permits the surviving spouse to roll over a lump-sum distribution on account of the employee's death.[27] This exception allows rollovers to individual retirement plans that are made within sixty days of the distribution.[28] The benefit of the spousal rollover rule is available if an individual dies while still a participant in the plan, whether as an active employee, a retiree, or a former employee.[29]

Under sec. 402(a)(5)(C) a rollover must occur within sixty days of receipt. A contribution to an IRA after the sixty-day period may be subject to the 6 percent excise tax imposed by sec. 4973 annually on excess contributions, and it may be includible in income upon distribution.[30] It may also be subject to the sec. 408(f) 10 percent penalty tax if the excess contribution is corrected by distribution before age 59½.[31] The Revenue Act of 1978 alleviated some of these problems by providing that unsuccessful rollovers are not subject to the 6 percent excise tax if the excess

24. §§402(a)(5) and 403(a)(4). See, e.g., I.R.S. Ltr. Ruls. 7930110, 7930178, 7929050, and 7927054.

25. See U.S., Congress, House, 96th Cong., 1st sess., 1979, H.Rep. 250, p.28.

26. §402(a)(5)(A)(i).

27. §§402(a)(7), 408(d)(3), and 403(a)(4)(B). The 1979 Technical Corrections Act makes it clear that a distribution to a surviving spouse as a result of plan termination is also eligible for rollover (H.Rep. 96-250, p.27).

28. See U.S., Congress, Joint Committee on Taxation, *General Explanation of the Revenue Act of 1978*, 96th Cong., 1st sess., 1979, p.113.

29. I.R. 2086 (February 6, 1979), ques. 13.

30. *Ibid*, ques. 21.

31. See *General Explanation of the Revenue Act of 1978*, pp.106, 110; and I.R. 2086, ques. 2.

contribution, and any earnings thereon, is returned by the due date of the return (including extensions) for the appropriate year.[32] Under the act, the full amount of the excess contribution, plus any earnings thereon, are includible in the individual's gross income for the year for which the excess contribution was made. The earnings on the excess contributed up to the date of withdrawal will not be subject to the 10 percent early distribution tax.[33]

Note While the treatment of sec. 403(b) tax-sheltered annuities for teachers and other employees of tax-exempt organizations is beyond the scope of this study, it should be noted that the Revenue Act of 1978 amended the code to permit rollovers to IRAs from such annuities.[34]

1705 Assets Eligible for Rollover

Both cash and other property may be rolled over. The general rule is that a noncash distribution from a qualified plan is includible in income in an amount equal to the property's fair market value, and this amount becomes the property's basis. (There is a limited exception, discussed in 1104, for unrealized appreciation on employer securities.)

The recipient may exclude noncash distributions from current taxable income by means of a rollover. Although under sec. 402(a)(5)(A)(iii) the rollover generally must consist of the property itself, the Revenue Act of 1978 now permits the recipient to roll over the proceeds from a bona fide sale of the property, rather than the property itself, to an IRA or to another qualified plan within sixty days from the date of distribution. If the full proceeds are rolled over, no gain is recognized on the sale, even on any postdistribution appreciation within the sixty-day period.

Sales of property in conjunction with partial rollovers are also permitted. In this case, the individual may find it advantageous to designate (*a*) the extent to which he has rolled over a cash distribu-

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32. §4973(b). Also see the *General Explanation of the Revenue Act of 1978*, p.116.

33. *Ibid.* The 10% tax also appears inapplicable to such an excess contribution. See ERISA Conf. Rep. (H. Rep. 93-1280), pp.339-40.

34. §403(b)(8). See, generally, *General Explanation of the Revenue Act of 1978*, p.101, and I.R. 2086, ques. 14.

tion (or the proceeds from the sale of one piece of property and not another) and the extent to which he has rolled over sales proceeds and (*b*) the portion of the money or property that is attributable to employee contributions.[35]

The individual may roll over a noncash distribution to an IRA if the trustee accepts it, in which case the postdistribution appreciation, which would otherwise be subject to capital gain treatment, is converted to ordinary income. IRA distributions are not subject to ten-year averaging or capital gain treatment.[36] If the property is rolled over to another qualified plan, either directly or through a conduit IRA, the character of the ultimate distribution is not entirely clear. The distribution should be eligible for ten-year averaging, assuming that the various requirements of sec. 402(e) are met, although it may be necessary to participate in the distributing plan for five years; however, the IRS may take the position that the rollover eliminates any capital gain treatment because there is no pre-1974 participation in the distributing plan.

If the recipient anticipates further appreciation in the distributed property, how can he salvage capital gain treatment on the postdistribution appreciation? Clearly, he can avoid rolling over the property and subject it to current tax. The individual may also sell the property, roll over the proceeds, and invest other funds in similar property whose appreciation should be subject to capital gain treatment. However, a purchase of the same (and perhaps even similar) property within the same approximate period as a rollover of sales proceeds may endanger the nonrecognition of income from the rollover because the legislative explanation emphasizes that only bona fide sales are eligible for rollover treatment.[37]

1705.1 Life Insurance

Because sec. 408(a)(3) prohibits IRA trust funds from being invested in life insurance contracts, it is not possible to roll over a distribution of a life insurance contract to an IRA. It has been suggested that a participant who wishes to maintain a life insurance

35. §402(a)(6)(D)(iii). For a discussion of the intricacies involved, see *General Explanation of the Revenue Act of 1978*, pp.110–12, and I.R. 2086, part IV.

36. §§408(d)(1), 402(a)(2) and (e). See, e.g., I.R. 2086, ques. 18.

37. *General Explanation of the Revenue Act of 1978*, p.110.

contract should purchase the contract from the plan prior to distribution and then receive a cash distribution, which could be rolled over to an IRA.[38]

1706 Amount of the Rollover

The maximum amount that may be rolled over is the fair market value of the distribution, less the employee's own contributions. This may permit the rollover of earnings attributable to employee contributions.[39]

Legislation enacted in 1978 allowed partial rollovers; so the taxpayer now has the option of subjecting any portion of the distribution to current tax and deferring income recognition on the balance of the distribution, which is rolled over.[40] It is clear that partial rollovers are permitted when combined with the sale of property;[41] however, without a sale of the property, there is some question about whether partial rollovers of lump-sum distributions of property other than money are permitted.[42]

The portion of the distribution that is not rolled over is included in current income, net of employee contributions. The negative aspect of the partial rollover alternative is that the taxpayer foregoes capital gain and ten-year averaging, which might be available if no portion of the distribution were rolled over. The retained portion is simply taxed as ordinary income.[43] This income is eligible for regular income averaging (discussed in chapter 2). There is legislative discussion indicating that the retained portion of a partial rollover is eligible for the 50 percent maximum tax on personal service income.[44]

38. *Working With the Revenue Code* 1979, p.171.

39. In an article that preceded the enactment of the partial rollover provisions, one commentator stated that increments on employee contributions "can (and must) be" rolled over (W.L. Sollee, "Shaping Qualified Plan Payout Provisions and Use of Rollovers Under New 2039(c)," *Journal of Taxation* 47 (July 1977): 3). *Working With the Revenue Code 1979*, p. 397, agrees that earnings on employee contributions and all appreciation attributable to contributions may be rolled over. I.R.S. Ltr. Rul. 7930105 refers to reducing the rollover by the amount of the distribution "attributable to employee contributions."

40. Pub. L. 95-458.

41. §402(a)(6)(D); I.R. 2086, part IV.

42. "Washington Item no. 4," Tax Management Memorandum 79-4 (February 12, 1979), p.9.

43. §402(a)(6)(C). I.R. 2086, ques. 17.

44. The Senate report on Pub. L. 95-458, reproduced in *CCH Standard Federal Tax Reporter*, vol. 4, ¶2618.0119, which sanctions partial rollovers, specifically refers to the re-

1707 Distributions From More Than One Plan

If the recipient receives lump-sum distributions from different plans, it is permissible to roll over both distributions to IRAs, whether or not they are received in the same taxable year, since there is no limitation on the number of rollovers of lump-sum distributions.[45] If lump-sum distributions from different plans are received in the same year, a rollover of one plan distribution is not subject to current tax, but the other is not eligible for ten-year averaging. This is because the two distributions were not aggregated, as is required for the election of lump-sum treatment and ten-year averaging.[46] If a taxpayer wants to roll over one distribution and elect ten-year averaging for the other, he can achieve this goal only if distributions are received in different years. An election of ten-year averaging in an earlier year will not adversely affect the ability to roll over a later distribution, nor will a rollover in one year affect the tax treatment of a later distribution. (For general discussion of these and other aspects of distributions from more than one plan, see chapter 11.)

1708 Rollovers Between IRAs

Rollovers between various forms of IRAs (IRA, IRA annuity, and IRA retirement bond) are permitted, and in such circumstances they may serve as substitute investment media.[47] The distribution or redemption is not taxable, and the rollover is not deductible.

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tained portion of a partial rollover as "ordinary personal service income." As discussed in chap. 11, herein, there is some question of whether the ordinary income portion of a lump-sum distribution that is not subject to ten-year averaging is eligible for the maximum tax (see p.145), although there is apparently no question that the maximum tax is available if the distribution is not a lump-sum distribution (see p.31). A distribution eligible for rollover may or may not be a lump-sum distribution, because both lump-sum distributions and certain distributions attributable to plan terminations are eligible for rollover.

45. I.R.S. Ltr. Rul. 7842049. Presumably the same is true whether the distribution is eligible for rollover as a result of being a lump-sum distribution or as a result of a plan termination.

46. I.R.S. Ltr. Ruls. 7842049 and 7928017.

47. §§408(d)(3) and 409(b)(3)(C).

There is no requirement that the entire IRA or IRA annuity be withdrawn.[48]

The same property that is distributed must be rolled over, and the entire amount withdrawn must be rolled over. The provisions permitting sales of property and contribution of the sales proceeds in a rollover (discussed in 1705) do not apply to rollovers between IRAs. Section 408(d)(3)(B) limits rollovers between IRAs to one a year; however, a transfer of funds between IRA trustees is not subject to this rule.[49]

In effecting a rollover from one IRA plan to another, it is necessary to notify the trustee of the IRA, in writing, that the amount to be withdrawn will be rolled over into another program.[50]

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48. §408(d)(3)(A)(i). *Tax Information on Individual Retirement Savings Programs*, I.R.S. Publication 590, 1979 ed., p.6. By contrast, in the case of "conduit IRAs" (discussed in 1703, herein), which receive distributions from a qualified plan and then roll over the assets into another qualified plan (rather than an IRA plan), the entire value of the IRA annuity must be distributed (§408(d)(3)(A)(ii)).

49. Rev. Rul. 78-406, 1978-2 C.B. 157. I.R.S. Publication 590, p.6.

50. I.R.S. Publication 590, p.6.

18

Deferred Income

Avoiding Unwanted Income

One method of income deferral that is explicitly authorized by sec. 453 is the installment method for reporting sales of property (further discussed in chapter 19). Other methods of avoiding unwanted income depend on passage of the stringent tests developed over the years by the courts and the IRS. Generally, the tests require that income be reported when actually or constructively received in the form of cash, cash equivalent, or other economic benefit.[1] Any planning in the area of income postponement must answer these questions:

1. Can actual, physical receipt be deferred?
2. If so, can the constructive receipt doctrine be 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 loans, escrow or trust arrangements, and nonnegotiable contractual obligations effectively defer income?

Note This tax study is concerned with individuals on the cash basis method of accounting; therefore, this discussion generally does not consider the reporting of income by accrual method individuals. Nevertheless, it should be noted that certain rules allow accrual method taxpayers to defer the inclusion of advance payments in their income in certain circumstances.[2]

1. Regs. §§1.446-1(c)(1)(i) and 1.451-1(a); *Sproull*, 16 T.C. 244 (1951), aff'd 194 F.2d 541 (6th Cir. 1952).

2. See regs. §1.451-5 regarding advance payments for future delivery of goods and Rev. Proc. 71-21, 1971-2 C.B. 549, dealing with payments (or amounts due and payable) for services to be performed by the end of the next taxable year.

1801 Deferring Actual or Constructive Receipt

In situations in which installment sale reporting is not available, an individual can avoid immediate taxation through a contractual arrangement for future receipts. The taxpayer should avoid any external segregation of funds through a trust, escrow agent, or other arrangement. Also, earnings on these receipts should not inure to the payee while they are held by the payor.

1801.1 Deferring Actual Receipt of Income

In considering the postponement of income for tax purposes, an individual must also be concerned with business exigencies, including monetary factors, and legal requirements. For example, the debtor must be evaluated as a continued credit risk. Moreover, the effect on the debtor's tax plans may also have to be considered.

The impact of these income deferral techniques may be mitigated, or in some cases made more restrictive, by sec. 125. (See the discussion of cafeteria plans in 507.) Cafeteria plans, in which the employee chooses between taxable and nontaxable benefits, do not include deferred compensation plans; however, in the case of a qualified cash or deferred profit-sharing or stock-bonus plan, the employee is not taxed currently, even if he is given the option of accepting cash or a plan contribution.

1801.2 Avoiding the Snares of Constructive Receipt and Economic Benefit

The constructive receipt doctrine turns on the *availability* of income, except when control over its receipt is subject to substantial limitations or restrictions.[3] The doctrine is delineated in Rev. Rul. 60-31, whose general principles can be stated as follows:[4]

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.

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3. See regs. § 1.451-2(a).
4. Rev. Rul. 60-31, 1960-1 C.B. 174.

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 recognize income that is received in cash or cash equivalent. 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 avoid income and thereby select the year in which he will report it. Nor may a taxpayer, by a private agreement, postpone receipt of income from one taxable year to another. (This does not mean that an employee cannot agree to defer compensation if the election to defer is made prior to the taxable year in which the income is made available to him. Of course, the employer's deduction may also be postponed.)[5]
5. The statute cannot be administered by speculating whether the payor would have been willing to agree to an earlier payment. The doctrine of constructive receipt is to be used sparingly. Amounts due from a corporation but unpaid are not to be included in the income of a cash basis individual 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 was the result of his own choice.
6. Consequently, any determination of whether the doctrine of constructive receipt applies must be made on the basis of the *specific* situation.

Revenue Ruling 60-31 then applies these principles to five situations involving deferred compensation arrangements. Although the ruling concerns deferred compensation, its precepts appear to be equally appropriate to other types of income.

Situations That Avoid Constructive Receipt

According to Rev. Rul. 60-31, mere contractual rights were sufficient to overcome application of the constructive receipt doctrine in the following situations.

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5. See, e.g., Rev. Rul. 69-650, 1969-2 C.B. 106; Rev. Proc. 71-19, 1971-1 C.B. 698; *James F. Oates*, 18 T.C. 570 (1952), acq. 1960-1 C.B. 5, aff'd 207 F.2d 711 (7th Cir. 1953).

Employees Are Taxable Only on the Actual Receipt of Installment Payments Previously Credited to Their Accounts Under the terms of an employment contract, an employer is under a merely contractual obligation to make payments when they are due. The parties did *not* intend that amounts in a bookkeeping reserve account should be held by the employer in trust for the employee. There is no specific provision in the contract for forfeiture of the taxpayer's right to distribution from the reserve; in the event that he dies prior to his receipt in full of the balance in the account, the remaining balance is distributable to his personal representative at specified rates.[6]

Regulations section 1.402(b)-1(a)(1) provides that substantially vested contributions to a nonexempt trust on behalf of an employee are immediately taxable to the employee. This provision is inapplicable to situations, such as examples (1) and (2) of Rev. Rul. 60-31, in which a trust for the employee's benefit is *not* created.

An Author Is Taxable Only on Royalties Actually Received Pursuant to a Previous Supplemental Agreement A principal agreement provides that royalties are payable as they are earned, and a concurrent agreement makes 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 the 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 carried over by the publisher into succeeding accounting periods; *the publisher is not required to pay the author interest on excess sums or to segregate them in any manner.*

Can constructive receipt be avoided if the creditor is willing to make immediate payment?

In *Ray S. Robinson*, 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.

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6. Congressional concern that the IRS might reverse this position caused Congress to codify present principles in the Revenue Act of 1978. U.S., Congress, Joint Committee on Taxation, *General Explanation of the Revenue Act of 1978*, 1979, 96th Cong., 1st sess., p.75, refers specifically to this example from Rev. Rul. 60-31. See the discussion of codification of present principles on p.247.

> 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.* [Emphasis supplied][7]

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.

An Actor Is Immediately Taxable on His Share of Net Profits as a Member of a Joint Venture Producing Theatrical Performances The actor and the producer were both "acting" in their own rights, the proposed performance was a joint venture, and the actor's status, as concerned the producer, was neither that of employee nor that of independent contractor. The actor's annual share of the play's net profits was currently taxable to him, even though the joint venture retained physical possession of 75 percent of the profits during the run of the play, pursuant to arrangement with the actor. Thus, the actor had authorized the venture's possession and subsequent distribution of the accumulated profits (payable after the play closes).[8]

A Football Player Is Taxable on a Bonus Paid, at His Suggestion, to an Escrow Agent Designated by Him The 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, which, 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 would 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.

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7. *Ray S. Robinson*, 44 T.C. 20 (1965), at 36, acq. 1970-2 C.B. 21.

8. See Rev. Rul. 70-435, 1970-2 C.B. 100, modifying Rev. Rul. 60-31; and *Basye*, 410 U.S. 441 (1973).

Application of the 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 his 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. . . .[9]

The revenue service applied the principles stated in the *Sproull* case to the football player and concluded that his bonus was fully taxable in the year in which the club unconditionally paid the sum to the escrow agent.

It appears that such a transfer would now be subject to sec. 83, which governs property transferred "in connection with the performance of services," since regs. sec. 1.83-3(f) states that sec. 83(a) applies to transfers in respect of future services. Furthermore, cash transferred to an escrow account is considered property under regs. sec. 1.83-3(e).

(See 1802 for factual variations that may yield opposite results.)

Note An employer generally is permitted a deduction for deferred compensation provided under a nonqualified plan in the year that the compensation is includible in the employee's gross income.[10] The Revenue Act of 1978 added sec. 404(d) to extend the same rules to independent contractors.[11]

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9. 16 T.C. 247 (1951).
10. §404(a)(5) and regs. §1.404(a)-12(b).
11. See the *General Explanation of the Revenue Act of 1978*, p.77.

In certain cases, sec. 83 may override the constructive receipt and economic benefit doctrines (see 1603). Section 83 applies to property transferred in connection with services. *Property,* for purposes of sec. 83, does not include money or an unfunded and unsecured promise to pay money in the future.[12] "The term also includes a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account."[13] The sec. 83 provisions generally prevail over the provisions of sec. 61.[14]

Codification of Existing Principles

The Revenue Act of 1978 contains a provision prohibiting the IRS from changing the rules that govern private deferred compensation plans.[15] (Qualified plans and plans subject to sec. 83 are excepted from the rules.) The provision states the following:

> The taxable year of inclusion in gross income of any amount covered by a private deferred compensation plan shall be determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978.[16]

The *General Explanation of the Revenue Act of 1978* explains that this was the legislative response to proposed regulations issued in 1978:

> Much uncertainty developed in the private plan sector because of the statement in the preamble to the proposed regulations that, if the regulations were adopted in final form, the Internal Revenue Service's acquiescenses in the decisions in *James F. Oates,* 18 TC 570 (1952) and *Ray S. Robinson,* 44 TC 20 (1965) would be reconsidered. The Service also indicated that it would be necessary to examine the facts and circumstances of cases similar to those de-

12. One commentator states that it is unclear whether an unfunded and unsecured promise to pay deferred compensation in the future is "property" if payment is to be in the form of stock or other property. See W.L. Sollee, "Final Section 83 Regs. Will Have Major Impact on Compensatory Property Payments," *Journal of Taxation* 49 (November 1978): 258. Another commentator states that an unfunded and unsecured promise to pay deferred compensation in stock is "apparently" considered property under §83. See L.L. Bravenec, "An Analysis of the Final Sec. 83 Regulations," *Tax Adviser* 9 (December 1978): 739, n.47.

13. Regs. §1.83-3(e).

14. Regs. §1.61-2(d)(6)(i). See the discussion by Sollee in "Final Section 83 Regs. Will Have Major Impact on Compensatory Property Payments."

15. Revenue Act of 1978, Pub. L. 95-600, §132 (1978).

16. *Ibid*, §132(a).

scribed in several published revenue rulings to determine whether the deferral of payment was in fact at the individual option of the taxpayers who earned the compensation.

One of the published rulings singled out by the Service involved a five-year employment contract between an employer and an executive employee under which a specified amount of compensation was to be credited to a bookkeeping reserve, accumulated, and then paid out in five equal annual installments beginning when the employee either (1) terminated employment with the employer, (2) became a part-time employee, or (3) became partially or totally incapacitated [Example 1 of Revenue Ruling 60-31, 1960-1 C.B. 174]. Because the example cited by the Service involved an employment contract and not an annual election to defer compensation, uncertainty was created in the private plan sector as to the effect of the proposed regulation.[17]

In the *Oates* decision insurance agents, after rendering services, agreed to receive renewal commissions in the form of monthly payments rather than a commission in the year of payment to the company. The commissioner argued that they should be taxed on renewal commissions that the company credited to their accounts.[18]

Another important ruling apparently covered by this congressional sanction is Rev. Rul. 69-650, in which the service ruled that certain employees who earn a specified normal compensation can elect to defer 5 or 10 percent of their salaries.[19] The election must be made prior to the year involved; for example, an election to defer 1981 salary must be made in 1980.

Thus, the employee should have ample precedent for deferring the receipt and taxability of compensation if the employer is willing to cooperate. Deferral should be possible even if the services have been rendered, as long as there is no present right to the income. The reason for this liberal congressional attitude is that the employer's deduction is correlated with the timing of the employee's income.[20]

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17. *General Explanation of the Revenue Act of 1978*, p.75. Reference is to prop. regs. § 1.61-16, 43 Fed. Reg. 4,638.

18. *James F. Oates*, 18 T.C. 570 (1952), acq. 1960-1 C.B. 5, aff'd 207 F.2d 711 (7th Cir. 1953).

19. Rev. Rul. 69-650, 1969-2 C.B. 106.

20. *General Explanation of the Revenue Act of 1978*, pp.75–76. Note that although the *General Explanation* refers to the deferral of the employer's deduction until the employee "includes" the compensation in income, § 404(a)(5) refers to when it is "includible" in income.

The *General Explanation* also says that the congressional purpose was to clarify the status of deferred compensation plans of taxable organizations. The newly enacted sec. 404(d) likewise defers deductions under deferred compensation plans for non-employees.[21]

An employee given a choice of nontaxable fringe benefits, taxable fringe benefits, or straight compensation may be subject to current tax under sec. 125 (see 507). Section 125 does not apply to deferred compensation.

1802 Restricted Receipts Not Constituting Income

If a taxpayer's financial position permits, he should create nontaxable "loans" by encumbering cash receipts with substantial restrictions on their use or disposition by the recipient. If their use is feasible, he should also consider escrow or trust arrangements, as well as non-negotiable contractual obligations.

> It is fundamental that not all receipts of money or property by a taxpayer constitute 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. . . .[22]

Practically all types of receipts are taxable when the recipient has uncontrolled dominion over their use. The matching concept employed in financial accounting is generally irrelevant for tax purposes. (The matching concept attempts to equate revenues with expenses in order to ascertain net income.)

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.

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21. *Ibid*, pp.77–78. There is also an explanation of the amendment of §404(b), which "clarifies current law by providing that a method of compensation or employer contributions having the effect of a plan deferring the receipt of compensation does not have to be similar to a stock bonus, pension, profit-sharing, or annuity plan to be subject to the deferred compensation deduction-timing rules (Sec. 404)."

22. *Hagen Advertising Displays, Inc.*, 47 T.C. 139 (1966), at 145.

All taxpayers are being compelled by the taxing authorities, slowly but surely, to account for their receipts on a strict cash basis. This has considerably narrowed the range of planning possibilities for the deferral of tax on actual cash receipts. If a client demands uncontrolled and outright possession of funds received from customers, the practitioner is limited to helping the client to prepare for the current payment of tax on those receipts.

If the client is more flexible, however, it is still possible to avoid immediate taxation of certain receipts that are tantamount to the proceeds of authentic borrowing, even though such borrowing may be from customers. Therefore, if customers' advances are needed only for temporary working capital requirements, the client can avoid current taxation by casting these gross receipts transactions as loans, in substance as well as in form. In addition, certain deposits can still be received without generating immediate tax if open or contingent transactions are involved or if the deposits are received in trust.[23]

1802.1 Borrowing Working Capital From Customers

In essence, this recommendation requires a reversal of the debtor-creditor relationship between the client and his customer. The dividing line between taxable receipts and nontaxable loan proceeds is extremely thin and depends on the genuineness of the purported loan transaction. For example, in *Modernaire Interiors, Inc.*, the Tax Court stated the following:

> 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. . . .[24]

1802.2 Receiving Deposits in Open, Contingent Transactions

The following situations exemplify various types of nontaxable deposits.

23. See, e.g., Rev. Rul. 77-260, 1977-2 C.B. 466, regarding tenants' security deposits.

24. *Modernaire Interiors, Inc.*, T.C.M. 1968-252.

Sale of Real Estate

In Rev. Rul. 69-93, 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.[25]

A deposit was received by A in October 1967. The service ruled as follows:

> 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

A 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 against the price if and when the coal and coke were delivered to them. The balance of deposits at the end of 1943 would apply to the price for 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 the following:

> 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.[26]

Contingent Contracts for the Sale of Space

In *Woodlawn Park Cemetery Co.* the taxpayer, planning to build an addition to its mausoleum, entered into contracts for the sale of

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25. Rev. Rul. 69-93, 1969-1 C.B. 139.

26. *Veenstra & De Haan Coal Co.*, 11 T.C. 964 (1948), acq. 1949-1 C.B. 4. See also *Watkins*, 287 F.2d 932 (1st Cir. 1961).

burial space.[27] The contracts did not require the company to complete the construction; it could refund the purchasers' deposits and be relieved of liability. Also, the purchasers could, under certain conditions, refuse to accept the space, and they would be entitled to a refund.

The court noted that a sales agreement from which either party may withdraw is not a completed sale; the contracts at that time were executory and contingent contracts to sell, not completed sales. The court, following *Veenstra & De Haan Coal Co.*, held that no part of the deposits made under these contracts prior to completion of construction and before building costs were ascertainable was taxable income to the taxpayer in the years in which they were received.

Conditional or Tentative Partial Payments

Partial payments received under DOD contracts for construction of equipment were reportable as income only on delivery and acceptance of the product. The court, observing that the partial payments were to be made prior to acceptance of the finished product, viewed the payments as attributes of a financing arrangement in the nature of a loan, the taxpayer's right to retain them being conditional or tentative until final acceptance.[28]

1802.3 Trust or Escrow Accounts

In *Angelus Funeral Home*, taxable income was not created by the receipt of funds, under written instruments of trust, that were deposited in segregated accounts.[29]

Interest on the deposits was paid to the funeral home; however, this did not alter the decision, since the court viewed this as the equivalent of a trustee's fee.

1802.4 Nonnegotiable Contractual Obligations

Revenue Ruling 68-606 states the following principles:[30]

1. Taxable income is not limited to cash receipts but may also include the fair market value of other property received.

27. *Woodlawn Park Cemetery Co.*, 16 T.C. 1067 (1951), acq. 1951-2 C.B. 4.
28. *Consolidated-Hammer Dry Plate & Film Co.*, 317 F.2d 829 (7th Cir. 1963).
29. *Angelus Funeral Home*, 47 T.C. 391 (1967), acq. 1969-2 C.B. 20, aff'd on other grounds 407 F.2d. 210 (9th Cir. 1969), cert. den. 396 U.S. 824.
30. Rev. Rul. 68-606, 1968-2 C.B. 42.

2. Certain evidences of indebtedness are property deemed equivalent to cash, but not all evidences of indebtedness are includible in income.
3. "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 on 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 is desirable to defer income in this manner depends on such factors 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 chapter 19, may also be considered.)

19

Deferred Income

Installment Sales

High on the list of taxpayer-oriented code sections is sec. 453, which expressly approves the use of the installment method as a means of reporting income for federal tax purposes. Installment sale reporting is available to dealers in personal property (sec. 453 (a)) and applies to other sales of real and personal property (sec. 453(b)).[1]

Installment sales of real or personal property are subject to the following basic requirements:

- 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 includible in inventory is only eligible for installment reporting under the rules applicable to dealers.

CAUTION This discussion has been substantially altered by the Installment Sales Revision Act of 1980 (Pub. L. 96-471), which was enacted into law on October 19, 1980 (as this tax study went to press).

1901 Tax Benefits

Installment sales enable taxpayers to control the timing of income, to equate tax payments with cash collections, and to mitigate the effects of depreciation recapture.

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1. A discussion of the installment sale provisions relating to dealers is beyond the scope of this study. See R. Steinman, *Tax Guide for Incorporating a Closely Held Business*, Federal Tax Study 1, rev. ed. (New York: AICPA, 1978), §504.5.

2. Proposed legislation would eliminate this requirement. See J.R. Melnick, "Installment Sale Simplification Bills S. 1063 and H.R. 3899," Tax Management Memorandum 79-17 (August 13, 1979). H.R. 3899 has been replaced by H.R. 6883, the Installment Sales Revision Act of 1980 (enacted into law on October 19, 1980, as Pub. L. 96-471).

1901.1 Control Over the Timing of Income

In chapter 4 the postponement of income is mentioned as one of four methods of smoothly spreading income over a series of years. (The other methods are acceleration of income, postponement of deductions, and acceleration of deductions.) Installment sales are another reliable and time-tested way of regulating the flow of income.

Delaying Tax Payment

Client purchased land in 1979 for $40,000. In December 1980 Mr. Byer offers Client $100,000 for immediate passage of title to the property.

A CPA advises Client to arrange the following installment sale.

$ 30,000	due December 15, 1980
70,000	due January 15, 1981
$100,000	Total selling price

No provision for interest is necessary, since all payments are due within a year of the sale.[3]

By postponing receipt of 70 percent of the selling price for only one month, Client is able to secure a year's delay in paying the related tax (assuming estimated tax payments are based on the prior year).

Avoiding Offset Against Ordinary Income

Assume the same facts as in the previous example, except that Client would otherwise sustain a net operating loss for 1980. In this case, the CPA's recommendation is as follows.

$ 10,000	due December 15, 1980
90,000	due January 15, 1981
$100,000	Total selling price

The 1980 loss can be carried back to 1977 and can be deducted against ordinary income. The 1977 refund would also be increased by 12 percent interest.[4] The possibility that the carryback could precipitate an IRS audit is dismissed because (*a*) 1977 has already

3. See §483(c)(1)(A).

4. See §6611(f)(1). I.R.2169 (October 12, 1979) and Rev. Rul. 79-366 announced that the interest rate will be 12% for amounts outstanding on February 1, 1980, or arising thereafter.

been examined, (*b*) 1980 is fairly clean, and (*c*) a 1980 review is likely in any event. As a result, Client is able to match ordinary deductions against ordinary income and thereby obtain unvitiated capital gain treatment for 90 percent of the gain arising from the sale of his land.

Similar matching principles apply if the land is sec. 1231 property and Client has sec. 1231 losses in 1980 (see 1203). Under Rev. Rul. 69-462 installment sale treatment is not available for a 1980 sale if 100 percent of the selling price is due in 1981.[5]

Inapplicability to Loss Sales

The installment method cannot be used to stagger losses throughout the payment period; however, this possible bracket impairment may be rectified by such defense mechanisms as the following:[6]

- The lifetime carryover of unused capital losses (see chapter 14).
- Income averaging for postloss years. Statutory income averaging is only a forward-moving device. A loss sustained in 1980, for example, cannot reduce a client's income tax for any preceding taxable years; however, the loss does cause 1980 to be a lower base year for averaging future years' income.
- Control of taxable income, for the year of the loss sale, in relationship to the taxable income of contiguous years. If the loss on a particular sale unduly lowers taxable income, a taxpayer can reverse its effect by accelerating other income or postponing other deductions (see chapter 4).

1901.2 Equating Tax Payments With Cash Collections

The installment sale technique also provides the opportunity to pay tax on installment sale profits commensurately with the receipt of installment payments (if such payments are desired by the purchaser).

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5. Rev. Rul. 69-462, 1969-2 C.B. 107. See also Rev. Rul. 71-595, 1971-2 C.B. 223.

6. *Martin*, 61 F.2d 942 (2d Cir. 1932), cert. den. 289 U.S. 737; Rev. Rul. 70-430, 1970-2 C.B. 51. See also Rev. Rul. 76-110, 1976-1 C.B. 126, regarding the sale of three parcels under a single contract, two at a gain and one at a loss.

1901.3 Mitigating the Effects of Depreciation Recapture

Chapter 12 discusses how installment sales can help a taxpayer to regulate his ordinary income bracket when it would otherwise be overly augmented by depreciation recapture, and also discusses the regulatory quid pro quo with respect to reporting ordinary income first and capital gains later.

1902 Installment Sales to Related Parties

An installment sale to a related party may enable a taxpayer to salvage the benefits of installment reporting in circumstances in which sec. 453 might not otherwise be available.

Examples of situations in which sec. 453 might not otherwise be available are when payments in the year of sale exceed 30 percent of the selling price and when the selling price is contingent. (The contingent-selling-price problem is discussed later in this chapter.)

The leading case in this area is *Rushing*, in which installment reporting was salvaged in the context of a corporate liquidation.[7] Installment reporting is not otherwise available to the shareholders of a liquidating corporation.[8] In *Rushing* the selling shareholders sold their stock on an installment basis to an independent third party, a trustee who proceeded to liquidate and sell the assets to the buyers. The selling shareholders were entitled to installment reporting and could not be taxed on the liquidating dividends.

In *Pityo* the taxpayer created several family trusts for the benefit of his wife and children.[9] An independent bank was named trustee upon creation of the trusts, to which the taxpayer gave appreciated stock as a gift. He later sold a large block of the same stock to the trust on an installment basis. The trustee then sold a major portion of the stock and invested in high-yield mutual funds.

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7. *Rushing*, 441 F.2d 593 (5th Cir. 1971), aff'g 52 T.C. 888 (1969). See also *J.H. Weaver, Jr.*, 71 T.C. no. 42 (1978). The service has ruled that a related party may not be used to effect an installment sale (Rev. Rul. 73-157, 1973-1 C.B. 213). See, generally, *Working With the Revenue Code 1979*, ed. I.F. Diamond and M. Walker (New York: AICPA, 1979), p.201. For a good example of how not to structure an installment sale, see *Lustgarten*, 71 T.C. no. 25 (1978).

8. *Freeman Trust*, 303 F.2d 580 (8th Cir. 1962), aff'g 36 T.C. 779 (1961); *West Shore Fuel, Inc.*, 79-1 U.S. Tax Cas. ¶9357 (2d Cir. 1979); *C.A. Simpson*, T.C.M. 1976-160.

9. *Pityo*, 70 T.C. 225 (1978). See also *C.E. Roberts*, 71 T.C. no. 26 (1978).

In permitting the taxpayer's installment reporting election, the court emphasized the independence of the trustee and the fact that the taxpayer had relinquished control over the securities (or sales proceeds). *Pityo* may serve as a model for structuring a transaction designed to diversify a portfolio at little or no immediate tax cost to the taxpayer or his family.

A *Rushing* trust gains a stepped-up cost basis and realizes relatively small gain or loss on a subsequent sale or liquidation. However, the installment-reporting election is merely an income deferral technique; the gain will be taxed as the trust pays on the installment note.

Installment sales between spouses have been permitted, but only where the husband and wife were both separate, "healthy economic entities."[10]

Proposed legislation would make installment reporting unavailable if property is disposed of, directly or indirectly, to a related party.[11]

1903 Pitfalls of Installment Sales

The tax planner should attempt to avoid the following pitfalls: imputed interest, election requirements, payments in year of sale, minimum number of installment payments, contingent sales price, and disposal of installment obligations.

1903.1 Imputed Interest Complications

If property is sold or exchanged under a contract, with one or more payments due more than one year later, and if stated interest is less than 6 percent simple interest per annum, payable with each installment of principal, then the code's minimum interest requirement is not met.[12] When insufficient interest exists, sec. 483 imputes interest — at a rate of 7 percent compounded semiannually — to all payments due more than six months after the sale or exchange. Of course, imputed interest is reduced by any stated interest. (See figure 19-1, p.260.)

Section 483 is inapplicable if the sales price does not exceed

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10. *Nye*, 407 F.Supp. 1345 (D. N.C. 1975). Cf. *P.W. Wrenn*, 67 T.C. 576 (1976). See, generally, *Working With the Revenue Code 1979*, p. 202.

11. See Melnick, "Installment Sale Simplification Bills S. 1063 and H.R. 3899." H.R. 3899 has been replaced by H.R. 6883, the Installment Sales Revision Act of 1980.

12. See regs. §1.483-1(d)(2). *Caution:* A new 9% test rate and a new 10% inputed rate have been proposed for post-Sept. 28, 1980, transactions.

$3,000 or if the entire gain would be considered ordinary income. The latter exception applies only to sellers.

Figure 19-1

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 on a discount rate of 7 percent per annum compounded semiannually. This rate, as well as the 6 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.

Example On December 31, 1980, A sells property to B under a contract that provides that B is to make three payments of $2,000 each. The payments are due at the end of each year for the next three years. The contract does not provide for any interest. The total unstated interest under the contract is $763.10, computed as shown in figure 19-2.

Figure 19-2

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 2.61845 (factor for 3 yrs., col. (b), table VI*))	5,236.90
Total unstated interest	$ 763.10

*Regs. sec. 1.483-1(g)(2).

Note The portion of each $2,000 payment treated as interest is $254.37, determined as follows:

$$\$2{,}000 \times \frac{\$\ 763.10}{\$6{,}000.00}$$

Effect of Imputed Interest

Interest manufactured by sec. 483 "shall constitute interest for all purposes of the Code."[13] Thus, the installment sale provisions of sec. 453 are confronted with the infiltration problem of sec. 483.

13. Regs. § 1.483-2(a)(1)(i).

This hazard is most evident 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. Under present law, $1,600 is considered unstated interest (the present value of the $7,000 balance is $5,400), and the selling price is reduced to $8,400. Since the $3,000 received in the year of sale is 36 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. Regulations section 1.483-1(f)(2) states that such changes are not reflected retroactively.[14]

Protecting the Installment Sale Election

If payments are not fixed, it may be possible for a taxpayer to avoid disqualification of an installment sale by reducing year-of-sale payments to less than 30 percent of the reduced sales price.

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 results 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 is undisturbed.

For instance, if the $3,000 in the example is received more than six months after the sale but within the year of sale, it becomes subject to the imputed interest rules. Assume that this increases the unstated interest by $200 to a total of $1,800 and reduces the sales price to $8,200. Under regs. sec. 1.483-1(a), the unstated interest in each payment is 1,800/10,000 or 18 percent. Thus, 18 percent of the $3,000 received in the year of sale ($540) is interest, while the balance ($2,460) is principal. Since $2,460 is

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14. For an illustration of a nonretroactive application in connection with qualifying for the 30% installment sale test, see Rev. Rul. 68-247, 1968-1 C.B. 199.

exactly 30 percent of the $8,200 sales price, the sale would still qualify for the installment election.

Legislation is pending that would eliminate the 30 percent test.[15]

1903.2 The Required Election

The taxpayer makes the election to adopt the installment method by computing the gross profit under this method with respect to a sale or other disposition. Regulations section 1.453-8(b) requires that the computation be set forth in the return for the year of sale or in a statement attached to the return.

An election cannot be revoked for the year of sale, nor can it be changed for subsequent years.[16]

Failure to Elect

Suppose a client sells property at a small loss. Upon subsequent audit, the revenue service determines that the property was actually sold at a gain. Can this gain be reported on the installment method? In Rev. Rul. 65-297 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 the election were not made on a timely filed original return for the year of sale (including extensions):[17]

- Those cases in which election of the installment method is made on an amended return for the year of sale not barred by the statute of limitations or the operation of any other rule of law, if the facts indicate no election inconsistent with the installment election has been made with respect to the sale.
- Those cases in which the election has been made on a delinquent return for the year of sale.

15. See Melnick, "Installment Sale Simplification Bills S. 1063 and H.R. 3899."

16. *Felton*, 57-1 U.S. Tax Cas. ¶9391 (D. Ga. 1957); *Marks*, 98 F.2d 564 (2d Cir. 1938), cert. den. 305 U.S. 652; *Pomeroy*, 54 T.C. 1716 (1970); Rev. Rul. 78-295, 1978-2 C.B. 165. See also *Pollack*, 47 T.C. 92 (1966), in which 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 that were subsequently disallowed). See also *Luckman*, 56 T.C. 1216 (1971).

17. Rev. Rul. 65-297, 1965-2 C.B. 152. Amplified by Rev. Rul. 76-44, 1976-1 C.B. 128. See also Rev. Rul. 74-421, 1974-2 C.B. 151. Rev. Rul. 65-297 was released in response to several cases cited in the ruling, pending the revision, yet to be promulgated, of regs. §1.453-8(b). See also *Mamula*, 346 F.2d 1016 (9th Cir. 1965), rev'g and rem'g T.C.

The following conditions must also be met:

- The failure to elect the installment method on a timely filed original return must have been an error made in good faith.
- The statute of limitations must not have expired.

> 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)). [Emphasis supplied][18]

Prolonging the Statute of Limitations

Installment sales may give the IRS more time to evaluate the manner in which the seller has treated the transaction for tax purposes. For example, capital gain treatment for installments received when the year of sale is closed can still be reclassified as ordinary income. Without the installment sale election, and using hindsight, it would be possible for the entire gain to be taxed at capital gain rates.

Such a result was approved in *Municipal Bond Corporation* under the following circumstances:

- A sale was consummated in a year that had since closed.
- The installment method was elected for that year, and the reportable gain was treated as long-term capital gain.
- Installment collections continued during years that were still open.
- The IRS contended that payments received in open years were taxable as ordinary income.[19]

1903.3 Payments in Year of Sale

In the determination of whether payments in the year of sale exceed 30 percent of the selling price, payments consisting of the purchaser's evidences of indebtedness are excluded by sec. 453(b)(2)(B). The following types of debt instruments cannot be considered a purchaser's evidence of indebtedness:

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18. Rev. Rul. 65-297.

19. *Municipal Bond Corp.*, 41 T.C. 20 (1963), ultimately reversed on other grounds by 382 F.2d 184 (8th Cir. 1967).

1. A bond or other obligation payable on demand that is issued by a corporate *or noncorporate* obligor.
2. Corporate or governmental bonds or other obligations that (*a*) have interest coupons attached or are in registered form (except those in registered form that 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.[20]

The Tax Reform Act of 1969 removed these obligations from buyer indebtedness 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 liquidation of 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).

> 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.* [Emphasis supplied][21]

The regulation is silent in regard to *unsecured* third-party debts; however, in Rev. Rul. 71-543 the service held that unsecured debt related to the seller's acquisition of the property that is assumed by the buyer in an installment sale is considered the same as an assumption of an existing mortgage in connection with the sale.[22] The service later distinguished Rev. Rul. 71-543 in Rev. Rul. 76-398, concerning a corporation that previously had made unrelated loans to shareholders attempting to qualify for installment reporting on a redemption of their shares.[23] The ruling held

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20. §453(b)(3); regs. §1.453-3.

21. Regs. §1.453-4(c).

22. Rev. Rul. 71-543, 1971-2 C.B. 223. See also *Batcheller*, 19 B.T.A. 1050 (1930); *Big "D" Development Corp.*, T.C.M. 1971-148, aff'd *per curiam* 453 F.2d 1365 (5th Cir. 1972), cert. den. 406 U.S. 945.

23. Rev. Rul. 76-398, 1976-2 C.B. 130.

that cancellation of such loans as part of the purchase price would be treated, in full, as payment in the year of sale.

The service currently adheres to the position that unsecured and unrelated liabilities (debts having no specific relation to the assets sold) are subject to regs. sec. 1.453-4(c) if they are incurred in the ordinary course of business.[24] If the total of all liabilities assumed by the buyer (including unsecured and unrelated debts) exceeds the property's basis, the excess is considered payment in the year of sale; otherwise, the assumption of unsecured, unrelated debt is not considered payment in the year of the sale. Revenue Ruling 73-555, in which the service advanced its current position, emphasizes that the liabilities involved were incurred in the ordinary course of business. The ruling further states, "If, on appropriate facts, it is evident that certain liabilities are incurred by the seller, or that liabilities incurred although due and payable are not paid by the seller for the purpose of avoiding the 30 percent limitation, then the amount of the liabilities so incurred and assumed will be included as 'payments' in the year of sale." The ruling also indicates that the service will continue to treat liabilities that are directed to be paid out of the original purchase price as payments in the year of sale.[25]

The buyer's assumption of selling expenses may be considered payment in the year of sale because the expenses were not incurred in the ordinary course of business. In Rev. Rul. 76-109 the service ruled that the buyer's assumption and payment in the year of sale of brokerage, legal, and accounting fees incurred by the sellers in connection with the sale of their stock are payments to the seller in the year of sale.[26]

Taxpayers must take great care to avoid any surprises that may cause payments in the year of sale to exceed 30 percent of the selling price. Such surprises may include sale-related expenses that are incurred by the seller and paid by the buyer. It is also advisable to structure direct payments in the year of sale in a manner that will provide a reasonable margin of error in connection with the 30 percent test.

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24. Rev. Rul. 73-555, 1973-2 C.B. 159.
25. See *Wagegro Corp.*, 38 B.T.A. 1225 (1933), acq. 1939-1 (Part 1) C.B. 36.
26. Rev. Rul. 76-109, 1976-1 C.B. 125. See also *Bostedt*, 70 T.C. 487 (1978).

1903.4 Minimum Number of Installment Payments

Revenue Ruling 69-462 holds that the installment method applies only to sales of real property that provide for two or more payments in two or more taxable years.[27] Thus, a lump-sum payment after the year of sale does not qualify for installment reporting.[28]

Revenue Ruling 71-595 holds that the two-or-more payments rule applies to sales of personal property, but that an option to make a single payment at a discount is not fatal if there are, in fact, at least two payments.[29]

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 Tax Reform Act of 1969 but rejected by the conference committee.[30] Proposed legislation would eliminate the two-payments rule.[31]

1903.5 Contingent Selling Price

If the selling price is subject to possible adjustment and thus is considered indeterminable, a taxpayer may be barred from using installment reporting.[32] The *Rushing* technique may be used in the context of a corporate liquidation in which the selling shareholders effect an installment sale to a trust at a fixed price, with the trustee then liquidating the corporation and selling the assets at a price contingent on future earnings.[33] The basic *Rushing* technique of making an installment sale at a fixed price to another party who

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27. Rev. Rul. 69-462, 1969-1 C.B. 107.

28. See also *Baltimore Baseball Club, Inc.*, 481 F.2d 1283 (Ct. Cl. 1973); *10-42 Corp.*, 55 T.C. 593 (1971); *W.T. Grant Co.*, 483 F.2d 1115 (2d Cir. 1973), rev'g and rem'g 58 T.C. 290 (1972), cert. den. 416 U.S. 937 (in regard to rehearing, see 548 F.2d 1109, aff'g T.C. decision denying motion for further trial, cert. den. 434 U.S. 819).

29. Rev. Rul. 71-595, 1971-2 C.B. 223.

30. See U.S., Congress, Conference Committee, 91st Cong., 1st sess., 1969, H. Rep. 782, p. 307.

31. See Melnick, "Installment Sale Simplification Bills S. 1063 and H.R. 3899," n. 5, therein.

32. *Gralapp*, 458 F.2d 1158 (10th Cir. 1972), aff'g 319 F.Supp. 265 (D. Kan. 1970); *C.A. Steen*, 509 F.2d 1398 (9th Cir. 1975), vac'g and rem'g unreported district court decision. See also Rev. Rul. 76-109, 1976-1 C.B. 125, and Rev. Rul. 77-56, 1977-1 C.B. 135. For general discussion of the contingent selling price problem, see J.M. Pusey, "When Will Possible Adjustments to Selling Price Bar Use of Installment Reporting," *Journal of Taxation* 47 (July 1977): 22. See 2701.2, note 17.

33. For a discussion of this technique, see *Working With the Revenue Code 1979*, p.201.

will effect the sale to the ultimate buyer can be adapted to other contingent-selling-price situations.

Another possible approach to sidestepping the contingent-selling-price problem is to carve out the contingency from the installment sale. For example, it may be preferable to retain a contract whose value cannot be agreed upon by the parties than to make the contract part of a contingent-price sale.[34]

Another approach is to postpone the year of sale until the contingencies are resolved. An option contract whose exercise price is subject to contingencies may facilitate this approach; however, the option payment will be considered received in the year of sale for purposes of the 30 percent test, even though the payment was actually received in an earlier year.[35]

It is not clear whether installment reporting is available when the selling price is a maximum amount that is subject to reduction for contingencies. Some commentators have suggested this as a possible method for circumventing the contingent-selling-price problem. One commentator suggests, "Until further development, vendors finding a *Gralapp* or *Steen* situation would be advised to approach the transaction by setting a maximum consideration with a potential *reduction* based upon the contingency, with the hope of relying upon the renegotiation concept at such time as the contingency materializes."[36] The "renegotiation concept" refers to *Jerpe* and related authorities that have recomputed selling price and gross profit percentage to reflect subsequent modifications of the agreement.[37]

In holding that contingent offsets against the selling price for breaches of warranty or representation do not make the selling price indeterminable, Rev. Rul. 77-56 effectively sanctions the

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34. For a discussion of this technique, see Pusey, "When Will Possible Adjustments to Selling Price. . . ."

35. *Waukesha Malleable Iron Co.*, 67 F.2d 368 (7th Cir. 1933), aff'g B.T.A. See also Rev. Rul. 73-369, 1973-2 C.B. 155; *Rosenthal*, 32 T.C. 225 (1959). Such arrangements can also cause questions regarding the year of sale. See M.D. Ginsburg, "Taxing the Sale for Future Payment," *Tax Law Review* 30 (1975): 506-07, 521-22; Mertens, *Law of Federal Income Taxation* (Chicago: Callaghan & Co.), § 12.118. Also see and cf. Rev. Rul. 75-563, 1975-2 C.B. 199, and Rev. Rul. 54-607, 1954-2 C.B. 177.

36. J.P. Giljum, 48-4th *Tax Management, Installment Sales*, p.A23.

37. *Jerpe*, 45 B.T.A. 199 (1941), acq. 1942-1 C.B. 9. See, e.g., Rev. Rul. 77-56, 1977-1 C.B. 135; Rev. Rul. 72-570, 1972-2 C.B. 241. Cf. the recomputational approach with *Rees Blow Pipe Mfg.*, 41 T.C. 598 (1964), nonacq. 1966-2 C.B. 8, aff'd 342 F.2d 990 (9th Cir. 1965). For an analogy, see regs. § 1.483-1(e) regarding indefinite payments for imputed interest purposes.

maximum-selling-price approach in circumstances similar to those of the ruling.[38] The question of offsets against the purchase price for other types of contingencies, such as failure to attain a particular level of earnings, is still unresolved; therefore, this remains a highly questionable method of circumventing the contingent-selling-price problem. The question may be resolved under pending legislation.

1903.6 Disposing of Installment Obligations

Installment obligations can be used to store potential income. Certain dispositions release this income into the obligee's tax bracket.

The tax planner can use taxable dispositions to achieve desirable acceleration of income. Deliberate dispositions of installment obligations release latent income and result in the immediate production of taxable income. Chapter 4 describes the advantages of controlling taxable income between years, which include the leveling of annual tax brackets and the absorption of expiring carryovers (net operating losses, investment credits, and so forth).

Nontaxable Dispositions Permit Income Deflection

Revenue Ruling 67-70 concerned a taxpayer who was able to shift the interest on an installment obligation to a two-year charitable trust (repealed by the Tax Reform Act of 1969) because the grantor-obligee retained the right to the principal payments.[39] The ruling held as follows:

> 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]

Revenue Ruling 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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38. Rev. Rul. 77-56, 1977-1 C.B. 135.
39. Rev. Rul. 67-70, 1967-1 C.B. 106.

Ineffective Deflection

The tax planner must be wary of ineffective deflection. A grantor transferred an installment note in trust for the benefit of his sister while the installment obligation still had eighteen years to run. 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 would revert to the grantor. Presented with these facts, Rev. Rul. 67-167 held as follows:

> 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][40]

Note The effective use of ten-year trusts is described in 902.2.

Is the Nontaxable Disposition of an Installment Note to a Ten-Year Trust Possible?

By transferring an installment obligation to a trust satisfying the requirements of secs. 671–679, the seller may be able to shift the taxation of the *interest income* on the installment note. As the trustee collects principal on the note, the capital gain reportable under the installment reporting provisions is taxed to the grantor in the taxable year in which the trust realizes the gain.[41] This may cause a cash flow problem, since the grantor must pay the capital gains tax currently, while the ten-year trust rules require the grantor to maintain a hands-off policy with respect to the trust for at least ten years. Over the term of the trust, however, the interest income from the installment obligation should be taxable to the trust or beneficiary.

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40. Rev. Rul. 67-167, 1967-1 C.B. 107. To the same effect, see *D.A. Springer*, 69-2 U.S. Tax Cas. ¶9567 (D. Ala. 1969).

41. Rev. Rul. 58-242, 1958-1 C.B. 251.

The success of such a plan requires that the transfer of the installment note to the ten-year trust not be a disposition. A transfer of an installment note to a trust is considered a disposition unless the grantor is considered the owner, under the Clifford trust rules, of the portion of the trust that consists of the deferred profit included in the installment obligation.[42] In Rev. Rul. 67-167, the transfer of an installment note to a ten-year trust was considered to be a disposition; however, it was significant that the entire amount of each installment and interest payment on the note was currently distributed to the beneficiary.

Subsequent to that ruling, a district court issued a decision dealing with the transfer of an installment note to a ten-year trust in which the grantor retained the deferred profit on the installment payments. Under the trust instrument, interest income was distributable to the beneficiaries but principal payments, including deferred profit receipts, were to be retained and reinvested by the trustee and returned to the grantor at the end of the trust term.The district court held that this constituted a disposition of the installment note in the year of the transfer.[43]

It appears that this decision may be erroneous, and the transfer of an installment note to a ten-year trust under similar terms may not constitute a disposition of the installment note under sec. 453(d).[44]

The IRS national office is apparently studying the issues involved in transfers of installment notes to Clifford trusts. The IRS has been unwilling to issue private rulings on such transfers until it completes its study.

The trust instrument should provide that the principal payments of the installment note, including deferred profit receipts, are to be retained and reinvested by the trustee and returned to the grantor at the end of the trust term. Even then, in view of the *Springer* decision and the IRS study of the question, taxpayers cannot be certain that such transfers will not be characterized as dispositions.

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42. Rev. Ruls. 67-70, 1967-1 C.B. 106, and 74-613, 1974-2 C.B. 153. Cf. A.W. *Legg*, 57 T.C. 164 (1971), aff'd *per curiam* 496 F.2d 1179 (9th Cir. 1974), holding that the grantors transferred their interest in the installment note, which resulted in a "disposition."

43. *D.A. Springer*, 69-2 U.S. Tax Cas. ¶9567 (D. Ala. 1969).

44. See M.D. Ginsburg, "Taxing the Sale for Future Payment," p.540. See also Rev. Rul. 64-302, 1964-2 C.B. 170.

1904 Technical Observations

Section 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) about computing the amount of realized gain or loss.)

Significant statutory exceptions exist for transmissions caused by death (sec. 453(d)(3)) and for distributions in certain corporate liquidations (sec. 453(d)(4)). Regulations section 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)."[45]

1904.1 Transmission at Death

Income residing in installment obligations that are transmitted at the holder's death is subsequently taxed to the actual recipient of the income (estate or heirs) as "income in respect of a decedent."[46] 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. This double taxation is eased somewhat by an income tax deduction for estate tax that is attributable to income included in a gross estate.[47]

1904.2 Special Rules for Repossessed Real Property

A relief provision, applicable *only* 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

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45. See Steinman, *Tax Guide for Incorporating a Closely Held Business*, §602.3, for a more intensive discussion of this regulatory exception relating to §351 incorporations.

46. §691(a)(4).

47. §691(c). Also see chap. 11, n.38, herein.

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.[48]

1904.3 Financial Implications

The tax planner cannot overlook the economic consequences of an installment sale. The tax planner must exercise keen business judgment 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.

Of course, the significance of this matter varies with the length of the installment period and the size of the unpaid selling price.

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48. U.S., Congress, Senate, 88th Cong., 2d sess., 1964, S.Rep. 1361, in 1964-2 C.B. 828, at p.832. For the specialized application of § 1038 to repossessed residences, see 601.3 and 1502.2, herein.

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Deferred Income

Deferral Transactions

2001 Short Sales

Short sales can be an effective technique for equalizing tax brackets, offsetting existing short-term gains against any subsequent capital losses, or postponing or completely avoiding tax payments.

A short sale has been described as follows:

> A short sale occurs when a person sells stock that he does not intend to deliver at the time of the sale, whether or not he owns the stock sold.
>
> If the seller does not own the stock sold, it is a true short sale. If he already owns stock substantially identical to that sold, the transaction is commonly referred to as a sale against the box.
>
> Short sales are generally made by traders who believe the stock will decline. A short sale is effected by instructing a broker to sell short. The broker borrows the stock so he can deliver the shares to the buyer. The money value of the shares borrowed is deposited by the broker with the lender of the stock. Sooner or later the short seller must cover his short sale by buying the same amount of stock he borrowed for return to the lender. It he is able to buy at a lower price than he sold, his profit is the difference between the two prices — not counting commissions and taxes. But if he has to pay more for the stock than the price he received, he incurs a loss. Stock exchange and federal regulations limit the conditions under which short sales may be made on a national securities exchange.[1]

2001.1 Equalizing Tax Brackets

A short sale can function as a means of controlling taxable income between years in order to equalize tax brackets (see chapter 4).

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1. John D. Smyers, "Tax Considerations for Individuals Investing in Common and Preferred Stock," *Federal Taxes–Tax Ideas* (Englewood Cliffs, N.J.: Prentice-Hall), ¶17,010.

2001.2 Offsetting Existing Short-Term Gains Against Subsequent Capital Losses

Client buys 100 shares of Rock Oil Co. on January 3, 1980, at $15 per share. Rock Oil advances to $50 per share by December 15, 1980, which Client thinks will be its highest point.

Client does not have any capital loss deductions.

A CPA advises Client to sell Rock Oil short against the box on December 15, 1980, and close the sale on January 4, 1981. Although this technique will not convert the short-term gain into a long-term gain, it will have the following advantages:

1. Client will be able to sell the stock at what he considers the optimum selling price.
2. Client will have an additional twelve months in which to use any capital losses that may be incurred as offsets against this ordinary income. (See the chapter 14 discussion of possible strategies for offsetting gains and losses.)
3. Since any resulting net gain will be taxable in 1981, Client obtains additional time for tax payments.

2001.3 Postponing or Avoiding Tax Payments

If Client actually sells his Rock Oil shares in 1980, any applicable tax will be due by April 15, 1981. 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 the income of the preceding year.

A short sale against the box that is not closed until the seller's death may completely avoid tax, since the securities that are sold short obtain a new basis, which is equal to the date-of-death value or, if elected, the alternate value.[2]

2001.4 Financial Considerations

The following financial factors may detract from the tax benefits of short sales:

1. Short sale expenses, such as a premium charge for the loan of shares. (Selling expenses, such as commissions, are usually immaterial and would be incurred on an actual sale. Thus,

2. See Rev. Rul. 73-524, 1973-2 C.B. 307.

they usually can be ignored in comparing the effects of short sales with those of actual sales.)

2. Large short positions that may either make loans difficult to obtain or compel their repayment at an unfavorable time.
3. Unproductive investment, whereby 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 that is sold short.

The problem can be compounded if the short sale securities are purchased on margin and additional collateral is required. (Collateral 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 a loan of an equal number of shares for a short sale. Only 10 percent of the 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.

2001.5 Short-term and Long-term Gain

> 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.[3]

Short-term gains *cannot* be converted into long-term gains by using short sales in the following manner.

On February 1, Client buys 100 shares of Venus Air Conditioning at $25 a share. Venus Air rises to $65 by January 1 of the following year, and Client decides to take his profit. He does not sell the shares he actually owns, but instead sells short. He closes

3. Regs. § 1.1233-1(a)(1) and (3).

the short sale on February 2 by delivering the securities purchased on February 1 of the preceding year.

Although the property used to close the short sale has been held more than a year, a special rule prescribed by sec. 1233(b) requires Client to treat the gain as a short-term capital gain, since property identical to the property that was sold short was held one year or less on the date of the short sale. The same result would occur if Client did not own the property at the time of the short sale but acquired it while the short sale was open.

2002 Options to Sell Property

Options provide both tax deferment and flexibility in the timing of financial transactions. They permit a taxpayer to realize gains in one year and to recognize the gains for tax purposes in a later year.

An option to sell property is a legal commitment that 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,* and options to purchase are known as *calls.* Both are customarily obtained for a separate consideration known as a *premium*.

Revenue Ruling 58-234 held as follows:

> 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. . . . 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 to exercise, or otherwise, with resultant gain or loss.[4]

The deferral techniques possible under an option's delayed reaction potential can be compared with those offered by short sales, as shown in figure 20-1.

Options and short sales can be further compared as follows:

> [By buying a one-year-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 [one year]. *His investment alternative, the short sale, would result only in a short term gain.* [Emphasis supplied][5]

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4. Rev. Rul. 58-234, 1958-1 C.B. 279. See Rev. Rul. 78-182, 1978-1 C.B. 265, for a general discussion of the income tax consequences to holders and writers of puts, calls, and straddles purchased, sold, or "closed out" on the Chicago Board Options Exchange.

5. William L. Morrison, "Tax Planning for the Unusual Securities Transaction," *Journal of Taxation* 29 (October 1968): 243. Rev. Rul. 78-182, Rul. C.2, at 267.

Figure 20-1

Short sale deferral techniques	Relevancy to options
Equalizing tax brackets	Applicable
Offsetting existing short-term gains against any subsequent capital losses	Applicable*
Tax payments:	
Postponement	Applicable
Complete avoidance	Not feasible

*Section 1233(b) treats options as short sales in preventing the use of identical property to convert short-term gains into long-term gains. This prohibition does not apply to puts used as *hedges* (options and their subject property simultaneously acquired), since the property's holding period cannot be extended without financial risk (sec. 1233(c)). Also see Mertens, *Code Commentary* (Chicago: Callaghan & Co.), § 1233:1; Rev. Rul. 78-182, 1978-1 C.B. 265, Rul. C.6, at 267.

Although the Chicago Board Options Exchange does not market puts exceeding nine months, a longer put may be transacted over-the-counter.

Section 1233(d) bans the use of short sales to create artificial short-term losses. Interestingly, this measure does not apply to options.[6] However, Rev. Rul. 77-185 disallowed short-term capital losses created to offset unrelated short-term capital gains through a series of transactions in silver future contracts that produced no real economic loss. The ruling also disallowed related out-of-pocket expenses incurred in creating the losses.[7]

Options, like short sales, have costs (premiums) that militate against the ultimate tax savings. Consequently, the tax planner must consider options' financial as well as tax effects in arriving at the most desirable overall result.

2003 Executory Contracts

Executory contracts can produce benefits similar to those of short sales and options.

In Rev. Rul. 69-93, A entered into an agreement with B during October 1967 for the conveyance of real estate on March 1, 1968.[8] B made a nominal payment when the contract was signed. The balance of the purchase price was paid at the date of conveyance

6. Regs. § 1.1233-1(c)(4).

7. For discussion of this ruling, see Tax Trends, ed. E.S. Linett, *Tax Adviser* 8 (September 1977): 574. Rev. Rul. 78-414, 1978-2 C.B. 213, states, "The conclusion of Rev. Rul. 77-185 would be equally applicable to a spread transaction in commodity futures contracts on Treasury bills."

8. Rev. Rul. 69-93, 1969-1 C.B. 139.

(March 1, 1968), at which time B took possession of the property. During the period between October 1967 and March 1, 1968, A, the vendor, had the legal title, the right of possession, and the right to the rents and profits that might arise from this property.

The ruling held 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 passsed or at the time possession and the burdens and benefits of ownership were transferred to the buyer. Since these events took place on March 1, 1968, that is the date on which the sale occurred. The payment made prior to the sale was deemed to be in the nature of a deposit on the purchase price of the property; it was to be taken into account in determining the character and amount of income, gain, or loss in the year of sale.

Revenue Ruling 67-100 illustrates how an executory contract can be used:

> 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 benfits 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.[9]

Section 341(d)(3) provides that the collapsible corporation provisions of sec. 341 do not apply to gains attributable to sec. 341 assets (defined in sec. 341(b)(3)) that are realized more than three years after manufacture or after purchase of the assets has been completed.

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9. Rev. Rul. 67-100, 1967-1 C.B. 76.

21

Deferred Income

Tax-Deferred Exchanges

2101 Exchange of Stock or Securities Pursuant to Corporate Reorganization

Under highly limited conditions, a taxpayer can "turn over" stock or securities 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 recognize gain or loss on their transaction. Sections 354 through 358, however, provide an exception to this rule by requiring that the tax consequences of certain exchanges be deferred when 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. . . ."[1] 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. . . ."[2]

Section 368(a)(1) recognizes six different types of basic corporate reorganizations (labeled types A through F) that will generate tax-free results. These nonrecognition provisions are activated only if the underlying reorganization fits one of the six statutory definitions *precisely*. Furthermore, the long-standing sec. 368 regula-

1. Mertens, *Code Commentary* (Chicago: Callaghan & Co.), §§354–358:1.
2. Regs. §1.354-1(a).

tions impose additional criteria, such as the business-purpose test enunciated by regs. sec. 1.368-1(b), to which the reorganization must meticulously adhere.

Deferment is accomplished by the prosaic process of not recognizing the gain or loss realized at the time of the current exchange. 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.

Perpetual deferral may be possible if the tax postponement is continued ad infinitum through a series of tax-free exchanges. Death may also intervene to provide a stepped-up basis. For example, Client, in contrast to Mr. Swapper, can exchange his shares of Sophisticated Enterprises for shares of Galaxian Products, Inc., without recognizing any gain or loss if the transfer is made pursuant to a type B reorganization. In the type of reorganization defined in sec. 368(a)(1)(B), Galaxian acquires a controlling interest in Sophisticated solely in exchange for all or part of Galaxian's own voting stock. The required control is 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. . . ."[3]

2102 Like-Kind Exchanges

The tax planner can use like-kind exchanges to achieve greater equities in eligible properties and to replace properties of like kind—without incurring tax in either process.

The planner can reduce taxable boot by advantageously arranging exchanges involving mortgaged properties. Any boot to be received in the form of cash should, instead, first be applied to reduce the mortgage on the property to be acquired.

Like-kind exchanges represent another deferment technique, similar in operation and effect to exchanges of stock.

Background

Various characteristics peculiar to sec. 1031 exchanges can be summarized as follows:

3. Rev. Rul. 59-259, 1959-2 C.B. 115. Also see J. Rabkin and M.H. Johnson, *Federal Income, Gift, and Estate Taxation* (New York: Matthew Bender), §32.02(2).

1. Business property can be exchanged for investment property and vice versa (regs. sec. 1.1031(a)-1(a)).
2. Regulations section 1.1031(a)-1(b) defines like kind as follows:

   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. . . .

3. Regulations section 1.1031(a)-1(b) also holds, "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."
4. Regulations section 1.1031(a)-1(c) provides the following 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. . . .

2102.1 When Are Tax-Free Exchanges Desirable?

Favorable factors are the monetary benefit (interest yield) obtained through the tax deferral and the possibility of a stepped-up basis in the event of death.

An unfavorable factor is the fact that the basis of the replacement property is reduced by the unrecognized gain. If the property is depreciable, its basis may be recoverable against ordinary income over the depreciation span.

When the gain, if recognized, is taxable at capital gain rates, nonrecognition has the effect of eliminating immediate capital gain at the expense of forfeiting potential ordinary income deductions over a period of time. The possibility of capital gain taxation, in the case of personal property dispositions, continues to diminish as time passes because of the depreciation recapture demanded by sec. 1245. On the other hand, recapture of depreciation on buildings and other sec. 1250 property can be less of a problem. Therefore, the decision whether to pay capital gains tax now and reduce ordinary income later may have lasting significance for like-kind exchanges of real property, whereas 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 the case study in 2103.)

If the prognosis is unfavorable, sec. 1031 can be used to increase a taxpayer's equities in eligible property without incurring tax in the process. This has been a standard procedure with respect to real estate, in particular. The procedure is made possible by the mortgage provisions of regs. sec. 1.1031(d)-2, which allow boot received through the other party's assumption of a taxpayer's mortgages to be offset by the taxpayer's assumption of the other party's mortgages.

The procedure is especially useful in the case of land exchanges in which there is no concern about the depreciation element (either with respect to recapture on the old property or to the depreciable basis of the new property).

2102.2 Controlling the Application of Section 1031

Since sec. 1031 is mandatory, a taxpayer can invoke its provisions by arranging his transaction to comply with the statute's requirements. In overly simplistic terms, he transacts an exchange of like-kind property. If sec. 1031 treatment is not desired, the transaction should be cast, in substance as well as in form, as a sale and purchase. Revenue Ruling 61-119 held as follows:

> 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.[4]

4. Rev. Rul. 61-119, 1961-1 C.B. 395.

Aside from the inferences to be drawn from the express statutory requirements regarding the exclusive use of only business or investment properties in like-kind exchanges, there are no apparent business-purpose criteria to be found in sec. 1031 or its accompanying regulations. In contrast, regs. sec. 1.368-1(b) provides an express business-purpose requirement in the case of exchanges of stock pursuant to corporate reorganizations. Nevertheless, it would be most imprudent to attempt to exchange properties tax-free under sec. 1031 in the absence of any bona fide business reasons.[5]

2102.3 Reducing Taxable Boot Through Exchanges Involving Mortgaged Properties

Regulations section 1.1031(d)-2 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. . . ."[6] Example (2) of regs. sec. 1.1031(d)-2 requires the following inconsistent treatment of boot:

- "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. . . ."
- "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. . . ."[7]

Avoiding Recognition of Gain on the Exchange of Mortgaged Property

Client and Wheeler own apartment houses with the following statistics (as of December 1, 1980).

5. See Rev. Rul. 77-297, 1977-2 C.B. 304, in which an exchange was taxable to one party to the transaction because he had not held his property for productive use in a trade or business or for investment.

6. Regs. § 1.1031(d)-2.

7. For a recent example of the application of this rule, see Rev. Rul. 79-44, 1979-6 I.R.B. 12. Exchange of individual interests by the two co-owners resulted in "boot" equal to the fair market value of the note given by one co-owner to the co-owner who assumed the mortgage. Cf. *Barker*, 74 T.C. no. 42 (1980).

	Client's house	Wheeler's 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

Figure 21-1

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

$40,000 cash to Client. The recognized (taxable) gains will be computed in two steps, as shown in figure 21-1.

To avoid recognition of gain by his client, the CPA points out that, unlike Wheeler, Client 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, the 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 will still be equal ($330,000 for each), and Wheeler will continue to be taxed on $30,000. *Client, however, will not have any recognized gain* since he will not receive any cash and his boot received will be determined as follows.

1. Liabilities transferred	$ 80,000
2. Less liabilities assumed	110,000
Net liabilities transferred (line (1) less line (2) but not less than zero)	$ None

2102.4 Three-Way Exchanges

Three-way exchanges are caused by mismatched consideration.[8] They can be illustrated as follows.

Mr. Ready owns land (site 10) that Mr. Willing will only buy for cash. Mr. Ready refuses such consideration, since he abhors the tax it will generate. Of course, Mr. Ready would be eager to sell for other land and thereby avoid tax in accordance with sec. 1031.

As a solution to the problem, Mr. Able enters into the transaction with these prime qualifications: He owns land (site 31) that 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 own.

In Rev. Rul. 77-297, the service ruled that such a transaction qualifies as a like-kind exchange for Mr. Ready, but that the exchange of site 31 for site 10 is taxable to Mr. Willing, who did

8. This discussion can only scratch the surface of the three-way exchange. For those interested in pursuing this subject further, see Walter G. Van Dorn, "Planning Tax-Free Like-Kind Exchanges of Real Estate," *Journal of Real Estate Taxation* 5 (1978): 293.

not hold site 31 for use in a trade or business or for investment. Any gain or loss realized by Mr. Willing should be small, however, since it was held only long enough to facilitate the exchange.[9]

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 a summary of selected activities that the tax planner should or should not avoid to preserve a nontaxable three-way exchange.

Permissible Activities

The following will preserve such an exchange:[10]

1. An alternative cash sale can be provided for in the exchange contract.
2. The taxpayer may—
   (*a*) Require the purchaser to finance improvements on the taxpayer'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

The taxpayer may not receive the cash purchase price (for the former property) either directly or through an agent (such as a broker). His contractual relationship must be limited to the other exchanging party.

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9. For a recent Tax Court decision sanctioning a three-way exchange, see *Biggs*, 69 T.C. 905 (1978), on appeal to 5th Cir. For a recent unsuccessful three-way exchange, see *Swaim*, 79-2 U.S. Tax Cas. ¶9462 (D. Tex. 1979).

10. Also see *Starker*, 602 F.2d 1341 (9th Cir. 1979), aff'g, rev'g, and rem'g 432 F.Supp. 864 (D. Ore. 1977), where property was disposed of for a fixed value of $1.5 million. The "seller" was able to select replacement properties over a period of time and offset their cost against this $1.5 million. Any remaining balance after five years was to be paid in cash. The unused $1.5 million value also earned 6% interest. Replacement properties worth $1.5 million were acquired within two years. The court treated this disposal as a like-kind exchange and only taxed the interest received (as ordinary income). Like-kind exchange treatment was also allowed for a nonsimultaneous three-way exchange, by use of an independent trustee, in I.R.S. Ltr. Rul. 7938087. This new opportunity to effect a delayed tax-free exchange without IRS opposition appears, however, to be short-lived; in Ltr. Rul. 8005049 the IRS revoked Ltr. Rul. 7938087 and stated that it is reconsidering its earlier position.

2102.5 Tangible and Intangible Property Exchanges

Figure 21-2 compares various attributes of like-kind exchanges under sec. 1031 with exchanges of stock or securities pursuant to sec. 368 reorganizations. These two code sections are *mutually exclusive.* Thus, investors cannot trade equities in stock upward 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 of sec. 368.

Like-Kind Exchange vs. Reorganization Comparative Chart **Figure 21-2**

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 (*b*) Stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest	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.

2103 Involuntary Conversions

The tax planner should perform calculations to determine whether or not the gain on the converted property should be recognized currently. Other planning considerations involve whether 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.

Definition of an Involuntary Conversion

Involuntary conversions are defined in sec. 1033(a) as the compulsory or involuntary transformation of property (1) into other property that is similar or related in service or use or (2) into cash or other property that 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 on 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 unrelated property, unless (1) property that is similar or related in service or use is purchased during the replacement period and (2) the taxpayer elects to have the gain recognized only to the extent that the amount realized on the conversion exceeds the cost of the replacement property (sec. 1033(a)(2)(A)).

Replacement property includes a controlling stock interest in a corporation owning similar or related property (sec. 1033(a)(2)(A)). In addition, there is a liberalized special rule affecting real property.

Treatment of Losses

Regulations section 1.1033(a)-1(a) states that sec. 1033 applies only with respect to gains; losses from involuntary conversions are recognized or not recognized without regard to this section.

The Replacement Period

Section 1033(a)(2)(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, if sooner, earliest date of threat or imminence of requisition or condemnation.
2. End of period. Two years after the close of the first taxable year during which any gain is realized from the involuntary conversion. A three-year period applies to condemnations of real property (sec. 1033(g)(4)).

Extending the Replacement Period

The taxpayer can extend the replacement period 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. Regulations section 1.1033(a)-2(c)(3) states, "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)][11]

Thus, it may even be possible to obtain an extension of the extension application itself!

In practice, extended extensions have been granted, if at all, only in extenuating circumstances. Consequently, the tax planner should not rely on them for planning purposes but should use them only as a last resort.

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11. A three-year period applies in the case of condemned real property.

2103.1 Should the Taxpayer Elect Not to Recognize Gain?

The advantages and disadvantages of this election are identical to those of tax-free sec. 1031 like-kind exchanges discussed in 2102.

Again, the decision 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. 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.

2103.2 A Case Study for Involuntary Conversions

I. M. Client
360 Computer Row
Martinsburg, West Virginia 01401

Dear Client:

In accordance with your request, we have prepared a summary of various income tax consequences of the replacement of your plant, which was destroyed by fire on May 1, 1980. The following are the gains and losses that are likely to be realized:

	Book value May 1, 1980	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, an election can be made to postpone the recognition of 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 will *not* be taxable *to the extent that the insurance proceeds are used to purchase replacement properties*. The cost of the new property will 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. (It is assumed that your taxable income, exclusive of any present gains or future additional depreciation deductions resulting from the involuntary conversion, will be $225,000 during the years involved. This would put you in the 70 percent ordinary income tax bracket. Investment credit is ignored.)

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		$ —	$18,690
5. Tax on line 3 (at 28%)†		6,618	9,810
6. Total current taxes (lines 4 and 5)	$35,118	$ 6,618	$28,500
7. Total cumulative tax savings through increased future depreciation (exhibit 2)	$59,770		
8. Less total current taxes (line 6)	35,118		
9. Net tax savings if gains are recognized in 1980	$24,652		

*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.
†70% × 40% (100% − 60% capital gain deduction).

Monetary Factors

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 the gains in 1980. This financial cost should itself be offset by the following subfactors:

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 if the current tax is paid with funds that would otherwise be 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) will have a reverse thrust during the replacement assets' lives. This 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 reflect straight-line depreciation. The use of accelerated depreciation would expedite these savings and thus hasten the recovery of your tax investment. In that case the negative monetary impact of your 1980 tax payment would be even further curtailed.

Exhibit 2

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. Additional depreciation:		
Years 1–10 ($788 + $6,174)	$ 6,962	
Years 11–30		$ 788
5. Annual tax savings at 70%	4,873	552
6. Cumulative tax savings	48,730	11,040
	11,040	
7. Total cumulative savings	$59,770	

Investment Credit

There is recapture of investment credit previously claimed on the destroyed property whether or not the election is made. On the other hand, credit is allowable for the eligible replacement property. The credit may be increased if the election to postpone recognition of gain is *not* made.

John Doe, CPA
Doe, Jones, and Smith, Inc.

2103.3 Other Planning Considerations After an Involuntary Conversion

Fragmented Conversions

The foregoing case study dealt with two basic kinds of converted property: buildings and machinery and equipment. Either kind of property has its own set of depreciation recapture rules, which may be triggered by an involuntary conversion. As we have seen, buildings (and other sec. 1250 property) may escape recapture completely if they have been depreciated under the straight-line method. In 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 the capital gains tax/stepped-up basis syndrome.

The question arises of whether it would be possible to recognize gain on the conversion of a nonrecapturable building while simultaneously electing not to recognize gain on machinery (pursuant to sec. 1033)—assuming that both properties have been fully replaced. Regulations section 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 when nonrecognition of gain is desired.

Lump-Sum Award In *Ticket Office Equipment Co.*, the Tax Court stated that "it is not essential that insurance be allocated in any specific manner to individual items destroyed."[12] The court cited *Massillon-Cleveland-Akron Sign Co.*, which involved an insurance contract that provided joint, as opposed to separate, coverage for all assets in a damaged manufacturing plant.[13]

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 trans-*

12. *Ticket Office Equipment Co.*, 20 T.C. 272, aff'd *per curium* on another matter by 213 F.2d 318 (2d Cir. 1954).

13. *Massillon-Cleveland-Akron Sign Co.*, 15 T.C. 79 (1950), acq. 1950-2 C.B. 3. Also see *Orders*, 64-2 U.S. Tax Cas. ¶9551 (D. S.C. 1964).

actions . . ."(emphasis supplied).[14] If converted properties are not replaced, capital and noncapital assets can be treated separately. In *Lehman Company of America, Inc.*, ordinary losses were allowed for destroyed inventory, while long-term capital gain was permitted on depreciable assets.[15]

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. There is no exception to the normal investment credit recapture provisions for involuntary conversions. The replacement property will be eligible for investment credit if it is qualifying sec. 38 property.

Stock as Replacement Property

In some cases, a taxpayer can replace converted property by purchasing at least 80 percent control of a corporation owning replacement property. The basis of the property at the corporate level may be greater than the stock, whose basis is generally lower by virtue of sec. 1033(b). This procedure may produce greater depreciation than direct acquisition of depreciable replacement property.

The Tax Court, in *John Richard Corporation*, has even sanctioned the technique whereby a corporate taxpayer replaces the involuntarily converted property by forming a corporate subsidiary, which subsequently acquires the replacement property.[16] The *John Richard Corporation* precedent should also apply to individuals, since any taxpayer may satisfy the replacement requirement by acquiring 80 percent control of a corporation.[17] A corporate taxpayer may further benefit from the increased depreciable basis by filing a consolidated return, which would include the subsidiary, and, possibly, later liquidating the subsidiary under sec. 332.[18]

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14. Mertens, *Law of Federal Income Taxation* (Chicago: Callaghan & Co.), §20.173. See n.95 citations for possible precedent allowing deductible losses without offset against unrecognized gains.

15. *Lehman Company of America, Inc.*, 17 T.C. 422 (1951), acq. 1952-1 C.B. 3.

16. *John Richard Corp.*, 46 T.C. 41 (1966), nonacq. 1974-2 C.B. 5. The service reaffirmed, in Rev. Rul. 77-422, 1977-2 C.B. 307, that it will not follow *John Richard Corp.*

17. See §§1033(a)(2)(A) and 7701(a)(14). See also Rev. Rul. 57-408, 1957-2 C.B. 525.

18. See *Working With the Revenue Code 1979*, ed. I.F. Diamond and M. Walker (New York: AICPA, 1979), p.326.

In view of the service's contrary position, taxpayers seeking to take advantage of the *John Richard* precedent may have to litigate the issue.

If the destroyed building had incubated sec. 1250 recapturable depreciation, its replacement with stock in lieu of another building causes ordinary income to be recognized.[19] Comparable provisions exist for similar situations involving personal property (and other sec. 1245 property).[20]

The use of stock as a substitute for property may also be detrimental because investment credit will not be generated by the acquisition.

Should a Ruling Be Requested?

If a client desires not to recognize his involuntary conversion gain, an advance ruling on whether a proposed purchase is a like-kind replacement or a replacement with property similar or related in service or use may be advisable. In considering such a ruling, however, the taxpayer should consider the following drawbacks:

1. Rulings take time. Therefore, the client must be able to suspend his plans 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 also be invitations to audit. Whether this factor is a calculated risk depends, naturally, on the state of the individual's affairs. The degree of doubt surrounding the sec. 1033 qualifications of the intended replacement property should be weighed against the degree of any exposure the individual may have to potential IRS adjustments.

Choice of Forum When a Ruling Is Desired Rulings are obtained from the IRS national office under the procedures enunciated in Rev. Proc. 80-20.[21] "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

19. § 1250(d)(4)(B).
20. See § 1245(b)(4)(B) and regs. § 1.1245-4(d)(2), example (2).
21. Rev. Proc. 80-20, published June 30, 1980.

converted. . . ."[22] In such instances the district director is authorized to issue a determination letter in lieu of a ruling.[23]

The choice of the national office forum does not decrease the odds that the taxpayer's file will find its way into his local district audit division's grasp. In this regard, sec. 17.02 of Rev. Proc. 80-20 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. . . ."

Not surprisingly, sec. 18 of the procedure prescribes a similar fate for determination letters on examination of the taxpayer's return.

The choice of a suitable forum for answering a client's replacement property question comes down to such practical considerations as conference sites and dealing with local as opposed to out-of-town IRS personnel.

2103.4 Special Rule for Real Property

If a taxpayer is to avoid recognition of gain, the replacement property must be similar or related in service or use to the converted property; however, a significant exception to this rule allows involuntarily converted real property to be replaced by real property that is merely of a like kind. The special rule applies only when the conversion is caused by seizure, requisition, condemnation, or the threat or imminence of any of these. Conversions due to destruction or theft are covered only by the general rule.

Both the replaced and replacement properties must be held either for productive use in a trade or business or for investment. Inventory or other property held primarily for sale is excluded from this like-kind test.[24] *The special rule also does not apply if the replacement property consists of a controlling stock interest in a corporation owning qualifying property.*[25]

The special rule of sec. 1033(g), which was a 1958 technical amendment, merely supplements the preexisting provisions of sec. 1033. Accordingly, qualifying like-kind property is treated as

22. §5.01, Rev. Proc. 80-20; reg. §601.201(b)(1).
23. §7.05, Rev. Proc. 80-20.
24. U.S., Congress, Senate, 85th Cong., 2d sess., 1958, S.Rep. 1983, in 1958-3 C.B. 994.
25. §1033(g)(2).

though it is similar or related in service or use to the converted property. *Furthermore, nonrecognition of gain is still available even though corporate stock is purchased as replacement property if the older similar-or-related-property rule is satisfied.*[26]

> 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. . . .[27]

Note "Like kind," for purposes of sec. 1033, has the same meaning as in sec. 1031, which pertains to like-kind exchanges.

2103.5 The Election Not to Recognize Gain

Regulations section 1.1033(a)-2(c)(2) provides that the details of an involuntary conversion at a gain should be reported in the return for the year or years in which gain is realized. The regulations state that the taxpayer, in electing to take advantage of sec. 1033, recognizes only the excess of the amount realized over the cost of replacement property; the regulations also state that the election is valid even if the required details are omitted from the return. The taxpayer can even make the election after the return is filed by filing a claim for refund or credit within the replacement period for the year.[28] The Tax Court has held, however, that the taxpayer

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26. Mertens, *Code Commentary*, § 1033(g):1 (emphasis supplied).
27. S.Rep. 85-1983, p.993.
28. Rev. Rul. 63-127, 1963-2 C.B. 333.

may not revoke an election not to recognize gain under sec. 1033 after he has made a qualified reinvestment.[29]

The IRS issued technical advice in November 1978, the salient points of which may be summarized as follows:[30]

a. If the taxpayer specifically designates the qualified replacement property in the election, that affirmative designation may not be changed once the taxpayer has acquired qualifying property. An affirmative designation of replacement property that is subsequently determined not to be qualifying property does not preclude the taxpayer from replacing the designated property with qualifying assets during the replacement period.

b. If the taxpayer makes a general sec. 1033 election and does not designate specific assets as replacement property, the taxpayer may later designate which specific qualifying assets are to be replacement property. Such a designation cannot be changed after it is made.

The taxpayer has more flexibility in a "general" election described in *b*; he therefore may want to avoid any specific designation of replacement property in the original election if the election is made in the first year that gain is realized.

Regulations section 1.1033(a)-2(c)(2) requires, "If the replacement of the converted property occurs in a year or years in which none of the gain on the conversion is realized, all of the details in connection with such replacement shall be reported in the return for such year or years."

29. *McShain*, 65 T.C. 686 (1976).

30. I.R.S. Ltr. Rul. 7809006.

22

Deferred Income

Other Deferral Techniques

2201 Designating Loan Repayments as Principal or Interest

The often contradictory tax interests of debtor and creditor sometimes coincide, permitting the two parties to report interest deductions and interest income at a mutually advantageous time. In such circumstances, both debtor and creditor may benefit from designating loan repayments as either principal or interest.

Control over timing is possible by virtue of Rev. Rul. 63-57, which contains the following summary:

> 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.[1]

The planning implications of this ruling are self-evident. Its actual implementation, naturally, depends on the extent to which the two parties' situations "fit."

Despite Rev. Rul. 63-57, there may be limits to what the IRS will accept. A district court decision states, "If the obligor and debtor (*sic*) do agree in an arm's length transaction that interest is to be allocated differently than the general rule requires, the IRS

1. Rev. Rul. 63-57, 1963-1 C.B. 103. See also Rev. Rul. 72-2, 1972-1 C.B. 19.

will respect the agreement unless it finds that the method of accounting does not clearly reflect income. . . ."[2] See also Rev. Rul. 68-586, 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 section 1.451-2 of the Income Tax Regulations, which would operate to prevent constructive receipt of the interest as credited.[3]

Any allocation would also be subject to the sec. 461(g) prohibition against current deductions for prepaid interest.

2201.1 Inapplicability to Sales or 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 7 percent per annum compounded semiannually), regs. sec. 1.483-1(d)(2) requires a minimum rate of "6 percent simple interest per annum, payable on each installment of principal at the time such installment is payable." (See p. 259, n. 12, for new rates.)

2201.2 Applicability to Federal Tax Deficiencies

A taxpayer who owes federal taxes and interest on those taxes will find that the service first applies a partial payment to the tax.[4] The taxpayer's specific directions to apply the payment to interest will be respected, however, and the amount of interest satisfied by the partial payment will be deductible.[5] Effective February 1, 1980, the interest rate is 12 percent instead of 6 percent.[6]

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2. *Raymond Mason*, 453 F.Supp. 845 (D. Cal. 1978).
3. Rev. Rul. 68-586, 1968-2 C.B. 195.
4. Rev. Rul. 73-305, 1973-2 C.B. 43, as modified by Rev. Rul. 79-284, 1979-39 I.R.B. 9.
5. *Ibid.*
6. See Rev. Rul. 79-366.

2202 Return of Capital Distributions

After-tax yields of stock or bonds should be among the factors in investment decisions.

A taxable dividend is defined as a corporation's distribution to its shareholders of money or other property from 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:

- The recipient reports no income of any variety until the basis of the stock has been fully recovered.
- "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."[7]

In view of the potential capital gains tax, it is misleading to consider these distributions true "nontaxable dividends."

Effect of Depreciation and Depletion on Earnings and Profits

A corporation that uses percentage depletion in computing taxable income must nevertheless use cost depletion in determining its earnings and profits.[8] Also, sec. 312(k) generally limits a corporation to the straight-line method of depreciation in its computation of earnings and profits, although use of the component method of depreciation for realty is not subject to sec. 312(k). To the extent that component depreciation exceeds otherwise allowable depreciation, it may increase the amount of nontaxable dividends.

When depreciable property is sold, the gain or loss for earnings and profits purposes is based on the depreciation that is allowed or allowable in the computation of earnings and profits—not on depreciation allowed or allowable for determination of taxable income.

Example Laser Power Company acquired equipment in 1973 for $1 million, 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 it was limited to straight-line depreciation of $700,000 in calculating its earnings and

7. § 301(c)(3)(A).
8. Regs. § 1.312-6(c)(1).

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).

Judged solely from a tax viewpoint, so-called nontaxable dividends obviously have extremely attractive features. Whether they constitute the best investment medium for the client is another matter. Of course, an individual should take their favorable tax characteristics into account, along with all other financial factors, in arriving at the most advisable overall investment decision. At this point the CPA must defer to the investment adviser.

Maximizing Income Tax Deductions and Credits

☐ Generally Applicable Deductions and Credits

☐ Specific Expenses

23

Generally Applicable
Deductions and Credits

Statutory Allowances

2301 The Zero Bracket Amount

In carefully selected circumstances, a taxpayer may be able to increase his total deductions over a span of two or more years by shifting as many itemized deductions as possible from a zero-bracket-amount year to a contiguous year or years and by electing itemized deductions for the contiguous years.

To simplify regular tax computations, Congress repealed the standard deduction and substituted the zero bracket amount, which is the income level in the rate schedules and tax tables for which no tax is imposed. The zero bracket amount is essentially a built-in standard deduction that is incorporated in the rate schedules and tax tables. Taxpayers who itemize deductions may deduct only the excess of their itemized deductions over the zero bracket amount; that is, their excess itemized deductions. Thus, while the computational procedure has changed, taxpayers still either itemize their deductions or have the benefit of the zero bracket amount.

2301.1 Doubling Up on Itemized Deductions

The technique of doubling up on itemized deductions can embellish the timing techniques highlighted in chapter 4 and can have an impact on income averaging.

Deductions may be matched with fluctuations in income. One particularly useful application of this technique can occur when a taxpayer rendering personal services anticipates retirement. It is usually quite worthwhile for the taxpayer to double up on itemized deductions during his last active year—especially if he visualizes a severe drop-off in income for his first retirement year.

The taxpayer should coordinate his total deductions with the medical deduction. The existence of the one percent and 3 percent (of adjusted gross income) limitations on the deductibility of medical expenses compels proper attention to the timing of medical payments. They should be concentrated in a year in which the client exceeds the limitations rather than in a year in which they would be wasted by these statutory limits. The desirability of concentrating medical payments in a given year may set the stage for concentrating other itemized deductions as well.

The tax planner must never lose sight of the effect that concentration of deductions has on an individual's tax brackets for the entire span of years involved in an itemized deductions/zero bracket amount cycle. Concentrating itemized deductions in a particular year may violate the cardinal rule of avoiding undue fluctuations in annual taxable incomes. The tax savings that the concentration technique might otherwise generate may be eroded by the higher brackets to which the individual's income is exposed in the zero-bracket-amount year. Therefore, this technique requires foresight and advance planning.

2301.2 Economic Feasibility of Shifting Deductions

For the taxpayer to take advantage of this approach, economic conditions must permit the shifting of deductions. The cooperation of the taxpayer's creditors is necessary in order for him to be able to postpone or accelerate deductions. Further, a shift of a medical payment from 1980 to 1981 may be possible if service is rendered in November 1980 but virtually impossible if the service is performed in February 1980.

The tax planner must also consider the monetary implications of shifting deductions. The interest expense factor inherent in the acceleration of deductions has a retarding effect on the attainable tax benefits. The extent of retardation varies with the length of the acceleration (prepayment) period: The shift of a property tax payment from January 1, 1981, to December 31, 1980, is unlikely to have any financial effect, but a 1980 prepayment of a charitable contribution pledge not due until 1985 will have financial implications. The reverse effect occurs when deductions are postponed.

Finally, certain deductions cannot be shifted. Examples are state sales and income taxes, where periodic withholding or estimated tax payments are required, unless state law permits their prepayment. (See page 38.)

2301.3 Background Information on Zero Bracket Amounts

Under code secs. 1 and 63, for years beginning after December 31, 1978, the zero bracket amounts are as follows.

Married taxpayers, joint return	$3,400
Married taxpayers, separate return	1,700
Single taxpayer, including head of household	2,300
Surviving spouse	3,400

Section 63(b)(2) requires certain individuals to increase their income by the unused zero bracket amount. These individuals are the following:

- A married individual filing a separate return if either spouse itemizes deductions.
- A U.S. citizen entitled to the benefits of sec. 931 (relating to income from sources within U.S. possessions).
- An individual, usually a minor child, with respect to whom an exemption is allowable to another taxpayer.

An individual's unused zero bracket amount is the excess of the zero bracket amount over itemized deductions. If an individual with respect to whom an exemption is allowable to another taxpayer has earned income in excess of his itemized deductions, the unused zero bracket amount is any excess of the zero bracket amount over earned income. The general effects of the unused zero bracket amount adjustment are that both spouses must itemize if separate returns are filed and either spouse itemizes and that minor children must itemize or limit their zero bracket amounts to the amount of their earned income.

A taxpayer may revoke the election to itemize deductions under sec. 63(g). Similarly, an individual who files a return without itemizing deductions may later elect to itemize. There are special requirements if the taxpayer's spouse filed a separate return. 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 (regs. sec. 1.63-1).

2302 Personal Exemptions

Planning for personal exemptions, at least from a tax standpoint, is primarily a defensive matter, since it is usually impossible to recognize a net after-tax profit on the financial obligations that are involved. Moreover, exemptions for age and blindness are beyond the taxpayer's control, and the use of marriage as a tax-planning tool, either to obtain an exemption for a spouse who has no gross income or to obtain joint return benefits, is a subject that is beyond the scope of this study.

To preserve dependency exemptions, the tax planner must be cognizant of special requirements concerning parents and children. Also, the tax planner should suggest multiple support agreements when they are applicable.

Proper documentation is essential in sustaining these deductions.

Tests for Dependency

1. *Support.* The taxpayer must furnish more than 50 percent of the dependent's total support during the calendar year unless multiple support agreements are filed or children of divorced or separated parents are involved.
2. *Gross Income.* The dependent's gross income (total taxable income) for the year must be less than $1,000. The gross income test does not apply in the case of children, including certain foster children, who are either students or under nineteen years of age 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. 1.152-1(b)). "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. . . ."[1] For example, a dependency exemption has been denied for a purported common-law wife because of failure to establish the legality of the relationship.[2] Various relationships of either blood or marriage that do not require the dependent to reside with the taxpayer or belong to his household are set forth in sec. 152(a).
4. *Citizenship.* Generally, dependents must be citizens or residents of the United States. Section 152(b)(3) provides several exceptions to this rule for certain foreign residents.

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1. Regs. § 1.152-1(b).
2. *Eichbaur*, T.C.M. 1971-133.

5. *Absence of Joint Return.* Exemptions are denied if the dependent has filed a joint return for the year (sec. 151(e)(2)). The IRS has relaxed this requirement in cases in which 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]

Controlling a Dependent's Gross Income

The taxpayer should take all possible precautions to prevent disqualification of a potential dependent through his receipt of small amounts of income in excess of the sec. 151(e) limitations.

Example As of December 15, 1980, Client, who is in the 50 percent bracket, can claim an exemption for his mother-in-law, since all five dependency tests are met. Her gross income at this point amounts to $935. She does some piecework at home during the end of December and thereby earns $75. This additional compensation is quite costly to Client, since it increases his tax by $500.

This lesson is inapplicable to children who are either students or under nineteen.

The Value of a Dependent's Joint Return

A taxpayer should compare the tax benefit of a dependency exemption with the advantages that will result if the potential dependent files a joint return with his or her spouse. The least expensive route should be selected, with the tax savings possibly split between the taxpayer and the dependent's spouse.

Support in the Form of Lodging

Support in the form of lodging is measured in terms of fair market value.[4] Elderly parents who own their own homes are considered to have furnished the fair market value of their lodging towards their own support.

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3. Rev. Rul. 65-34, 1965-1 C.B. 86. Cited with approval in *Martino*, 71 T.C. 456 (1978), acq. 1979-42 I.R.B. 6.

4. Regs. § 1.152-1(a)(2)(i).

Parents' Exempt Income

> 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. . . . For 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.[5]

Exempt income that is not expended for support can be eliminated from consideration.[6] Examples include social security checks that are deposited in savings accounts or otherwise invested.

The service has reversed its earlier position with respect to the effect of basic medicare in the computation of support. It now disregards both basic and supplemental medicare benefits in the computation of support.[7]

The Operation of the Unit Rule as It Affects Support of Parents

Revenue Ruling 64-222 enunciates the following rules regarding allocation of support contributions:

> 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.
>
> Moreover, where members of a household contribute to their own support, and also receive support from an individual outside the

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5. Regs. § 1.152-1(a)(2)(ii).

6. *Carter*, 55 T.C. 109 (1970), acq. 1971-2 C.B. 2; *Jewell*, 69 T.C. 791 (1978), acq. 1978-1 C.B. 2; Rev. Rul. 71-468, 1971-2 C.B. 115.

7. Rev. Rul. 79-173, 1979-23 I.R.B. 6.

household not sharing in the common fund, in the absence of evidence of actual support, the individual outside the household will be considered to be contributing equal amounts to each member of the household.[8]

Where specific contributions cannot be proven, these allocation rules operate on an all-or-nothing basis by treating the entire household as one unit in determining the percentage of support contributed by its members (as opposed to the percentage of outside support contributions). In such situations, an outsider obtains 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 taxpayer contributes some support to another household but does not meet the more-than-50 percent test, he may be able to salvage one or more exemptions by specific allocations of his contributions.[9]

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. This deprives him of any exemptions because he is not 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

8. Rev. Rul. 64-222, 1964-2 C.B. 47. Cited with approval in *De La Garza*, 46 T.C. 446 (1966), aff'd *per curiam* 378 F.2d 32 (5th Cir. 1967).

9. See Rev. Rul. 72-591, 1972-2 C.B. 84, which clarifies Rev. Rul. 64-222 by stating that a taxpayer's uncontradicted support designations will be given effect to the extent that the householder's own income does not exceed his or her pro rata share of total support.

Client can mitigate the adverse operation of the unit rule if he specifically allocates his contributions towards his mother's support, and if his 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

Client has contributed 80 percent of his mother's total support of $2,500.

It appears that the service generally respects uncontradicted designations on support checks.[10] Nevertheless, an individual should consider paying potential dependents' expenses directly. This may be especially important in the case of medical expenses, since the taxpayer can increase his potential medical deduction.

The unit rule can be superseded by the following special statutory provisions:

- Support test for children of divorced or separated parents (sec. 152(e)).
- Multiple support agreements (sec. 152(c)).

Special Rule for Scholarships

Scholarships received by students are not considered in the determination of whether a taxpayer has furnished more than half of a child's support.[11]

Example Client's son receives a $1,000 scholarship to attend Hardnocks University for one year. Client contributes $500, which is the balance of his son's support for the year. Client is allowed a

10. See Rev. Rul. 72-591, 1972-2 C.B. 84.
11. Regs. § 1.152-1(c).

dependency exemption because the scholarship is eliminated from the support computation.

Providing for Exemptions for Children Upon Divorce or Separation

Section 152(e), as amended by the Tax Reform Act of 1976, attempts to curtail the litigation that can result when divorced or separated parents file income tax returns that accord conflicting treatment to the dependency exemptions for their children. The provision enables parents contemplating divorce or separation to specify who will be entitled to exemptions for their children.[12] If the necessary conditions are not met, precise rules eradicate the inconsistent treatment.

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:

- No one else contributed more than half the dependent's support.
- The taxpayer contributed over 10 percent of the support.
- The dependent receives over half his support from a group of persons, each of whom could claim him as an exemption if not for the 50 percent support test.
- 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 the dependent.

Regulations section 1.152-3(c) requires these statements to be attached to the taxpayer's return for the year in which the deduction is claimed. The required statement can be executed on IRS Form 2120.

Obviously, it is most beneficial to allow the supporter in the highest bracket to claim the exemption. If there are several high-bracket supporters, annual rotation may be equitable.

12. For a liberal example, see Rev. Rul. 70-73, 1970-1 C.B. 29.

Adequate Documentation

The importance of proper records to support the various requirements for dependency exemptions cannot be sufficiently emphasized. Otherwise, a taxpayer may find himself, for example, attempting to prove that a parent's social security benefits were invested in a savings account and were not expended for his support. A Tax Court opinion describes 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. . . .[13]

13. *Rose D. Seraydar*, 50 T.C. 576 (1968), at 761, acq. 1969-2 C.B. xxv.

24

Generally Applicable
Deductions and Credits

Medical Expenses

Tax planning for medical expenses should involve an awareness of the various types of expenditures that give rise to deductions.

2401 Definitions

Detailed knowledge of medical expense definitions prevents the 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.[1]

2401.1 Medical Insurance

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. The maximum outright deduction for medical insurance premiums on a joint return is $150. If a married couple files separate returns, this deduction can be doubled.

2401.2 Medical Travel

Transportation Costs

Transportation costs that are primarily for medical care and that are essential to that care are valid medical expenses. Such costs include public transportation fares and variable automobile operating

1. Regs. § 1.213-1(e)(1)(i).

expenses (gas, oil, and so forth). A standard rate of 9 cents per mile in lieu of actual auto expenses is permitted by Rev. Proc. 80-32 (IRB 1980-29). Parking fees and tolls can be added to the standard mileage.

The IRS recognizes the transportation expenses of certain persons accompanying a patient as medical expenses of the patient. Such persons include a parent who must accompany a child or a nurse accompanying a patient requiring injections, medications, and so forth.[2]

Meals and Lodging

The cost of meals and lodging while a person is away from home receiving medical treatment is not a medical expense except when included as part of a hospital bill.[3] Such costs have been allowed, however, when incurred en route to obtain medical treatment.[4]

2401.3 Special Foods

Special foods, even though prescribed by a doctor to control disease, are not deductible when they substitute for a regular diet.[5] 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.[6]

The Tax Court, in *Leŏ R. Cohn*, has allowed deductions for special service charges paid to restaurants for preparation of salt-free meals, as well as taxi fares to such restaurants.[7] The IRS does not agree with this position.

In *Cohn v. U.S.*, Cohn argued that his health deteriorated to the point where he was unable to travel outside his living quarters for meals. As a result, he had to pay an amount in excess of the usual cost of lodging to obtain accommodations with kitchen facilities so that salt-free meals could be prepared. The district court held that the excess amount was not deductible,[8] but the Tax

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2. *Your Federal Income Tax*, I.R.S. Publication 17, 1979 ed., p.78.
3. Regs. § 1.213-1(e)(1)(iv). *Robert M. Rose*, 52 T.C. 521 (1969), aff'd 435 F.2d 149 (5th Cir. 1970), cert. den. 402 U.S. 907.
4. *M.C. Montgomery*, 51 T.C. 410 (1968), aff'd 428 F.2d 243 (6th Cir. 1970).
5. *John R. and Clyde Newman*, 68-1 U.S. Tax Cas. ¶9411 (D. West. Ark. 1968).
6. Rev. Rul. 55-261, 1955-1 C.B. 307.
7. *Leo R. Cohn*, 38 T.C. 387 (1962), nonacq. 1963-2 C.B. 6.
8. *Cohn v. U.S.*, 240 F.Supp. 786 (D. Ind. 1965).

Court has permitted deductions for the additional cost of organic, chemically uncontaminated food necessary to avoid allergic reaction.[9] It has also allowed a deduction for the percentage of grocery bills deemed to be a reasonable estimate of the cost of protein foods consumed in addition to the taxpayer's normal diet when a high-protein diet was prescribed by a doctor.[10]

2401.4 Nursing Homes

A portion of nursing home expense may qualify as a deductible medical expense, even if it is paid prior to the time the medical services are rendered. While prepayments of medical expenses are generally not deductible, payments pursuant to an obligation imposed by the institution are deductible, even if the medical services are to be rendered at a later date.[11] In Rev. Rul. 75-302, a 78-year-old taxpayer agreed to make a lump-sum payment to a retirement home in exchange for lifetime care. The home provided a financial breakdown showing that 30 percent of the fee was designed to pay for future medical care. The service ruled that the portion of the fee attributable to future medical care was deductible in the year in which it was paid.

The same treatment should be accorded to payments made on behalf of a dependent, such as a child's payment to a nursing home for the medical care of a dependent parent. A single child may also qualify for the more favorable head-of-household tax rates by maintaining a parent in a nursing home.[12]

2401.5 Capital Expenditures

Expenditures that otherwise qualify as medical expenses are not disqualified merely because they also constitute capital expenditures. Regulations section 1.213-1(e)(1)(iii) establishes the categories and treatment for such capital expenditures, as shown in figure 24-1.

When substantial capital expenditures are made in accordance with medical advice, the taxpayer should obtain a competent appraisal of the increase in the property's value. This procedure should prevent disputes with the revenue service. Appraisal fees

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9. *Theron G. Randolph*, 67 T.C. 481 (1976).
10. *Leona von Kalb*, T.C.M. 1978-366.
11. Rev. Ruls. 75-302 and 75-303, 1975-2 C.B. 86–88.
12. Rev. Rul. 70-279, 1970-1 C.B. 1; *Robinson*, 25 A.F.T.R. 2d 70-807 (9th Cir. 1970).

incurred to determine property values for income tax purposes are usually deductible as miscellaneous itemized deductions.[13]

Figure 24-1

Category	Example	Treatment
1. Expenditures relating only to sick person (not related to permanent improvement or betterment of property)	Wheelchair, crutches, inclinator, or air conditioner that is detachable from property and purchased only for the person's use	Deductible in full (to the extent otherwise allowable)
2. Expenditures for permanent improvement of property if related directly to medical care	Elevator installed in residence of heart disease patient	Qualifies as medical expense to 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

2401.6 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."[14]

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13. See Rev. Rul. 67-461, 1967-2 C.B. 125, regarding property donated to charity, and Rev. Rul. 58-180, 1958-1 C.B. 153, dealing with casualty losses.

14. Regs. § 1.213-1(e)(1)(v)(a).

In Rev. Rul. 70-285 tuition fees and transportation costs qualified as medical expenses because they were paid by a parent for a mentally retarded child's attendance in a regular school that had a special curriculum for retarded children.[15]

2402 Dependents' Medical Expenses

Taxpayers should attempt to qualify medical payments for dependents and certain other persons as deductible medical expenses. Multiple support agreements can help taxpayers to qualify these expenses.

Deductible medical expenses include amounts paid on behalf of dependents or persons who would qualify as dependents if not for their failure to meet the gross-income test under sec. 151(e) or the joint-return test. In other words, only the following tests must be met for a taxpayer to claim deductions for medical expenses paid on behalf of other persons (subject to the 3 percent-of-adjusted-gross-income limitation):

- Support test (contribution of more than 50 percent of total support).
- Member-of-household or prescribed-relationship test.
- Citizenship test.

2402.1 Multiple Support Agreements

The support test can be satisfied through multiple support agreements.

Multiple support agreements can be used to increase a client's medical deduction even though a dependency exemption cannot be obtained (because the would-be dependent has excessive gross income or has filed a joint return). These agreements may permit an individual to meet the required support test despite the individual's inability to satisfy its general more-than-50-percent requirement.

Individuals should coordinate contemplated support contributions, medical payments, and multiple support agreements to produce maximum tax benefits in the form of the greatest potential medical deductions. For example, expected support should be con-

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15. Rev. Rul. 70-285, 1970-1 C.B. 52. Cf. *Pfeifer*, T.C.M. 1978-189, aff'd 79-2 U.S. Tax Cas. ¶9518 (10th Cir. 1979).

tributed as medical expense payments by a taxpayer who will be able to deduct the amounts with the assistance of a multiple support agreement.

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 her support will be furnished by her own gross income of $3,000.

Following past practice, Charles is expected to pay his mother's medical expenses. These payments will be completely wasted as deductions. Charles will be precluded from claiming them on his return because 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 (more than 10 percent of total support). His mother cannot claim the expenses relating to her own medical care because she has not paid them. (Medical expenses are deductible only by the actual payor and only in the year in which they are paid. For a special exception to this rule in the case of payments by a decedent's estate, see 2405.)

A CPA recommends that Charles discontinue medical payments. In determining who should pay the expenses, the CPA makes projections of the potential tax benefit to be derived if such payments are made by Client, his mother, or the two other brothers. The projections reveal that Client would obtain greatest benefit. Hence, the CPA recommends that Client pay all of his mother's medical expenses as part of his support contribution and that his brothers Abel and Barry execute a multiple support agreement in favor of Client.

2402.2 Divorced, Noncustodial Parent

In Rev. Rul. 76-344 the IRS sanctioned a procedure that ensures a medical deduction even to a divorced parent who does not have custody of the children.[16] The taxpayer, who was entitled to claim the children as dependents, made support payments, which the taxpayer's former spouse placed in a special account. The former spouse, who was the custodial parent, paid the children's medical expenses with funds from the special account. These expenses were deductible as medical expenses by the noncustodial parent.

2403 Medicine and Drugs

An individual should maintain adequate substantiation for medicine and drugs. Where appropriate, the individual should establish separate charge accounts for this purpose.

> 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. . . .[17]

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 considered medicine or drugs if they are taken to preserve general health without medical prescription or recommendation.[18]

Substantiation of deductions for medicine and drugs is often a cumbersome chore. For example, cancelled checks are inadequate in view of the great variety of nonmedical merchandise sold by pharmacies. It may be desirable for taxpayers to establish separate charge accounts when considerable amounts of drugs and medicine or other medical supplies are purchased.

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16. Rev. Rul. 76-344, 1976-2 C.B. 82.
17. Regs. § 1.213-1(e)(2).
18. *Your Federal Income Tax*, p.77.

2404 Working With Income Limitations

Proper timing of medical payments may mitigate the effects of income limitations. Also, married taxpayers should consider the advisability of separate returns.

Except for the limited outright deduction accorded medical insurance premiums, 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 the 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.

2404.1 Timing of Payments

Since expenses for medical and dental services and for medicine and drugs are allowable as deductions when they are paid, a client can determine, to some degree, the year of the deduction by the mere timing of his payments. Of course, he will have more latitude in exercising discretion in the case of services performed towards the end of a year, when payment can more easily be extended into the following year.

The existence of these one percent and 3 percent limitations compels the tax planner to pay proper attention to the timing of medical payments. Payments should be concentrated in a year in which the taxpayer exceeds the limitations rather than in a year in which they would be wasted by these statutory obstacles.

If 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 the taxpayer to shift premium payments to the subsequent year so that they can be doubled up with the next premium paid the following December.

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.

In view of the many variables involved in these circumstances, detailed and specific projections are far more illuminating than any generalized conclusions.

Advance payments for medical services to be performed in a future year are not deductible in any year, unless an institution imposes an obligation to make the payment. (See chapter 4 and 2401.4.)

2404.2 Separate vs. Joint Returns

Separate returns may yield greater medical deductions than joint returns, since the separate percentage limitations are based on smaller adjusted gross incomes. Because of the progressive nature of our tax rates, this technique usually reduces the spouses' combined taxes only when their taxable incomes, before any medical deductions, are in the same bracket, as shown in figure 24-2.

Figure 24-2

	1980		
	Separate returns		Joint return
	Husband	Wife	
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	—	—
Contributions	4,975	2,975	7,950
Property taxes	—	2,000	2,000
Total itemized deductions	6,375	4,975	9,950
Zero bracket amount	1,700	1,700	3,400
Excess itemized deductions	4,675	3,275	6,550
Exemptions	1,000	1,000	2,000
Total deductions	5,675	4,275	8,550
Taxable income	$44,325	$45,725	$ 91,450
Tax*	$17,651	$18,477	$ 36,954
Total separate taxes			36,128
Tax savings through separate returns			$ 826

*Maximum tax on personal service income is not available when married individuals file separate returns (sec. 1348(c)).

2405 Expenses Paid After Death

The tax planner should determine whether medical expenses paid by a decedent's estate within one year after his death should be deducted for income tax or estate tax purposes. The planner should also consider whether the decedent's medical expenses should be paid by the surviving spouse instead.

Although medical expenses are generally deductible only when they are 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 the expenses are 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.[19]

On the other hand, a decedent's medical expenses paid by a surviving spouse are deductible in the year in which they are paid.[20]

The general rule also applies to a deceased dependent's medical expenses (deductible when paid, whether before or after death).[21]

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 chapter 32.)

These rules permit great flexibility in obtaining the most favorable tax benefit for medical deductions in respect of a decedent. By employing the proper procedures, a taxpayer can choose the most advantageous of several returns in which to claim the deductions. These optional approaches are summarized in figure 24-3.

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19. See regs. §1.213-1(d).
20. *Your Federal Income Tax*, p.79.
21. *Ibid.*

Figure 24-3

Returns producing greatest benefit from decedent's medical deductions	Effective tax rate may be affected by	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 IRS has taken the position that medical expenses not deductible for income tax purposes because of the 3 percent limitation may not be deducted as a claim against the estate under sec. 2053 (Rev. Rul. 77-357, 1977-2 C.B. 328, which also indicates that, pursuant to Rev. Rul. 70-361, 1970-2 C.B. 133, it is permissible to claim a portion of the medical expenses as a deduction on the decedent's final income tax return and a portion as an estate tax deduction).

†The decedent's income tax return most frequently involved is 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.

25

Generally Applicable
Deductions and Credits

Residence Expenses and Credits

2501 Loss on the Sale of a Residence

An individual can convert a nondeductible loss on the sale of a personal residence to a deductible loss within limits by renting the property prior to sale.

Pursuant to regs. sec. 1.262-1(b)(4), losses sustained on sales or exchanges of personal residences are normally not deductible. 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 minus amount realized from sale equals loss.

The basis of property converted from personal to income-producing or business purposes is the *lesser* of (*a*) the fair market value at the time of conversion or (*b*) the adjusted basis for loss (under usual rules) at the time of conversion, without reference to fair market value.[1] Whichever amount is appropriate must be reduced by the depreciation allowed or allowable after the property has been converted to income-producing purposes.[2]

Upon conversion, the taxpayer should receive a competent appraisal of the fair market value in order to determine allowable

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1. See *G.D. Hix*, T.C.M. 1979-105.
2. Regs. § 1.165-9(b)(2).

depreciation and any subsequent loss. Presumably, appraisal costs are deductible. (See the similar discussion in 2401.5 regarding appraisals in connection with capital expenditures that may qualify as medical deductions.)

The Tax Court has held that the renting of a single residence constitutes a trade or business.[3] There are judicial decisions to the contrary, but in view of the IRS' acquiescence in the *Hazard* decision, there should not be any dispute about treating losses on converted residences as incurred in a trade or business.[4] Such losses should be eligible for the favorable, noncapital loss provisions of sec. 1231 (see 1203).

The preponderance of decided cases supports the criteria enunciated in regs. sec. 1.165-9(b)(1): that prior to sale, an individual must completely terminate personal use and actually rent the residence in order to achieve the desired conversion to business (or income-producing) property. The courts have considered mere listing with a broker for sale or rental (whether or not on an exclusive basis) to be inadequate for this purpose.[5] Nominal rents have also been considered inadequate.[6]

When a residence must be sold because of employment-connected relocation, and its cost exceeds current fair market value, any realized capital loss still is not deductible.[7] In such a situation, the taxpayer should consider selling the home to the employer who, in effect, reimburses the employee for the prospective loss. The reimbursement (excess of selling price over fair market value) constitutes taxable income to the employee.[8] (Reimbursement of moving expenses is further discussed in 2802.)

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3. *L. Hazard*, 7 T.C. 372 (1946), acq. 1946-2 C.B. 3.

4. See, e.g., *I.H. Grier*, 218 F.2d 603 (2d Cir. 1955), aff'g district court dec.

5. See *Morgan*, 76 F.2d 390 (5th Cir. 1935), cert. den. 296 U.S. 601, which has been followed in quite a few subsequent cases. For some isolated exceptions in which listing sufficed, see *Jay Burns*, 21 T.C. 857 (1954), acq. 1954-2 C.B. 3, rem'd on another issue by the 5th Cir., and *Est. of Heine*, 10 T.C.M. 738 (1951).

6. See *Johnson*, 19 T.C. 93 (1952), acq. 1953-1 C.B. 5, cited in Rev. Rul. 79-136, 1979-18 I.R.B. 10 (dealing with excess investment interest).

7. U.S., Congress, House, 91st Cong., 1st sess., 1969, H.Rep. 413, part 2, p.51.

8. See, e.g., *Bradley*, 324 F.2d 610 (4th Cir. 1963); *Kobacker*, 37 T.C. 882 (1962); and *Ritter*, 393 F.2d 823 (Ct. Cl. 1968), cert. den. 393 U.S. 844.

2502 Depreciation and Maintenance Expenses Related to a Converted Residence

Depreciation and maintenance expenses are deductible after a residence is abandoned and listed for rent (or for rent and sale). Actual rental of the residence is not required.

If certain conditions are met, deductions may also be allowed when property is listed for sale.

Depreciation and maintenance expenses are deductible only after a residence has been converted to business (or income-producing) use; however, the test for determining whether conversion has occurred for this purpose is significantely less stringent than it is for purposes of claiming losses upon disposition (see 2501).

To deduct depreciation and maintenance expenses after a personal residence has been abandoned, the taxpayer must merely list the property for rental.[9] The Tax Court held that deductions are allowable if 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.[10] This matter, however, is on the IRS prime issues list. The IRS will ordinarily litigate the issue of whether the taxpayer is entitled to depreciation and maintenance deductions during the period prior to sale if he ceases to use residential property and immediately offers it for sale without attempting to rent it, and the IRS holds that it will not concede or compromise on this issue.[11]

The sec. 280A limitations (discussed in 3002) may deny deductions in the year of conversion if the former residence is not actually rented during the taxable year and if certain requirements are not satisfied. The Tax Reform Act of 1976 added sec. 280A, effective for taxable years beginning after December 31, 1975, which generally denies any deductions for depreciation, mainte-

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9. See, e.g., *Mary L. Robinson*, 2 T.C. 305 (1943), acq. 1944 C.B. 23 (withdrawing prior nonacq. in 1943 C.B. 38). See also *Ray V. Frost*, 69-2 U.S. Tax Cas. ¶ 9468 (D. Colo. 1969), in which such deductions were allowed, under special circumstances, even though there was a long delay in renting and the property was never advertised. The service agrees that a taxpayer may convert a personal residence to income-producing property by offering it for rent or by simultaneously offering it for rent and sale. See the I.R.S. Prime Issues List, in *CCH Standard Federal Tax Reporter* (Chicago: Commerce Clearing House), ¶195, citing *Robinson* and other cases.

10. *Newcombe*, 54 T.C. 1298 (1970).

11. I.R.S. Prime Issues List, in *CCH Standard Federal Tax Reporter*, ¶195.

nance, utilities, and so forth with respect to a dwelling unit that the taxpayer uses as a residence during the taxable year. The provisions hold that the individual uses the dwelling unit as a residence if he uses it for personal purposes for more than the greater of (*a*) fourteen days or (*b*) 10 percent of the number of days during the year for which the unit is rented. If the residence is merely listed for rent and the taxpayer uses the residence for more than two weeks during the year, the taxpayer is subject to the limitations of sec. 280A.

Section 280A(c)(3) provides an exception to the general disallowance rule for actual rental of the dwelling unit.

In any case, sec. 280A(c)(5) limits such deductions to gross income (net of certain other expenses). This limitation may deny a taxpayer deductions for a year in which he receives no gross income from the converted residence.

The Revenue Act of 1978 added sec. 280A(d)(3), effective for taxable years beginning after December 31, 1975, because Congress did "not believe that the personal use of a principal residence for a portion of the taxable year should result in the disallowances of deductions for the period when the residence has been converted to rental property."[12] The new provision disregards personal use during the taxable year occurring before or after a "qualified rental period."[13] Among the salient features of the definition of *qualified rental period* is the fact that it includes the period the dwelling unit is rented, or is held for rental, to someone other than a family member. Also, this exception to sec. 280A is limited to the taxpayer's principal residence (as defined in sec. 1034), and the residence must be rented, or held for rental, at a fair rental.[14]

The taxpayer should be alert to the requirements of sec. 280A(d)(3), which must be satisfied to avoid the sec. 280A limitations in a year in which a residence is converted to rental property.

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12. U.S., Congress, Senate, *Report on H.R. 6715*, 95th Cong., 2d sess., 1978, S.Rep. 745, p.20. The effective date is prescribed by act §701(h)(2).

13. For this purpose, a *qualified rental period* is a consecutive period of 12 or more months, beginning or ending during the taxable year, during which the property is rented (other than to a brother, sister, spouse, ancestor, or lineal descendant) or held for rental at its fair market value. The 12-month rental requirement does not apply if the residence is sold or exchanged before it has been rented, or held for rental, for the full 12 months.

14. The statutory definition of *personal use* includes any day the dwelling unit is not rented at a "fair rental" (§280A(d)(2)(C)). Thus, in the absence of a fair rental, the §280A limitations apply even if the residence is "rented" for the entire year.

2503 Partial Business Use

If possible, taxpayers should seek to meet the stringent tests for deductibility of expenses for the partial business use of a residence.

A taxpayer must satisfy strict requirements to obtain any tax relief for business use of a residence, since sec. 280A severely restricts office-at-home expense deductions. In general, the taxpayer is denied any deduction for expenses attributable to the use of his residence for business purposes, except to the extent that they are attributable to a portion of the residence that is exclusively used on a regular basis as the taxpayer's principal place of business or as a place for meeting patients, clients, or customers in the normal course of business. In the case of an employee, there is the further requirement that the business use of the residence be for the convenience of the employer. If the taxpayer satisfies these requirements, there is a further limitation: The deductions allowed for business use of a residence cannot exceed the amount of gross income derived from the use of the residence for the taxable year, less allocable deductions allowable regardless of business use.[15]

2504 Energy Credits

Residential energy credits are provided against income tax as an incentive for taxpayers to install energy-saving devices in their homes. The tax planner should consider taking advantage of these credits.

2504.1 Credit for Energy Conservation Expenditures

The Revenue Act of 1978 introduced a credit equal to 15 percent of the first $2,000 of expenditures for insulation and other energy-saving devices installed on or in the taxpayer's principal U.S. residence. The maximum credit allowable is $300. Construction of the residence must have been substantially completed before April 20, 1977. The expenditures must be made after April 19, 1977, and before January 1, 1986. The credit is subject to carryover to the extent that it exceeds the taxpayer's tax liability (ignoring certain credits), but the credit carryover is limited to taxable years ending before 1988.

The credit is available to individual homeowners (including

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15. §280A(c)(5).

cooperative apartment and condominium owners) or to tenants. Vacation houses and second homes are not eligible.

The credit is available for any of the following:

- Insulation.
- Storm doors and windows.
- Caulking or weatherstripping of exterior doors and windows.
- Meters showing energy uses.
- Furnace replacement burner.
- Device for modifying flue openings.
- Furnance ignition system (which replaces a gas pilot light).
- Automatic energy-saving setback thermostat.
- Other energy-efficient devices to be specified by regulations.

These items must have a reasonable probability of remaining in operation for at least three years and must satisfy any performance and quality standards prescribed by regulations and in effect at acquisition. Their original use must begin with the taxpayer.

2504.2 Renewable-Energy-Source Expenditures

Homeowners or renters are also eligible for credits with respect to "renewable-energy-source property," as defined in sec. 44C. For taxable years beginning after 1979, the credit is 40 percent of the first $10,000 invested. The maximum credit is $4,000.

The credit may be claimed for expenditures made after April 19, 1977, and before January 1, 1986. Original use of the property must begin with the taxpayer. The property must be expected to remain in operation for at least five years and must satisfy performance and quality standards prescribed by regulations.

A credit carryover is provided to the extent that the credit exceeds the taxpayer's tax liability (ignoring certain credits). The carryover extends for two years beyond the termination date (through taxable years ending before 1988).

Further guidance on the availability of the energy credits may be obtained from IRS Publication 903, *Energy Credits for Individuals*, the regulations, and the Crude Oil Windfall Profit Tax Act of 1980.[16]

The Crude Oil Windfall Profit Tax Act of 1980 contains provisions that modified these credits, including an increase in the credit for renewable-energy-source expenditures.

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16. See regs. §§1.44C-1—1.44C-3 and 1.44C-5.

26

Generally Applicable
Deductions and Credits

Tax Shelters

There are certain forms of investment that have achieved notoriety as shields against taxation. Foremost among these shelters are real property and oil and gas investments.

2601 Real Property

Investments in real property can (*a*) generate ordinary income deductions and credits that may exceed the cash invested, (*b*) provide ordinary income deductions for costs incurred that may eventually be recouped at capital gain rates, (*c*) obtain income that is taxed at capital gain rates, and (*d*) achieve tax-free build-up of equity through nontaxable exchanges.

2601.1 Ordinary Income Deductions and Credits

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 the cash investment. Monetary conditions permitting, a buyer usually can finance a high percentage of the purchase price of real property with borrowed funds.

Declining-balance depreciation at 150 percent of straight line also is available for new or constructed properties. The 200 percent declining balance or sum-of-the-years-digits method is available for residential rental property. Sixty-month amortization is possible for rehabilitation expenditures incurred before 1982 for low-income rental housing and for certain historic-structure rehabilitation expenditures capitalized before June 15, 1981.[1]

1. See *Working With the Revenue Code 1979*, ed. I.F. Diamond and M. Walker (New York: AICPA, 1979), p.81, which discusses tax benefits for certified historic structures. See also discussions therein regarding § 167 on pp.55–59.

A change to the straight-line method during a later year in the asset's life—after giving effect to estimated salvage value, if any—may be desirable. The taxpayer may make such a change pursuant to Rev. Rul. 74-324 or, in some cases, Rev. Proc. 74-11, in which case application to change must be filed within 180 days of the beginning of the year for which the change is sought.[2]

Accelerated depreciation is an item of tax preference subject to the 15 percent add-on minimum tax. Component depreciation, whereby various building components are depreciated separately, may result in greater depreciation deductions, and component depreciation is not an item of tax preference subject to the minimum tax (see chapter 1).

Investment Credit

> [The Revenue Act of 1978] extends the investment credit to rehabilitation expenditures incurred in connection with existing buildings used in all types of business or productive activities, except those, such as apartments, which are used for residential purposes. Eligible buildings include factories, warehouses, office buildings, hotels and retail and wholesale stores.
>
> In order to qualify as a rehabilitation expenditure, the expenditure must be incurred after October 31, 1978, in connection with the rehabilitation or reconstruction of a building which has been in use for a period of at least 20 years before the . . . rehabilitation. . . .
>
> A rehabilitation of a building, or a major portion thereof, which had previously been rehabilitated would not be eligible for the credit until 20 years after the building was placed in service following completion of a prior rehabilitation for which a credit was allowed. . . . In addition, in order to exclude minor repairs or improvements, the costs must be of the type which must be capitalized under existing law (and not expensed) and must be incurred for property which has a useful life of at least five years.
>
> In situations where a part of a building is rehabilitated, the rehabilitation costs will qualify for the credit only if the rehabilitated part constitutes a "major portion" of the building. . . .
>
> Under these rules and existing law, qualifying expenditures will be eligible for a two-thirds investment credit if the improvements attributable to the expenditures have a useful life of five or six years, and a full credit where the useful life is seven years or more. . . .
>
> Qualified rehabilitation costs will be considered as incurred for new property and, therefore, not subject to the $100,000 used property limitation, except to the extent such costs are for property (such

2. Rev. Rul. 74-324, 1974-2 C.B. 66, and Rev. Proc. 74-11, 1974-1 C.B. 420. See also 1202, herein.

as used elevators) which otherwise qualify for the investment credit. . . .

The rehabilitation of a building will include the renovation, restoration, and reconstruction of an existing building. Thus, interior or exterior renovation or restoration to materially extend the useful life of the building, to significantly upgrade its usefulness, or to preserve it will normally qualify. Capital expenditures for the replacement of plumbing, electrical wiring, flooring, permanent interior partitions and walls, and the heating or air conditioning systems (including temperature control systems) could qualify as qualified rehabilitation expenditures when incurred in connection with a rehabilitation. . . .

The costs of acquiring a building or an interest in a building (such as a leasehold interest) will not be considered as qualifying expenditures nor will costs that are incurred in connection with facilities, such as parking lots, which are related to an existing building. In addition, construction costs for a new building, or for completing a new building after it has been placed in service, will not qualify.

Limitations are also provided to exclude costs incurred for new construction or enlargement of an existing building. . . .[3]

The Technical Corrections Act of 1979 makes the noncorporate lessor limitation of sec.46(e)(3) inapplicable for purposes of the investment credit on rehabilitation expenditures.[4]

2601.2 Deductions for Carrying Charges

Construction-period interest and taxes must be capitalized and amortized in accordance with the provisions of sec.189. Interest deductions may also be limited by the prohibition against deducting prepaid interest (see chapter 4) and the limitations pertaining to deductions for investment interest (see 3001). Losses incurred in the prerental phase of real estate operations may also be subject to IRS challenge under the pre-opening-expense theory, which limits sec. 162 deductions to ordinary and necessary expenses of carrying on a trade or business.[5]

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3. U.S., Congress, Joint Committee on Taxation, *General Explanation of the Revenue Act of 1978*, 96th Cong., 1st sess., 1979, pp.155–57.

4. See U.S., Congress, Senate, 96th Cong., 1st sess., 1979, S.Rep. 498, p.49.

5. See I.R.S. Ltr. Rul. 7842007 and D.M. Roth, "Trade or Business Requirement of Sec. 162 and the Deductibility of Preoccupancy Expenses Incurred in Rental Real Estate Projects," *Taxes: The Tax Magazine* 57 (January 1979): 33. For a general discussion of this doctrine, see W.E. Seago, "The Tax Treatment of Start-Up Costs," *Tax Adviser* 9 (July 1978): 410. Also see S.A. Bleyer and T.E. Kelly, "Preopening Expenses: A Hot Issue," Tax Clinic, ed. S.R. Josephs, *Tax Adviser* 11 (May 1980): 288–89.

2601.3 Capital Gain Opportunities

The use of accelerated depreciation to produce capital gains has been largely vitiated by the recapture provisions of sec. 1250 (discussed at 1202). Section 1250 recapture, however, is somewhat less pervasive than sec. 1245 recapture (relating to personal property). Thus, the ordinary deduction/capital gain gambit may have some vitality for real estate.

The capital gain opportunities inherent in real property are discussed in 1201.

2601.4 Tax-Free Exchanges

The benefits of trading real properties in nontaxable exchanges, including three-party transactions, are described in 2102.

2601.5 Tax on Disposition in Excess of Cash Realized

The benefit of claiming depreciation deductions in excess of cash investment is reversed when the taxpayer sells the property and the buyer assumes the outstanding indebtedness. The IRS treats assumptions of outstanding indebtedness as additional sale proceeds that 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 1202.)

Example On January 1, 1980, Sharpo acquires a building for $20,000 cash and an $80,000 mortgage at 13 percent interest, payable monthly over twenty-five years. If, after making mortgage payments of $10,300, he sells the building on January 1, 1991, for $5,000 cash, with the buyer assuming the unpaid mortgage, his income tax return will reflect the figures shown in figure 26-1.[6]

In this case, the tax exceeds the cash realized by $1,440; however, depreciation deductions have exceeded cash investment by $19,100 ($49,400 less the sum of $20,000 and $10,300). Consequently, Sharpo's overall cash flow from the investment must reflect the tax savings attributable to these depreciation deductions (which, in turn, depend on his ordinary income tax rates through-

6. Derived from *Thorndike Encyclopedia of Banking and Financial Tables—1979 Yearbook* (Boston: Warren, Gorham & Lamont, 1979), p.2–64. Figures are rounded to the nearest hundred dollars.

Figure 26-1

Line			
	Proceeds of sale		
1.	Cash		$ 5,000
2.	Assumption of mortgage		69,700
3.	Total proceeds		74,700
	Basis of building		
4.	Original cost	$100,000	
5.	Less accumulated depreciation	49,400[a]	
6.	Basis		50,600
7.	Total gain		24,100
8.	Less additional depreciation recaptured as ordinary income ($49,400 less $44,000 straight-line depreciation)		5,400
9.	Long-term capital (sec. 1231) gain		$18,700
10.	Tax on line 8 (50%)[b]		$ 2,700
11.	Tax on line 9 (20%)[c]		3,740
12.	Total tax[d]		$ 6,440

[a]Computed under 150 percent declining-balance method, useful life of 25 years (rounded to nearest hundred dollars).
[b]Assumed ordinary income tax rate.
[c]50% × 40% (100% less 60% capital gain deduction).
[d]The alternative minimum tax is assumed to be inapplicable.

out the 1980-to-1990 holding period). On the other hand, his overall cash flow will be diminished by his net (after-tax) interest payments on the mortgage.

2601.6 Exception to "At-Risk" Rules

The holding of real property, except mineral property, is immune from the at-risk provisions, which are intended to limit tax loss deductions to the amount the individual has "at risk" in the activity.[7] The following is an excerpt from the Joint Committee's *Explanation of the Revenue Act of 1978* pertaining to the exclusion for real property:

> *Exclusions for real property.*—In the case of activities to which the Act extends application of the at risk rule, the holding of real property (other than mineral property) is to be treated as a separate activity, and the at risk rule is not to apply to losses from this

7. §465(c)(3)(D). S.F. Klein, "Coping With the At-Risk Rules: Planning Opportunities Suggested by the 1978 Act," *Journal of Taxation* 51 (July 1979): 22.

activity. For purposes of this exclusion, personal property and services which are incidental to making real property available as living accommodations shall be treated as part of the activity of holding such real property. For example, this exception is intended to exclude from application of the at risk rule situations where a taxpayer owns and operates a hotel or motel. In such instances, the making available of personal property such as furniture and services in conjunction with the renting of the hotel or motel room are to be considered incidental to making real property available as living accommodations. Similarly, providing personal property and services in renting a furnished apartment are to be considered incidental to making real property available as living accommodations.

The Act does not change the treatment provided under the Tax Reform Act of 1976 with respect to real estate used in one of the specified activities covered by the 1976 Act provisions (farming, oil and gas activities, motion pictures, or leasing of personal property). This real estate would be treated as part of the activity, rather than as a separate activity. Thus, for example, real property used in farming would be considered a part of the farming activity subject to the at risk rules.[8]

2602 Oil and Gas

While recent legislation has diminished the attraction of oil and gas as a tax shelter, such investments still may provide capital gain potential (discussed in 1204), percentage depletion, and current deductions for intangible drilling costs.[9]

The percentage-depletion deduction for oil and gas will gradually be phased down from 22 percent in 1980 to 15 percent after 1983. Percentage depletion is generally limited to 65 percent of the taxable income of "independent producers and royalty owners" and is further restricted to an average of 1,000 barrels of oil or 6 million cubic feet of gas per day after 1979. Section 613A(c)(9) generally denies percentage depletion to the transferee of a proven oil and gas property. Percentage depletion is also unavailable for lease bonuses and, in the absence of production, for advanced royalties.[10]

8. *General Explanation of the Revenue Act of 1978*, pp. 132–33; footnotes omitted.

9. For example, see D.G. Glickman and H.D. DeBerry III, "Post-1976 Oil and Gas Operations Require Careful Planning to Overcome Adverse Effects," *Journal of Taxation* 46 (April 1977): 230; and T.M. Larason, "Distinctive Features of Oil and Gas Allocations Yield Tax Benefits for Partners," *Journal of Taxation* 49 (December 1978): 362.

10. J.L. Houghton et al., eds., *Miller's Oil and Gas Federal Income Taxation* (Chicago: Commerce Clearing House, 1979), §§5–4, 5–11, 6–2, and 11–4; citing prop. regs. §1.613A-7(f)(1) and 1.613A-3(a)(4), example 5; and I.R.S. Ltr. Rul. 7828008. See also I.R.S.

Intangible drilling costs that would otherwise be capitalized (such as labor, fuel, and so forth, in connection with drilling a well, clearing ground, making roads, surveying, and doing geological work) may be deducted currently at the taxpayer's election.[11] Excess intangible drilling costs constitute tax preferences for the 15 percent add-on minimum tax to the extent they are greater than net income from oil, gas, and geothermal properties for the same year.[12] The excess of depletion over the adjusted basis of the property is also a tax preference for the 15 percent tax.[13]

Oil and gas properties may also qualify for like-kind exchanges (described in 2102).[14]

The ability to generate oil and gas tax losses in excess of economic investment is eliminated by the at-risk rules.[15]

The Crude Oil Windfall Profit Tax Act of 1980 may affect individual investors in oil and gas.

2603 Not-for-Profit Issue

To avoid disallowance of deductions for these shelters, the tax planner should, if possible, take steps to comply with the engaged-in-for-profit requirements.

While real estate activities are not usually susceptible to attack under sec. 183 (activities not engaged in for profit), the tax planner should be careful that real estate operations are conducted in a manner that establishes their "for-profit" nature.[16]

The IRS recently ruled that sec. 183 would not be applied to disallow losses incurred in activities to provide low- and moderate-income housing under sec. 236 of the National Housing Act.[17]

Investors should avoid the personal-use restrictions imposed on dwelling units (sec. 3002).

Announcement 76-34, 1976-12 I.R.B. 28, in Mertens, *Law of Federal Income Taxation—1976 Rulings* (Chicago: Callaghan & Co.), M.A. 2585, p.92.

11. Regs. §1.612-4(a).
12. §57(a)(11).
13. §57(a)(8). The 15% add-on minimum tax is discussed in chap.1, herein.
14. *Working With the Revenue Code 1979*, p.323.
15. §465, especially §465(c)(1)(D).
16. See *Ong*, T.C.M. 1979-406, in which the taxpayer consistently attempted to minimize rental losses and successfully rebuffed a §183 attack by the IRS.
17. Rev. Rul. 79-300, 1979-40 I.R.B. 8.

27

Generally Applicable
Deductions and Credits

Other Deductions

2701 Accounting and Legal Fees

Charges for professional services should be carefully itemized and allocated as applicable to deductible, capital, or personal functions.

Accounting and legal services performed for individuals are deductible if 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 2804).
- 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.
- Services "in connection with the determination, collection, or refund of any tax" (sec. 212(3)).

This definition is not restricted to income taxes, of course, but includes *all* other taxes as well (such as estate, gift, or excise taxes).

On the other hand, outright current deductions are not available for fees paid for services that constitute capital expenditures.[2] Expenses for services that are personal in nature are never deductible.

Some examples of professional services and their tax treatment follow:

- *Deductible activity.* Record-keeping regarding rent and royalty income.[3]

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1. For additional discussion, see A.C. Wegher, "Deductibility of Fees for Professional Services—Accountant or Attorney: Divorce and Separation; Estate Planning; Tax Advice; Title Matters, Etc.," *N.Y.U. Institute on Federal Taxation* 34 (1976): 163.

2. The cost of tax advice concerning a capital transaction, however, may be deductible. See *Sharples*, 533 F.2d 550 (Ct. Cl. 1976), and *Collins*, 54 T.C. 1656 (1970), acq. 1971-1 C.B. 2.

3. *M. Frost*, 1 T.C.M. 849 (1943).

- *Capital expenditures.* Defending or perfecting title to property. (Under regs. sec. 1.212-1(k), these costs are added to the basis of the property.)
- *Personal services.* Legal expenses generated by a separation or divorce.[4]

2701.1 Situations in Which Allocation Is Advisable

Charges for professional services should be carefully itemized and allocated to deductible, capital, or personal functions.

Professional services frequently cut across deductible and nondeductible lines by involving a variety of activities, such as the following:

- Functions relating to the production of income or income-producing property.
- Tax advice, preparation of tax returns, pursuit of 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 enables the taxpayer to salvage at least part of a fee as a deduction. In the absence of such breakdowns, *no* deduction at all may be allowed.[5]

Legal Services Regarding Defense of Title and Collection of Income

Regulations section 1.212-1(k) states, "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."

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4. *Gilmore*, 372 U.S. 39 (1963).

5. For an example of such a dire consequence, see the reviewed Tax Court decision in *G.L. Schultz*, 50 T.C. 688 (1968), aff'd on another issue 420 F.2d 490 (3d Cir. 1970).

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 in Missouri was concerned with a shareholder's income tax treatment of an invoice from an accounting firm for the following services.[6]

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 the 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). The $1,000 charge, however, was not deductible because

> 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. . . .[7]

Would this cost be an addition to the basis of the stock?

Tax Advice in Connection With Divorce and Separation Proceedings

Fees allocable to advice about the tax consequences of an alimony and property settlement in a divorce action are fully deductible, *even if the advice will also be of future use.*[8]

Only the taxpayer's own expenses are deductible. Consequently, a husband cannot deduct fees for tax advice rendered to his (former) wife.[9]

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6. *Basil L. Kaufmann*, 227 F.Supp. 807 (D. Mo. 1963).

7. For a contrary decision, see *W.K. Carpenter*, 338 F.2d 366 (Ct. Cl. 1964).

8. See *Carpenter*, *ibid*, following *Davis*, 287 F.2d 168 (Ct. Cl. 1961), aff'd and rev'd on other grounds by the Supreme Court; *Goldaper*, T.C.M. 1977-343; Rev. Rul. 72-545, 1972-2 C.B. 179.

9. *U.S. v. Davis*, 370 U.S. 65 (1962), at 74.

Estate Planning

Estate planning services usually consist of one or more of the following elements: tax advice, investment matters, and dispositive arrangements. Generally, an individual should claim deductions for services rendered relative to the first two elements, while expenses involving the last element are not deductible. Consequently, the professional should specifically allocate estate planning fees among these categories and appropriately describe them when invoicing clients.

Following is a brief technical discussion of the deductibility of the basic elements of estate planning services.

Tax Advice Section 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 should be deductible under sec. 212(3) and the corresponding regulation.[10]

Consequently, it is desirable to determine the portion of the estate planning allocable to tax advice and tax planning. The fee allocation should be supported by detailed time records, but subjective evaluations of the tax work involved may also be in order.

> It will be found, however, that many items of work in estate planning do not fall neatly into one category or another. For example, the attorney drafts a will containing a Charitable Remainder Trust or a Front End Charitable Trust. How much of the drafting time is allocable to the charitable trust? Moreover, the trust has both charitable and tax saving objectives and consequences. How much of the fee for drafting the trust is allocable to the tax saving aspects of the work? It would seem that the allocation must be based on estimates as to the relative significance of the tax saving objectives and the time spent in achieving these objectives. Here, subjective judgments are involved; so that reasonable persons may differ, but certainly no one is better able to make these judgments than the attorney who prepared the will. . . .[11]

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10. *Merians*, 60 T.C. 187 (1973), acq. 1973-2 C.B. 2. This decision was reviewed by the Court and contains several concurring and dissenting opinions.

11. J.I. Friedman, "Estate Planning from Client to Cremation and Beyond," *N.Y.U. Institute on Federal Taxation* 33 (1975): 1–2. See also Wegher, "Deductibility of Fees for Professional Services," pp. 179–83.

Investment Matters Section 212(2) allows an individual to deduct expenses paid for the *conservation* of property held for the production of income. Regulations section 1.212-1(g) specifically includes investment counsel in this category. The Tax Court made the following statement in *Nancy Reynolds Bagley:*

> 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. . . .[12]

Some of the concurring opinions to *Merians* also suggest that sec. 212(2) may sanction the deductibility of a portion of the estate-planning fees if the issue is raised. "Here again, careful and detailed records must be kept and a separate fee charged for that portion of the work relating to the management, conservation, or maintenance of income producing properties. . . ."[13]

(For further discussion of investment expense, see chapter 30.)

Dispositive Arrangements It has long been established that such expenditures as legal fees paid in connection with the preparation or construction of wills are nondeductible personal expenses.[14] However, one commentator has suggested the following:

> The *Estate of Helen S. Pennell* is often cited for the proposition that the attorney fees incurred for preparation of a will are not deductible. See, for example, Judge Whithey's dissenting opinion in *Merians*. It must be recognized, however, that the *Pennell* case was decided prior to enactment of Section 212 of the Code. Accordingly, it appears that a portion of the legal fees associated with preparation of wills may be deductible under Section 212(2) and (3) under the principles previously discussed. . . .[15]

12. *Bagley*, 8 T.C. 130 (1947), acq. 1947-1 C.B. 1.

13. Friedman, "Estate Planning from Client to Cremation and Beyond," p.2. See also Wegher, "Deductibility of Fees for Professional Services," pp.181–84.

14. *Helen S. Pennell*, 4 B.T.A. 1039 (1926); *Cornelius Vanderbilt, Jr.*, 16 T.C.M. 1081 (1957). See Mertens, *Law of Federal Income Taxation* (Chicago: Callaghan & Co.), §25.18. For further background, see M.E. Marmer, "Professional Fees: When Are They Deductible for Estate Planning Work?" *Journal of Taxation* 27 (November 1967): 300.

15. Wegher, "Deductibility of Fees for Professional Services," p.183. See also Friedman, "Estate Planning from Client to Cremation and Beyond," pp.1–2.

2701.2 Tax Indemnification Agreement Upon the Sale of a Business

The taxpayer should consider executing a satisfactory indemnification agreement upon the sale of a 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 deficiences 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.[16] However, the taxpayer might be entitled to claim capital loss treatment under *Arrowsmith*, 344 U.S. 6 (1952), or to recompute the remaining profit reported under an installment sale.[17]

2702 Alimony and Support Payments

Parties to a divorce can control the income tax consequences of the resulting payments. Generally, the payor-spouse (husband) should arrange for all such payments to be deductible by him and taxable to the payee, even though some additional payments may be necessary.

The code permits spouses contemplating divorce to determine which of them will bear the tax burden of alimony and support payments.[18] Section 71 sets forth certain conditions under which such payments will or will not be includible in the recipient's gross

16. *Southern Arizona Bank and Trust Co., Ex'rs., Est. of George Martin*, 386 F.2d 1002 (Ct. Cl. 1967), cert. den. 391 U.S. 967.

17. See J.M. Pusey, "When Will Possible Adjustments to Selling Price Bar Use of Installment Reporting?" *Journal of Taxation* 47 (July 1977): 22. On May 2, 1979, the chairmen and ranking minority members of the congressional tax committees introduced an installment sale simplification bill (H.R. 3899 and S. 1063). The Treasury subsequently testified in favor of this measure on the condition that basis recovery provisions are also adopted to deal with contingent payments. (See *Daily Tax Report* (July 27, 1979), pp.J-15–J-17.) This testimony reflected suggestions by the AICPA Federal Tax Division (*Tax Adviser* 10 (August 1979): 493–94) and the American and New York State and City Bar Assns. (*Daily Tax Reporter* (July 27, 1979), pp.J-9–J-10). See chap. 19, n.2, and 1903.5.

18. See, generally, the following articles in *N.Y.U. Institute on Federal Taxation* 37 (1979): M.H. Alcott, "Selected Tax Problems in Matrimonial Disputes and Settlements," chap.33; D.H. Halpert, "Planning for Shifting Taxable Income in Divorce and Separation," chap.34; T.G. Bost, "Divorces in Community Property States: Selected Tax Problems," chap.35; and A.E. Hull, "The New Uniform Divorce Laws: The *Davis* Decision," chap.36.

income. Usually, these conditions are such that their compliance or noncompliance can be controlled by mutual consent of the parties involved.

Deductions are allowed to the payor under sec. 215 to the extent that 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.[19]

Only periodic alimony payments are deductible. Installment payments of a principal sum (an amount that is definitely stated or that can be definitely fixed) qualify as periodic alimony payments if they are 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, the wife's remarriage, or change in the economic status of either spouse.[20]

Alimony is now a deduction from gross income rather than an itemized deduction.[21]

2702.1 Planning Implications Regarding Alimony and Support

If a husband is in a higher tax bracket than his (former) wife, it is mutually advantageous to follow these steps:

1. Arrange for all payments, including child support, to qualify as deductions for the husband (taxable to the wife).
2. Negotiate the division of the resulting overall tax savings between the spouses. This saving is 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 amounts as child support payments. Other means of

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19. §71(b). See also the Supreme Court decision in *J. Lester*, 366 U.S. 299 (1961); and Rev. Rul. 70-557, 1970-2 C.B. 10.

20. Regs. §1.71-1(d)(3).

21. §62(13). This is a change from prior law, enacted by the Tax Reform Act of 1976, that favorably affects both the maximum tax on personal service income and the alternative minimum tax that may be imposed on "excess" (i.e., adjusted) itemized deductions. See, generally, *Working With the Revenue Code 1979*, ed. I.F. Diamond and M. Walker (New York: AICPA, 1979), p.26.

achieving deductibility of payments to a former wife include the following:

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 the wife insists on full payment within a ten-year period, making the payments subject to any of the contingencies previously mentioned that can be negotiated to the wife's satisfaction.

2703 Consuming Expiring Carryovers

A taxpayer can curtail the waste of net operating losses, investment credits, jobs credits, energy credits, charitable contributions, and other carryovers by shifting income or deductions and stepping up the basis of property.

For background on this subject, see the discussions in chapter 4 and 702.

28

Specific Expenses

Employees

2801 Individual Retirement Accounts

Individual retirement accounts (IRAs), IRA annuities, and IRA retirement bonds offer current tax savings and are tax-exempt vehicles whose earnings are exempt from income tax until they are distributed. Estate tax advantages are also possible.

2801.1 Technical Observations

Individual Retirement Account

Section 408(a) describes an individual retirement account as a U.S. trust or custodial account whose written governing instrument meets the following requirements:

- Except in the case of rollovers, no contribution will be accepted unless it is in cash, and for any taxable year contributions in excess of $1,500 will not be accepted on behalf of any individual.
- The trustee is a U.S. bank (including a domestic building and loan association or an insured credit union) or other entity who demonstrates to the Treasury that it can administer the trust in a manner consistent with the IRA law.
- No part of the trust funds will be invested in life insurance.
- The balance in an individual's account is nonforfeitable.
- The assets will not be commingled with other assets except in a common trust fund or common investment fund.
- The individual's entire interest will be distributed by the close of the year in which he attains age 70½, or distribution will begin by the close of that year and continue over the life expectancy of the individual, the life expectancy of the individual and his spouse, or a specified term of years not exceeding those life expectancies.

- If the individual or the surviving spouse dies before receiving the entire interest, the balance must be either distributed to the beneficiaries or applied to purchase an immediate annuity for them, payable for life or for a period not exceeding their life expectancies. This action must be taken within five years of the person's death.

Individual Retirement Annuity

Section 408(b) describes an individual retirement annuity (IRA annuity) as an annuity or endowment contract issued by an insurance company that generally conforms to the requirements for individual retirement accounts. For example, premiums on behalf of any individual must not exceed $1,500. The contract, if issued after November 6, 1978, must provide for flexible premiums.[1]

IRA Retirement Bonds

Under sec. 409(a), an IRA retirement bond is a U.S. government bond, issued under the Second Liberty Bond Act, with the following characteristics:

1. The bond provides for payment of interest or investment yield only on redemption.
2. No interest or investment yield is payable if the bond is redeemed within twelve months.
3. The bond ceases to bear interest or provide investment yield at the earlier of the following dates:
   - When the registered owner attains the age of 70½.
   - Five years after his death, but not later than the date he would have attained age 70½.
4. Except in the case of rollovers, the registered owner may not purchase bonds in excess of $1,500 in any one taxable year for any one individual.
5. The bond is not transferable.

2801.2 The IRA Deduction

An employee or self-employed individual who is not an active participant in another (non-IRA) qualified retirement or govern-

1. §408(b)(2) as amended by §§157(d)(1) and (2) of the Revenue Act of 1978.

mental plan may deduct up to $1,500 per year for cash contributions to an IRA plan (an IRA, IRA annuity, or IRA retirement bond). Contributions may be made to one or more IRAs.[2] (For simplicity, all three varieties of IRA plans are referred to in this tax study as an IRA.)

The deduction is limited to 15 percent of compensation (earned income in the case of self-employed individuals) or to $1,500, whichever is less. The IRS recently explained the operation of limitations when the employee has both salary and a self-employment net loss. The individual had $9,000 of employee compensation, net income of $1,000 from one business that he operated as a sole proprietor, and a $2,000 net loss from another sole proprietorship. The service ruled that the aggregate $1,000 loss from self-employment activities did not reduce the employee compensation, so the individual was entitled to deduct $1,350 (15 percent of $9,000) as an IRA contribution. If there was a combined net $1,000 self-employment profit instead of a loss, the deductible IRA contribution could have been $1,500 (15% × ($9,000 plus $1,000)).[3]

Married individuals may both claim the $1,500 maximum deduction if both spouses qualify. The maximum deduction on a joint return is $3,000. Community-property laws are disregarded for this purpose; so an inactive spouse is not considered to have compensation or earned income merely because the couple happens to live in a community-property state.[4]

No deduction is permitted for rollover distributions (discussed in chapter 17).

2801.3 Spousal IRAs

In lieu of the regular IRA deduction, sec. 220 allows an individual to deduct up to $1,750 for contributions to a spousal IRA. To be eligible for this deduction, the individual must satisfy the following conditions:

- He or she must be married.
- His or her spouse must not have any compensation or earned

2. Rev. Rul. 79-265, 1979-36 I.R.B. 14.
3. Rev. Rul. 79-286, 1979-39 I.R.B. 12. Cf. *Est. of Hall*, T.C.M. 1979-342.
4. §219(c)(2).

income during the taxable year. Community-property laws are ignored for this purpose.

- Neither spouse may be an active participant in a non-IRA qualified retirement or governmental plan.

Contributions under a spousal IRA must be paid to separate IRAs for the husband and the wife or to an IRA with subaccounts for both spouses. The deduction is limited to the smallest of the following:

- $1,750.
- 15 percent of compensation or earned income for the taxable year.
- Twice the smallest amount contributed for either spouse.

A taxpayer should contribute equal amounts to the IRAs of both spouses to avoid loss of deduction and the annual 6 percent excise tax on excess contributions.[5] An individual with income of $11,666.67 is eligible to make the maximum contributions to a spousal IRA ($11,666.67 × 15% = $1,750). However, if the individual contributes $1,000 to his own account and $750 to his wife's account, his deduction is limited to $1,500 ($750 × 2 = $1,500). The $250 contribution in excess of the allowable deduction is also subject to the 6 percent excise tax on excess contributions.

Gift Tax

Payments to spousal IRAs are eligible for the $3,000 annual gift tax exclusion to the extent that they are deductible for income tax purposes under sec. 220.[6] If any gift tax is payable with respect to a spousal IRA, it cannot be added to basis, because basis in an IRA is always zero.[7] Designating a surviving spouse or other individual as beneficiary of an IRA after the individual's death exempts the amount from gift tax under sec. 2517(a)(5).

2801.4 Timing the IRA Contribution

Contributions for a taxable year may be made as late as the due date of the return for that year, including extensions.[8]

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5. §4973.
6. §2503(d).
7. I.R. 1809 (May 9, 1977), ques. 18.
8. §§219(c)(3) and 220(c)(4).

A taxpayer should consider making the IRA contribution early in the year. For example, a 1981 contribution may be made in January 1981. Because the IRA is itself tax-exempt, early contributions permit a greater amount of earnings, which avoid tax until distribution from the IRA.

On the other hand, if the taxpayer is short of cash, he can file his return early and claim his IRA deduction before making the payment (or even before establishing the IRA) and then use his tax refund to help fund the IRA. The IRA may be established any time prior to, or at the time of, the first contribution.[9]

Revenue Ruling 66-144 allowed a calendar-year corporation that obtained an automatic three-month filing extension to make a contribution to a qualified retirement trust by June 1 and deduct it for the preceding year, even though it filed its return by March 15.[10] The rationale of this ruling may also be applicable to the timing of IRA contributions.

If, later in the year, the individual becomes covered by an employer's qualified plan, and thus ineligible to contribute to the IRA, the individual should withdraw the contribution and the earnings thereon by the due date (including extensions) of the return for the year to avoid imposition of the 6 percent annual excise tax on excess contributions.[11] In appropriate circumstances, the individual should consider postponing participation in the employer's plan until the following year in order to avoid withdrawing the IRA contribution.

2801.5 Eligibility Requirements

Age

Contributions, other than nondeductible rollovers, cannot be made to an IRA in the year in which an individual attains age 70½ or in later years.[12]

Active Participation in a Qualified Plan

An individual is not eligible to deduct contributions in a taxable year in which he is an *active participant* (as defined in regs. sec. 1.219-2) in a qualified plan of his employer, a governmental plan,

9. I.R. 1809, ques. 19.
10. Rev. Rul. 66-144, 1966-1 C.B. 91.
11. §408(d)(4).
12. §219(b)(3).

or a tax-deferred annuity plan of a public school or tax-exempt organization.[13] Active participation in a self-employed retirement plan (Keogh plan) also precludes contributions to an IRA. Social security and railroad retirement plans are not considered governmental plans for this purpose; however, the Civil Service Retirement Plan is considered a governmental plan.[14] There are exceptions to the active participation rule for members of military reserve components and volunteer firemen.[15]

Generally, an individual is an active participant in a regular pension (defined-benefit) plan if, for any portion of the plan year ending with or within the individual's year, he is not excluded under the plan's eligibility provisions.[16] An individual is an active participant in a money-purchase plan if employer contributions or forfeitures must be allocated to the individual's account with respect to the plan year ending with or within the individual's year.[17] An individual is an active participant in a profit-sharing or stock-bonus plan if employer contributions are added, or if forfeitures are allocated, to his account.[18]

An employee who is an active participant in a qualified plan cannot make contributions to an IRA, even if contributions on his behalf to the qualified plan are less than $1,500 or 15 percent of his compensation. However, if an employer contributes less than the $1,500/15 percent-of-compensation limit to a simplified employee pension, the employee, if not covered by a separate qualified plan, may contribute and deduct the amount necessary to bring the total contribution up to $1,500 or to 15 percent of compensation.[19]

In appropriate circumstances, the taxpayer should consider waiving participation in a qualified plan in order to be eligible to make deductible contributions to an IRA. The conference report on ERISA provides the following:

> If an employee is given the option to elect not to be covered by a qualified, etc., plan and he so elects, generally he will not be treated as being an active participant in the plan for purposes of the retire-

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13. §219(b)(2). See also *Orzechowski*, 69 T.C. 750 (1978), aff'd 592 F.2d 677 (2d Cir. 1979); and *Foulkes*, T.C.M. 1978-498.

14. U.S., Congress, House, 93d Cong., 2d sess., 1974, H.Rep. 807, p.129, also found at 1974-3 C.B. Supp. 364.

15. §219(c)(4).

16. Regs. §1.219-2(b).

17. Regs. §1.219-2(c).

18. Regs. §1.219-2(d).

19. §219(b)(7).

> ment savings deduction. The conferees also agree . . . that where an employee who elects out of a qualified plan can elect later to become an active participant in it and can receive benefits for all prior years (for which he elected out) upon payment of, e.g., all mandatory contributions plus interest for prior periods, the employee is to be treated as being an active participant in the plan for the prior years with respect to which he pays the required amount and accrues benefits.[20]

Voluntary nonparticipation by lower-paid employees, however, can cause the plan to be discriminatory, and the withdrawal of a single employee can be fatal to a self-employed retirement plan. Therefore, employees may find that employers require plan participation to avoid disqualification.[21]

It has been held that a participant attempting to waive participation was nevertheless an active participant because the plan did not permit such a waiver;[22] however, the IRS will issue private rulings that an employee has successfully waived his right to participate in his employer's plan. (For example, see IRS Ltr. Rul. 7935122.)

2802 Moving Expenses

Employees and self-employed individuals can partially recoup certain unreimbursed moving expenses through income tax deductions. Since reimbursement for all moving expenses is includible in gross income, qualifying the expenses for deduction provides an offset against this otherwise taxable income.

Figure 28-1, below, summarizes the income tax treatment accorded to moving expenses.

Figure 28-1

	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

20. U.S., Congress, House, 93d Cong., 2d sess., 1974, H.Rep. 1280, p.336.

21. See *Working With the Revenue Code 1979*, ed. I.F. Diamond and M. Walker (New York: AICPA, 1979), p.188.

22. *Orzechowski*, 69 T.C. 750 (1978), aff'd 592 F.2d 677 (2d Cir. 1979).

In order for moving expenses (direct and indirect) to qualify as deductions, they must meet a thirty-five-mile minimum distance requirement and either a thirty-nine-week minimum employment requirement for employees or a seventy-eight-week test for self-employed individuals.[23] The longer time period was imposed on self-employed individuals because self-employed relocation is more likely to be voluntary than employee relocation.[24] Special rules apply to retirees or decedents who worked abroad.[25]

Moving expense deductions are deductible *from gross income* in the taxpayer's determination of adjusted gross income.[26]

2802.1 Technical Background for Moving Expense Deductions

Premove 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 the 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 they are looking for, or waiting to move into, a permanent residence. Only those expenses incurred within any thirty consecutive days after obtaining employment are deductible.[27]

Expenses of Disposing of and Acquiring Residences

The deduction for expenses of selling or exchanging a former residence is confined to those items that would be allowed as

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23. § 217(c)(1) and (2).

24. See U.S., Congress, Senate, Finance Committee, *Summary of H.R. 13270 (Tax Reform Act of 1969)*, 91st Cong., 1st sess., 1969, p.39.

25. § 217(i).

26. § 62(8). See 2803, herein, for the significance of this treatment.

27. Regs. § 1.217-2(b)(6).

offsets against the selling price in determining the realized gain.[28] 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 that are deductible as moving expenses cannot also be used to reduce the realized gain.

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 that 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 ("points") that do not represent interest or prepaid interest. (Points that are essentially interest expense are deductible as such pursuant to Rev. Ruls. 69-188 and 69-582, provided the criteria set forth in sec. 461(g)(2) are satisfied. Also see chapter 4.)

Purchasing expenses exclude prorated real estate taxes and insurance, points that constitute prepaid interest, and the residence's purchase price.[29] Since double benefits are denied by sec. 217(e), deductible purchasing expenses must be eliminated from the residence's tax basis.

The expenses of settling a lease are also deductible as moving expenses. These expenses consist of items incident to settling an unexpired lease on a former residence, including payments to secure release from the lease, and legal fees, commissions, and similar expenses incurred to obtain an assignee or sublessee.[30]

A taxpayer may deduct the expenses of acquiring a lease on a new residence. 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

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28. § 217(b)(1)(E) and (b)(2); regs. § 1.217-2(b)(7) and (8); U.S., Congress, House, 91st Cong., 1st sess., 1969, H.Rep. 413, part 1, p.76, and part 2, p.51. For this purpose, a residence is property owned or leased by the taxpayer, his spouse, or the couple jointly, including a house, apartment, houseboat, house trailer, cooperative or condominium dwelling unit, or similar dwelling.

29. Regs. § 1.217-2(b)(7)(ii).

30. Regs. § 1.217-2(b)(7)(iii).

location of his new principal place of employment. Rent or prepaid rent and security deposits are not includible as lease acquisition expenses.[31]

Mileage Test

The new place of work must be at least thirty-five miles further from the old residence than the old place of work. In determining the distance between these two points, the IRS will use the shortest of the more commonly traveled routes between them rather than the actual distance.[32]

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 thirty-nine weeks during the twelve months immediately following his arrival at the location. Appropriate procedures are provided if this test is not satisfied when the return for the year is due and it is then still possible for the test to be satisfied subsequently.

As previously mentioned, the same test applies to self-employed persons, except that a seventy-eight-week period is substituted for the thirty-nine-week period applicable to employees.

Section 217(d)(1)(A) waives this time test if it cannot be satisfied because of death or disability. The test is also waived if an *employee* obtains full-time employment and can 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.

Foreign Moves

Special rules are provided in sec. 217(h) for foreign moves.

Members of the Armed Forces

Section 217(g) contains several liberalizing provisions for members of the U.S. armed forces.

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31. Regs. § 1.217-2(b)(7)(iv).
32. Regs. § 1.217-2(c)(2)(iii).

2802.2 Reimbursements

Pursuant to sec. 82, all direct and indirect reimbursements for moving expenses must be included in gross income as compensation for services, while deductions for such expenses are 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.

Section 3401(a)(15) provides that moving expense reimbursements are not subject to withholding to the extent that it is reasonable to believe that offsetting deductions will be available.

2802.3 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.

- Moving of household goods and personal effects. (See detailed description in regs. sec. 1.217-2(b)(3).)
- Transportation costs of employee and family.
- 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 are depicted in figure 28-2.

The maximum deductions are not increased if a husband and wife both obtain new employment in the same general area;

Figure 28-2

Category of expense	Maximum amount deductible
1. Premove house-hunting trips	$ 800
2. Temporary living expenses at new job site	900
3. Limit on deduction for both (1) and (2)	1,500
4. Reasonable expenses of selling, purchasing, or leasing a residence	1,800
Maximum deduction	$3,000

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 that either decrease the net sale price of the old residence or increase the tax basis of the new one.

Generally, it is 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 can instead be reduced in those rare instances in which the latter approach is more advantageous. In other words, such a choice may not be possible for moving expenses that are allowable as deductions.

2803 Effect of Deductions on Adjusted Gross Income, Other Itemized Deductions, and the Use of the Zero Bracket Amount

Taxpayers should claim certain expenses as deductions in arriving at adjusted gross income. The zero bracket amount is allowable in addition to these expenses, and greater medical deductions may result, although the charitable contributions deductions may be reduced.

Section 62(2) provides that employee expenses are to be claimed as other itemized deductions, with the following exceptions:

- Travel expenses away from home.
- Transportation expenses.
- Expenses of outside salesmen.
- Reimbursed expenses (to the extent that the reimbursements are included in gross income; hence, this deduction has a wash effect).

These exceptions are instead deductible from gross income in the taxpayer's determination of adjusted gross income. (Itemized deductions, to the extent that they exceed the zero bracket amount, are deducted from adjusted gross income in the computation of 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):

- They can be claimed *in addition to* the zero bracket amount (in contrast to all other employee expenses, that is, those not described in sec. 62(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, 30 percent, or 50 percent of adjusted gross income) is lowered.[33] This may not be a serious matter if the five-year carryover of excess contributions is available.[34] (Charitable contribution limitations and carryovers are further discussed in chapter 31.)

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).

2804 Other Selected Planning Considerations

It has long been held that services performed as an employee constitute a trade or business.[35] Accordingly, expenses attributable to such a business are generally deductible for income tax purposes. A detailed catalogue of all the various employee expenses that may be allowable as deductions is outside the function of this tax study; instead, this section will focus on several planning aspects that have current practical interest.

2804.1 Delayed Additional Withholding

Certain employees should conserve their working capital through delayed additional withholding.

In appropriate circumstances, employees who have other sources of

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33. Technically, these percentages apply to the employee's *contribution base*, which is defined by § 170(b)(1)(E) as adjusted gross income computed without regard to any net operating loss carrybacks.

34. § 170(d)(1).

35. See, as representative of the decisions espousing this view, *J.M. Trent*, 291 F.2d 669 (2d Cir. 1961), and *Deputy v. DuPont*, concurring opinion of Justice Frankfurter, 308 U.S. 488 (1940).

income in addition to compensation can take 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, taxpayers generally must make payments quarterly with respect to tax estimated to be due for noncompensatory income (interest, dividends, and so forth). Deficient payments for earlier due dates (for example, April 15 or June 15) cannot be rectified by subsequent excessive payments (for example, September 15 or January 15 of the next year).

In contrast, sec. 6654(e)(2) provides that the total withheld tax will be deemed to have been paid in equal quarterly installments "unless the taxpayer establishes the dates on which all amounts were actually withheld." In the latter case, withholding is applied on an actual basis:

Therefore, sec. 6654(e)(2) gives taxpayers an option in regard 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 equal quarterly installments may permit the taxpayer to satisfy the quarterly estimated tax requirements *retroactively*.

For example, estimated tax payments attributable to investment income that are required to be made on April 15 and June 15 can instead be satisfied through additional tax withheld in November and December. Such a procedure, of course, permits a taxpayer to satisfy his estimated tax requirements as late as possible during the year—thereby enabling maximum utilization of working capital.

Example A single person anticipates that his 1980 income will be 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 (1980) is \$45,000 (current year rates and exemptions applied to previous year's income).

Of this amount, it is expected that \$19,924 will be satisfied through usual withholding procedures, determined as shown on p.363.

Withheld tax on salary (table 4, prescribed by the IRS under sec. 3402(a))	$14,924
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	$19,924

Consequently, the following estimated tax computations are submitted for a CPA's review.

Total estimated tax required to be paid	$45,000
Less income tax to be withheld during 1980 (rounded)	19,900
Net estimated tax payable	$25,100
Quarterly installment	$ 6,275

Client's financial position will compel him to borrow money at 18 percent interest in order to pay these quarterly installments. Since Client expects to be in the 63 percent bracket after deductions, the effective interest rate should be 6.66 percent (18 percent multiplied by 37 percent (100 percent less 63 percent)). Therefore, borrowing would be preferable to incurring penalties at 12 percent, which are *not* deductible.

Client requests the CPA to suggest ways and means of remedying this undesirable financial situation. The CPA advises him to pay only the estimated tax installment due January 15, 1981, and to satisfy the remaining estimated tax requirement of $18,825 by additional tax to be withheld from the bonus in December 1980. In summary, these procedures would permit three $6,275 payments due April 15, June 15, and September 15 to be postponed, without penalty, until December. To accomplish this, the CPA suggests that additional withholding should be authorized by a written agreement pursuant to Employment Tax Regs. sec. 31.3402(i)-1.

Such additional withholding must, of course, be predicated on the availability of sufficient net compensation (after reduction for normal withholding and so forth). When this procedure is used, 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.

As a related matter, the tax planner should not overlook the additional withholding tax created by excess withholding of FICA tax.

2804.2 Providing Required Substantiation of Travel and Entertainment Expenses

Taxpayers should be careful to substantiate travel and entertainment expenses properly.

The regulations provide a comprehensive set of rules with regard to the substantiation of deductions for travel, entertainment, and gift expenses. Regulations section 1.274-5, particularly paragraph (c)(2)(iii), contains detailed requirements for obtaining documentary evidence, such as receipts for lodging and for other expenditures of $25 or more. The extreme importance of adhering to these regulations cannot be overemphasized.

Standard Mileage Rates

A taxpayer can lighten the substantiation burden (record-keeping, receipts, and so forth) in connection with deductions for the business use of his automobile by resorting to the following standard mileage rates:[36]

First 15,000 business miles—20 cents per mile
Additional business miles—11 cents per mile
Fully depreciated autos—11 cents per mile

Business parking fees and tolls are not reflected in those rates and are deductible as separate items. Interest and state and local taxes incurred to purchase the auto are also deductible in addition to the mileage allowance. Investment credit is also available if otherwise applicable.

The increase to 20 cents also applies to mileage allowance reimbursements by employers. Reimbursements at this rate satisfy the "accounting to employer" requirements of regs. sec. 1.162-17(b) for local transportation. Such reimbursements also satisfy the substantiation requirements of regs. sec. 1.274-5(c) for "amounts" in

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36. Rev. Proc. 80-32, 1980-29 I.R.B. 27.

the case of travel away from home. However, the time, place, and business purpose of the travel must also be substantiated.[37]

The use of standard mileage rates, for either claiming deductions or determining reimbursements, also requires substantiation of the business mileage.

2804.3 Travel Expenses Away From Home

To maximize deductions taxpayers should be aware of the rules for travel expense deductions.

Under sec. 162(a)(2) the only business travel expenses allowable are those paid or incurred while away from home. The IRS has generally interpreted the phrase "away from home" as requiring a taxpayer to be away from home overnight on a temporary, as opposed to an indefinite, assignment.

For example, in Rev. Rul. 68-663 a federal government employee traveled away from his post on official business for a one-day trip, leaving at 9:00 A.M. and returning at 10:00 P.M.[38] Expenses for his noon and evening meals were not deductible, since his one-day trip did not require a stop for sleep or rest.[39]

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. . . ."[40]

The away-from-home issue has been the subject of numerous and often conflicting court decisions. Travel expenses for foreign conventions are subject to the limitations of sec. 274(h).

2804.4 Travel Expenses of Spouses

If certain business requirements are met, taxpayers should consider deducting travel expenses for their spouses.

Regulations section 1.162-2(c) requires a wife's presence on a trip to

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37. Rev. Rul. 80-203, 1980-29 I.R.B. 6.

38. Rev. Rul. 68–663, 1968-2 C.B. 71.

39. The ruling cited the 1967 Supreme Court decision in *Correll*; 389 U.S. 299 (Ct. D. 1917, 1968-1 C.B. 64), which upheld the sleep-or-rest rule imposed by the IRS. See also *Mazzotta*, 465 F.2d 1399 (2d Cir. 1972), aff'g *per curiam* 57 T.C. 427 (1971); and Rev. Rul. 75-170, 1975-1 C.B. 60.

40. *Travel, Entertainment, and Gift Expenses*, I.R.S. Publication 463, 1979 ed., pp.2–3. See also Rev. Rul. 75-432, 1975-2 C.B. 60.

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 clarified 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.[41]

Using these standards, the courts have generally upheld disallowance of wives' traveling expenses; however, there are several decisions in which taxpayers have prevailed. For examples, see *Roy O. Disney* and *P.C. Warwick*, in which the husbands were officers 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.[42]

Also see *John Charles Thomas*, which was favorably cited in Rev. Rul. 55-57, for further illustrations of valid business functions performed by a wife.[43]

2804.5 Education Expenses

If certain criteria are met, taxpayers should claim deductions for educational expenses.

Deductions are allowable for expenses of education (even if leading to a degree) that 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 for retention of an established employment relationship, status, or rate of compensation.

Expenses are not deductible if the education also (*a*) is required in order to meet minimum educational requirements for qualification in an individual's employment (or other business) or (*b*) will enable qualification for a new trade or business.[44]

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41. *William H. Johnson*, T.C.M. 1966-164.

42. *Disney*, 413 F.2d 783 (9th Cir. 1969), aff'g D. Cal. Cf. *Fenstermaker*, T.C.M. 1978-210, and *Warwick*, 236 F.Supp. 761 (D. Va. 1969).

43. *Thomas*, B.T.A.M., CCH dec. no. 10,622-A (1939), cited in Rev. Rul. 55-57, 1955-1 C.B. 315. For further discussion of this subect, see J.J. McCoy, "Tax Treatment of Spouse's Travel Expenses," Tax Management Memorandum 79-14 (July 2, 1979).

44. See, e.g., *Ardavany*, T.C.M. 1979-127.

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.[45]

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*.[46] 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.

In Rev. Rul. 68-591, however, 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.*
>
> 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][47]

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45. Regs. § 1.162-5(b)(3)(i).

46. *Furner*, 393 F.2d 292 (7th Cir. 1968), rev'g 47 T.C. 165 (1966). Also see and cf. *Picknally*, T.C.M. 1977-321; *Reisinger*, 71 T.C. 568 (1979); and *Wyatt*, 56 T.C. 517 (1971).

47. Rev. Rul. 68-591, 1968-2 C.B. 73. Compare the "year or less" language of Rev. Rul. 68-591 with the "less than one year" language of Rev. Rul. 60-189, 1960-1 C.B. 64, and I.R.S. Publication 463.

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.[48] In addition, the revenue service also permits the deduction of certain local transportation expenses.[49]

Travel Itself as an Educational Activity

Regulations section 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.

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, does not determine that the required relationship exists between the 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 chosen itinerary and the major portion of activities undertaken are designed to improve skills in using and teaching French. The travel expenses are deductible, even though the activities consist 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 it were taken by an English or mathematics teacher.[50]

Section 127 exempts direct or indirect employer payments for certain educational programs from an employee's income before 1984 (see 505).

2804.6 Partial Business Use of the Home

If possible, taxpayers should seek to meet the stringent tests for deductibility of expenses for the partial business use of residences.

Deductions with respect to partial business use of a residence (such as office-in-home deductions) are generally not available (see 2503).

48. Regs. § 1.162-5(e).
49. *Your Federal Income Tax*, I.R.S. Publication 17, 1979 ed., p.94.
50. *Ibid.*

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Specific Expenses

Self-Employed Retirement Plans

This chapter 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 business, as are moving expenses.

Overall financial advantages and disadvantages should be weighed carefully, and incorporation should be considered, before an individual adopts a self-employed retirement plan, an IRA, or a simplified employee pension.

In 1601 various tax attributes of self-employed retirement plans are compared with corporate plans (regular qualified plans).[1] This comparison reveals that a retirement plan for self-employed persons permits deferral of the tax on "employer" contributions to the plan and on earnings derived from contributions.

In self-employed (Keogh) plans, deductible contributions on behalf of self-employed individuals are limited to the lesser of $7,500 or 15 percent of earned income.[2] Pursuant to sec. 401(a)(17), only the first $100,000 of compensation can be considered for this purpose; however, these limitations may be exceeded in the case of a defined benefit self-employed retirement plan.[3] On the other

1. Also see R. Steinman, *Tax Guide for Incorporating a Closely Held Business*, Federal Tax Study 1, rev. ed. (New York: AICPA, 1978), pp.46–53.

2. Self-employed individuals whose adjusted gross incomes do not exceed $15,000 may instead deduct the lesser of (*a*) $750 or (*b*) 100% of their earned income. This minimum-contribution rule applies without regard to the usual 15% limitation under §404(e)(1) or the 25% limitation under §415(c)(1). (See §§404(e)(4) and 415(c)(5).)

3. §401(j).

hand, "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 that they exceed the lesser of $7,500 or 15 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.)

For a corporate profit-sharing or stock-bonus plan, sec. 404(a)(3) generally limits deductible contributions to 15 percent of compensation. Under sec. 404(a)(7) this limitation may be increased to 25 percent of compensation for certain combinations of plans. In the case of a corporate pension plan, deductible contributions are limited to the following:

1. Normal cost plus amortization of past service cost (principal plus interest) in ten equal annual installments.[4]
2. The amount under the "level cost" method.[5]
3. A contribution required by minimum funding standards, if greater than (1) or (2).[6]

There are also limitations on benefits and contributions contained in sec. 415.

As discussed in chapters 11 and 17, distributions from qualified self-employed retirement plans and corporate retirement plans may be subject to ten-year averaging and/or capital gain treatment, as well as rollover privileges that are not available for distributions from IRAs unless the rollover is to another IRA.

Coverage and vesting requirements for self-employed plans are more restrictive than those for corporate plans, including subchapter S corporation plans. For example, self-employed plans

4. §404(a)(1)(A)(iii).

5. The cost resulting from distribution of the remaining unfunded cost of past and current service credits for all covered employees as a level amount or level percent of compensation over the remaining service of each such employee. If 50% of the unfunded cost relates to any 3 individuals, their cost must be distributed evenly over a period of at least 5 years (§404(a)(1)(A)(ii)).

6. §404(a)(1)(A)(i). The maximum deduction cannot exceed the full funding limitation under the minimum funding standards set forth in §412(a). There is an exception for certain collectively bargained plan amendments under a special election provided by §404(a)(1)(B).

must include all full-time employees with at least three years of service and must provide for immediate and full vesting of contributions made on their behalf.[7] All corporate plans can also provide more liberal provisions for employee contributions and the availability of a $5,000 income tax exclusion for lump-sum distributions (see 502).

Self-employed individuals who are not active participants in qualified plans (including self-employed retirement plans) are eligible to establish individual retirement accounts or other individual retirement plans. (These plans are discussed in 2801.) One of the primary disadvantages of such plans is that deductible contributions are limited to the lesser of 15 percent of earned income or $1,500 ($1,750 in the case of spousal IRAs). Also, distributions from such plans are taxable in full as ordinary income without the benefit of ten-year averaging or capital gains. On the other hand, such plans are simpler to administer and do not have to meet the permanency, antidiscrimination, and other requirements of qualified plans.[8] It is not necessary to make contributions on behalf of employees merely because the owner or partner contributes to his own IRA, except in the case of a simplified employee pension.

7. §401(d)(2) and (3). Employees covered by a collective-bargaining agreement (described in §410(b)(2)(A)) can be excluded (§401(d)(3)(B)(i)). "A single conditioned exception is made to this vesting requirement, applicable where there is an early termination of the plan. In that event the Treasury imposes limits on the benefits accruing to certain key persons as a result of the termination, and this vesting requirement will not apply to the extent that it conflicts with those limits and results in discriminatory benefits for such highly paid and other employees. In any case, however, this [particular] vesting requirement does not apply where the plan does not cover any owner-employee. Thus, where a partnership is composed of partners, none of whom owns more than a 10-percent interest, the rules for plans at large would apply . . . ."[Mertens, *Code Commentary* (Chicago: Callaghan & Co.), §401:16, footnotes omitted]

8. See, e.g., regs. §1.401-1(b)(2).

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Specific Expenses

Investors

3001 Investment Interest

The taxpayer should avoid borrowing substantial funds to invest in properties that will not be currently profitable—the resulting interest expense may not be immediately deductible.

Section 163(d) limits the amount of investment interest deductible by an individual in a taxable year to the sum of $10,000 ($5,000 in the case of a married individual filing a separate return) plus investment income and out-of-pocket losses on property subject to a net lease. Net long-term capital gains are not considered investment income for this purpose.

The $10,000 exemption is increased by as much as $15,000 for interest paid on indebtedness incurred by a taxpayer to acquire certain corporate stock or partnership interests. To qualify for this exemption, the taxpayer, his spouse, or his children must own (or acquire) 50 percent or more of the total value of all classes of stock or 50 percent or more of all capital interests in the partnership. The basic $10,000 exemption is increased by the lesser of $15,000 ($7,500 on separate returns of married individuals) or the amount of interest paid or accrued during the taxable year on investment indebtedness related to the acquisition of the corporation or partnership equity interests.

The investment interest limitation applies to indebtedness incurred or continued to purchase or carry property held for investment. (Business property under construction is not considered investment property for this purpose; however, construction-period interest deductions are limited by sec. 189.) Personal or business interest is not subject to these limitations.

Rental property is considered trade or business property, and thus is not subject to the investment interest limitation, unless the property is rented under a net lease arrangement. Accordingly, the taxpayer should consider structuring rental contracts and/or controlling expenses in a manner that will avoid the guarantee prohibition and satisfy the 15 percent test of sec. 163(d)(4)(A).[1] To avoid the difficulties inherent in applying the 15 percent test on a lease-by-lease basis, lessors of real property containing several units subject to separate leases may elect to treat all leased portions of the property as subject to a single lease.[2]

For real property that the taxpayer has both owned and used commercially for more than five years, net lease classification may be avoided if the taxpayer elects to exclude the property from the 15 percent test.[3] Thus, if there is excess investment interest on such property, and if the 15 percent test is not satisfied, the election prevents limitation of the interest deduction.

The 15 percent test and the five-year election do not apply to leases under which the lessor is either guaranteed a specified return or is guaranteed completely or partially against loss of income. These leases are always deemed to be net leases.[4]

In Rev. Rul. 79-136 the IRS took a restrictive view of the circumstances in which it will permit taxpayers to avail themselves of the out-of-pocket loss rule.[5] The taxpayer purchased land for $2 million and leased it under a two-year grazing lease at $7,000 per annum, which was less than half of the annual property taxes. The service reasoned that while sec. 163(d)(4)(A) treats net-leased property as investment property for purposes of the investment interest limitation, that provision only applies to property used in a trade or business. *Johnson* was cited for the principle that nominal rents are inadequate to convert investment property to trade or business property.[6] Therefore, the IRS held that the property could not be considered subject to a net lease under sec. 163(d)(4)(A). Consequently, the taxpayer could not increase his interest deduction for

1. See the discussion of "escalation" clauses (whereby the lessee bears certain rising costs) that may cause the taxpayer to fail the 15% test in *Working With the Revenue Code 1979*, ed. I.F. Diamond and M. Walker (New York: AICPA, 1979), p.44.

2. § 163(d)(6)(A). The procedure for making this election is prescribed by temp. regs. § 12.8, promulgated under § 57(c).

3. § 163(d)(6)(B). The procedure for making this election is also prescribed by temp. regs. § 12.8 under § 57(c).

4. §§ 163(d)(4)(A)(ii) and (6)(B). Also see S.R. Josephs, S.A. Tuller, and M. Greenburg, "The Excess Investment Interest Limitation: How It Works and How to Plan to Avoid It," *Journal of Taxation* 39 (October 1973): 216.

5. Rev. Rul. 79-136, 1979-18 I.R.B. 10.

6. *Johnson*, 19 T.C. 93 (1952), acq. 1953-1 C.B. 5.

out-of-pocket losses. From a planning standpoint, taxpayers should attempt to rent property for more than a nominal rent, if possible, in order to avoid the impact of Rev. Rul. 79-136.

While it is often advantageous to avoid net lease classification, it may also be advantageous to have property classified as net lease property if it produces net investment income that may permit interest attributable to other investments to be deductible currently.

The alternative minimum tax is calculated by adding back excess itemized deductions (see chapter 1); thus, a client who avoids these limitations and deducts significant interest may nevertheless be subject to the alternative minimum tax.

Any interest disallowed by sec. 163(d) may be carried over indefinitely to future years.[7] Thus, this carryover can continue through the individual's existence.[8]

The Tax Reform Act of 1976 significantly altered the investment interest limitations. While these rules are generally applicable to years beginning after 1975, interest from pre-1976 indebtedness is subject to sec. 163(d) as in effect prior to amendment by the Tax Reform Act of 1976.[9] Thus, carryovers of pre-1976 interest continue to be deductible under prior law.[10]

3001.1 Definitions

Net investment income is, simply, investment income less investment expense. *Investment income* consists of income, derived outside the conduct of a trade or business, from interest, dividends, rents, royalties, short-term capital gains on investment property, and ordinary gains resulting from recapture of deprecia-

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7. However, the IRS national office has issued a technical advice memorandum barring a carryforward of disallowed investment interest that merely increased negative taxable income. See I.R.S. Ltr. Rul. 7935002.

8. § 163(d)(2).

9. § 209(b)(2) of the Tax Reform Act of 1976 applies the pre-1976 investment interest limitations to "indebtedness attributable to a specific item of property which (A) is for a specified term, and (B) was incurred before September 11, 1975, or is incurred after September 10, 1975, pursuant to a written contract or commitment which on September 11, 1975, and at all times thereafter before the incurring of such indebtedness, is binding on the taxpayer. . . ." Also see J.D. Bierman and I. Stechel, "New Investment-Interest Rules Restrict Deductions and Pose Definitional Problems," *Journal of Taxation* 46 (April 1977): 242.

10. U.S., Congress, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976*, 94th Cong., 2d sess., 1976, p. 104.

tion. Rents derived from a net lease are considered investment income. A *net lease* exists (1) if business expenses (defined as the usual operating expenses, except for interest, taxes, depreciation, rent, and reimbursed expenses) are less than 15 percent of the property's rental income or (2) if the lessor is either guaranteed a specific return or guaranteed completely or partly against loss of income.

Investment expenses consist of property taxes, bad debts, depreciation, amortizable bond premiums, depletion, and other expenses for the production of income. 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 under the straight-line method, and cost depletion can be used.

3002 Personal Use of Rental Property

Because of the limitations on deductions for property used for personal and rental purposes, the taxpayer should curtail his personal use of rental property.

The owner of a rental property that is also used for personal purposes (for example, a vacation home) deducts real estate taxes, mortgage interest, and certain other items, regardless of the extent of personal use. If the property is held exclusively for rental purposes, other expenses, such as maintenance costs and depreciation, are also deductible, subject to the not-for-profit provisions of sec. 183. If the property is also used personally by the owner or his family, however, the deductibility of such expenses is subject to the statutory limitations of sec. 280A.

If the dwelling unit is used as a residence and rented for less than fifteen days during the taxable year, sec. 280A(g) precludes the deduction of maintenance, depreciation, and similar rental expenses. In that case, though, rental income is also not recognized for tax purposes.

If rental use exceeds fourteen days during the taxable year and personal use exceeds the greater of fourteen days or 10 percent of the number of days during the taxable year that the dwelling unit is rented, the limitations of sec. 280A apply. Section 280A(c)(5) imposes a ceiling on maintenance, depreciation, and similar rental expenses equal to the rental income for the taxable year less the deductions allocable to rental use that would be allowable absent such rental use, such as property taxes and mortgage interest. Such deductions are further limited under sec. 280A(e)(1) by the ratio of the number of days the unit is rented at a fair rental to the total days of use.

Example The taxpayer owns a mountain cabin that he rents for sixty days and lives in for thirty days. Rental income for the sixty days is $2,800. The total expenses for the cabin are as follows.

Interest	$1,500
Taxes	900
Utilities	750
Maintenance	300
Depreciation	1,200

Gross rental income		$2,800
Less		
Interest allocable to rents ($1,500 × 2/3)	$1,000	
Taxes allocable to rents ($900 × 2/3)	600	(1,600)
Sec. 280A(c)(5) limitation		1,200
Less		
Allocable portion of utilities ($750 × 2/3)	500	
Allocable portion of maintenance ($300 × 2/3)	200	(700)
Operating income		500
Less depreciation limited to allocable portion ($1,200 × 2/3 = $800) or $500, if less		(500)
Net rental income		$ 0

The interest ($500) and taxes ($300) allocable to personal use of the cabin are deductible as itemized deductions.[11]

These limitations may not apply in a year in which a principal residence is converted to rental property (see 2502).

3002.1 Definitions

Dwelling Unit Section 280A uses the term "dwelling unit," which may include a vacation home as well as a principal residence.[12] A dwelling unit includes a house, apartment, condominium, mobile

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11. This example is based on *Your Federal Income Tax*, I.R.S. Publication 17, 1979 ed., p.42.

12. See *Working With the Revenue Code 1979*, p.93.

home, boat, and similar property, but does not include a unit used exclusively as a hotel, motel, or similar establishment (sec. 280A(f)(1)).

Personal Use A taxpayer generally is deemed to use a dwelling unit for personal purposes for a day if, for any part of the day, the following occurs:

The unit is used for personal purposes by:
1. The taxpayer or any other person who owns an interest in the home;
2. Their brothers and sisters, spouses, ancestors or lineal descendants;
3. Any individual who uses the unit under a reciprocal arrangement (whether or not a fair rental is charged); or
4. Any other individual who uses the dwelling unit during a day unless for that day the unit is rented for a fair rental. . . .[13]

Nonresidence Use

You are not considered to use the dwelling unit as a residence if you use it for personal purposes *no more than* the greater of 14 days or 10% of the number of days it is rented at a fair rental. If you do not use the property as a residence, *and the facts show that the rental use is an activity engaged in for profit,* you report the rental income and all expenses allocable to rental use on Schedule E (Form 1040). The allocation of the expenses is based on the number of days the unit is rented at a fair rental as compared to the total number of days that the unit is used during the year. *Your deductible expenses are not limited to the gross rental income from the property.* However, interest, taxes, and casualty losses allocable to personal use of the property are deductible on Schedule A (Form 1040) if you itemize deductions.

Example You own a summer home and used it for 10 days during the year. You rented the home at a fair rental for 110 days during the year. Your rental income is $5,400. Your total expenses are as follows:

Interest	$1,800
Taxes	1,200
Operating expenses	2,400
Depreciation	1,500

13. *General Explanation of the Tax Reform Act of 1976*, p.145, which explains I.R.C. §280A(d)(2).

Since you used the summer home less than 14 days, you did not use the home as a residence. However, you must allocate the total expenses between the rental use and the personal use of the home. You determine that you must allocate 11/12 (110 days rental use ÷ 120 days total use) of the total expenses to the rental use of the property. Your rental income and expenses are computed as follows.

Gross rental income		$5,400
Less		
1. Allocable portion of interest ($1,800 × 11/12)	$1,650	
2. Allocable portion of taxes ($1,200 × 11/12)	1,100	
3. Allocable portion of operating expenses ($2,400 × 11/12)	2,200	
4. Allocable portion of depreciation ($1,500 × 11/12)	1,375	6,325
Net rental loss		($ 925)

You must report your gross rental income, allocable rental expenses, and net rental loss on Schedule E (Form 1040). The interest ($150) and taxes ($100) allocable to your personal use of the summer home are deductible on Schedule A (Form 1040) if you itemize deductions. . . .[14]

3003 Other Investor Expenses and Losses

3003.1 Deductibility of Investment Expenses

The tax planner should not overlook the deduction of any expense that is reasonable in amount and that 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.

The Supreme Court has consistently held that an investor's activities cannot constitute a trade or business.[15] By virtue of sec. 212, expenses for the production of income (otherwise known as nontrade or nonbusiness expenses) are allowable as itemized deductions.

14. *Your Federal Income Tax*, p.42; emphasis supplied.
15. See, e.g., *A.J. Whipple*, 373 U.S. 193 (Ct. D. 1882, 1963-2 C.B. 641).

An exception exists for deductions attributable to property held for the production of rents or royalties that are deductible from gross income instead of from adjusted gross income.[16] (For the generally favorable consequences of such treatment, see 2803.)

> 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)]

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 investor expenses are deductible against ordinary income:

- State and local transfer (stamp) taxes and state excise taxes.[17]
- Investment counsel.
- Financial periodicals.
- Safe deposit box rentals.
- Collection charges.
- Office rent.
- Compensation of secretaries, and so forth.
- Custodial, agency, or trustee fees.
- Ordinary and necessary travel expenses (see 2804). However, Rev. Rul. 56-511 holds that transportation and other incidental expenses of attending stockholders' meetings are not sufficiently related to investment activities to warrant deduction under sec. 212.[18]
- Statistical services.

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16. § 62(5).
17. § 164(a).
18. Rev. Rul. 56-511, 1956-2 C.B. 170.

Commissions on the purchase of securities (which increase cost basis) and commissions on sales of securities (which reduce selling prices) are deductible against capital gains or additions to capital losses.[19]

3003.2 Allocation of Expenses to Exempt Income

If exempt income is involved, the tax planner should study all facts and circumstances to determine a reasonable allocation.

Under sec. 265(1) investor expenses directly allocable to exempt income, including municipal interest, are not deductible. Furthermore, a reasonable proportion of expenses indirectly allocable to both exempt and nonexempt income must be allocated to both categories of income "in the light of all facts and circumstances in each case."[20]

In an early Tax Court decision, an investor's indirect expenses were allocated in proportion to the relationship of exempt and nonexempt income to total combined income, as in figure 30-1.[21]

Figure 30-1

Line	Amount	Percent of 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

Revenue Ruling 73-565 holds that in an allocation based on the relationship between exempt and nonexempt income, it is acceptable to include capital gains in full as nonexempt income and to disregard capital losses.[22]

19. Included in this category were federal transfer (documentary stamp) taxes imposed by chap.34, subtitle D, of the 1954 code prior to its repeal by the Excise Tax Reduction Act of 1965 (Pub. L. 89-44).

20. Regs. § 1.265-1(c).

21. *Edward Mallinckrodt, Jr.*, 2 T.C. 1128 (1943), acq. 1944 C.B. 18, aff'd on other grounds.

22. Rev. Rul. 73-565, 1973-2 C.B. 90.

Although *Mallinckrodt* has been followed in subsequent decisions, Rev. Rul. 63-27 holds that its income allocation formula is not mandatory.[23] Other methods of allocation are found in *John E. Leslie,* where the IRS determined nondeductible interest expense under sec. 265(2) according to the following computation (which was roughly based on the value of exempt and nonexempt assets owned by a stock brokerage firm).[24]

$$\text{Total interest expense} \times \frac{\text{Average monthly value of tax-exempt securities}}{\text{Average monthly value of total assets}}$$

In *Louis M. Alt,* in the absence of a fee computed on the basis of time spent or services rendered, the court upheld an IRS computation of a deductible bank management fee based on the percentage of the value of non-tax-exempt securities to the value of all securities.[25]

This asset formula could be detrimental. When a client has indirect expenses allocable to exempt income (whether or not the income is received), the tax planner should make a careful study of all pertinent facts and circumstances in order to arrive at an allocation formula that will be reasonable from both the government's and the client's viewpoints.[26] Such a review should especially include classification of all investor expenses into the following categories:

- Directly allocable to exempt income (not deductible).
- Indirectly allocable to both exempt and nonexempt income (subject to allocation by formula).
- Directly allocable to nonexempt income (completely deductible as itemized deductions if otherwise allowable).

The *Leslie* asset formula 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

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23. Rev. Rul. 63-27, 1963-1 C.B. 57.

24. *Leslie*, 413 F.2d 636 (2d Cir. 1969), rev'g 50 T.C. 11 (1968), cert. den. IRS guidelines with respect to §265(2) are set forth in Rev. Proc. 72-18, 1972-1 C.B. 740, as clarified by Rev. Proc. 74-8, 1974-1 C.B. 419. §7.02 of Rev. Proc. 72-18 provides a formula for the disallowance of interest based on the average amount during the taxable year of the taxpayer's tax-exempt obligations (valued at their adjusted basis) in relation to total assets (valued at their adjusted basis), less indebtedness, whose interest is not subject to disallowance under the revenue procedure.

25. *Alt*, T.C.M. 1969-292.

26. Regs. §1.265-1(b)(1).

the form of capital gains upon disposition. Thus, an income formula is more advantageous if capital gains on otherwise tax-exempt securities can be included as nonexempt income in determination of the allocation ratio. In *Whittemore* the Eighth Circuit Court of Appeals adopted this approach in regard to capital gains on municipal bonds and rejected the government's advocacy of a similar asset formula.[27]

A taxpayer must submit a detailed allocation statement with his return and must include a recitation that each deduction claimed in the return is in no way attributable to exempt income.[28]

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.[29]

3003.3 Ordinary Rather Than Capital Losses

If it is feasible and desirable to do so, the tax planner should seek conditions for obtaining ordinary losses rather than capital losses.

Losses from sales or exchanges of capital assets are subject to the relatively unfavorable treatment described in chapter 14.

In addition to losses arising from actual sales or exchanges, the Internal Revenue Code places losses stemming from the following events in the capital loss category:

- Worthlessness of securities that are capital assets (sec. 165(g)). (Regulations section 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.
- Worthlessness of nonbusiness debts that are treated as short-term capital losses (sec. 166(d)). (Regulations section 1.166-5(a)(2) requires such debts to be *totally* worthless before such losses can be recognized.)

27. *Clinton L. Whittemore, Jr.*, 383 F.2d 824 (8th Cir. 1967). See also Rev. Rul. 73-565, 1973-2 C.B. 90; disting. by Rev. Rul. 77-355, 1977-2 C.B. 82, relating to a simple trust not distributing capital gains.

28. Regs. § 1.265-1(d)(1).

29. Rev. Rul. 61-86, 1961-1 C.B. 41. Also see § 265(1) for the precise terminology responsible for these distinctions.

Under the Supreme Court's *Whipple* decision, investors, as such, are precluded from designating funds advanced by them as business debts.[30] Hence, they cannot claim ordinary deductions if and when such advances become totally worthless, but must resign themselves to capital loss treatment upon that eventuality.

There are two statutory provisions that convert capital losses into ordinary losses under limited circumstances:

- Losses on small business stock (sec. 1244).
- Losses on small business investment company stock (sec. 1242).

A taxpayer might consider investments in these stocks if (*a*) the tax requirements can be met and (*b*) these stocks are attractive from an investment standpoint.

30. See also *Generes*, 405 U.S. 93 (1972).

Further Lifetime Advance Planning

- ☐ Income Taxes
- ☐ Estate and Gift Taxes

31

Income Taxes

Charitable Contributions

The modern-day debate regarding use of the tax structure to attain social objectives is certainly not a purely contemporary phenomenon. In fact, such concepts may have originated with the passage of the Revenue Act of 1917, which, for the first time, permitted deductions 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 in any way disparaging the humanitarian goal served by such legislation, which has been continued in expanded form as part of every subsequent tax statute, a tax planning study must confront the variety of ways and means of effectuating these gifts, whose tax consequences warrant prudent consideration.

Itemized deductions in excess of 60 percent adjusted gross income may subject the taxpayer to the alternative minimum tax. Large charitable contributions should be timed to avoid or minimize the alternative minimum tax.

3101 Lifetime vs. Testamentary Gifts

Lifetime gifts can provide income tax as well as estate tax savings. If such gifts are incomplete for estate tax purposes, additional estate tax savings may be possible through an increased marital deduction.

Lifetime gifts, as opposed to testamentary gifts, can generate current income tax deductions and accelerate the financial benefit obtained by the charity. On the negative side, the donor must

1. U.S., Congress, Conference Committee, 65th Cong., 1st sess., 1917, H.Rep. 172, found in 1939-1 C.B. (part 2), 72.

make an irrevocable decision that will permanently remove property from his dominion and enjoyment.

Both lifetime and testamentary gifts enable the donor to exclude property from his taxable estate. Naturally, any unconsumed income tax savings resulting from lifetime gifts may be subject to estate tax upon the donor's death.

3101.1 Effect of Charitable Gifts on the Estate Tax Marital Deduction

The maximum marital deduction cannot exceed the greater of \$250,000 or 50 percent of the adjusted gross estate, which is the gross estate reduced by funeral expenses, administrative expenses, debts, and certain losses. 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 may be reduced by diminution of the gross estate and, conversely, may be increased by additions thereto. Thus, a lifetime charitable contribution may reduce the maximum marital deduction because it depletes the gross estate. If the donor can make these contributions 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:

- Current income tax deductions will continue to be available.
- The contribution will be added back to the gross estate, increasing the base for computing the maximum marital deduction.
- The same contribution will be deductible in determining the taxable estate, exactly offsetting the addition to the gross estate.
- The net effect may be a reduction of the taxable estate equal to 50 percent of the charitable contribution (which is added back to the gross estate in those situations in which the maximum marital deduction is desired and is based on the size of the adjusted gross estate).

Example Client's gross assets total \$1,600,000. He wishes to contribute $500,000 to charity during his lifetime and also to obtain the maximum marital deduction for bequests to his wife upon his death. His taxable estate would be computed as shown in figure 31-1.

Figure 31-1

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	—
Taxable estate	$ 500,000

Client should make charitable contributions with certain strings attached or under such conditions that they must be added back to the gross estate. This procedure will achieve the estate tax savings shown in figure 31-2.

Figure 31-2

Gross estate	$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
Total	1,250,000
Taxable estate, revised	$ 250,000

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.

Estate taxes at the death of the first spouse can be reduced if the maximum marital deduction based on the adjusted gross estate is available and if the gross estate is increased by assets that have been given or bequeathed to charitable organizations.

For example, it may be advisable, if the maximum marital deduction based on the adjusted gross estate 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 901.5.)

Since there is no complete correlation between these estate tax sections and the income tax sections, such predeath transfers are usually deductible for income tax purposes.[2]

This planning technique depends on 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, under sec. 2013, for estate tax credit in her estate. 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%	3d or 4th
40%	5th or 6th
60%	7th or 8th
80%	9th or 10th

Thus, this credit has limited application and cannot be relied on, in any event, for planning purposes.

3101.2 Revocable Transfers

A revocable transfer is a gift, usually in trust, that is considered incomplete for estate tax purposes. 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*

2. The tax planner can use the following estate tax provisions to add charitable gifts to the gross estate: §2035 (gifts within 3 years of the taxpayer's death), §2036 (transfers with retained life estate), §2038 (revocable transfers), §2040 (joint interests), and §2042 (life insurance proceeds).

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. Section 2038, however, 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 distributable shares.

Regulations section 1.170A-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 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 can be used to obtain the following advantages:

- A current income tax deduction for the full value of the transferred property.
- A possible additional estate tax deduction due to a greater marital deduction (equal to 50 percent of the property's estate tax valuation).

Example In 1980 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 are 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 1980 income tax return (subject to the limitation of 20 percent of adjusted gross income—contributions to the trust, in this example, do not qualify for the 50 percent limitation and the five-year carryover, since a substantial part of its support is not normally received through direct or indirect contributions from the general public).

Client dies in 1985. The value of the trust's assets is included in his estate, because of the powers that he had reserved, as shown in figure 31-3.

Figure 31-3

Trust (market value of investments in 1985)		$ 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	650,000
Taxable estate		$ 350,000

If Client had made an outright contribution in 1980, 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
Taxable estate	$ 425,000

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 that is still retained by the donee. (Presumably, all of the original property was included in the estate.)[3]

3101.3 Transfers With Retained Life Estate

Section 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 may increase the maximum allowable marital deduction.[4]

3. *L.H. Howard, Ex'r*, 125 F.2d 986 (5th Cir. 1942).

4. The IRS ruled that property included in the gross estate under § 2036 qualified for the estate tax charitable contribution deduction under § 2055 and increased the maximum marital deduction under § 2056 (Rev. Rul. 72-552, 1972-2 C.B. 525). See also I.R.S. Ltr. Rul. 7844041.

Various requirements must be met in order to obtain income, estate, and gift tax deductions for a gift of a remainder interest to charity.

3101.4 Joint Interests

Section 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. . . ."

Example In 1980 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 1980 income tax return. At his death, 100 percent of the property's value at that time is included in his gross estate, with a possible resulting increase in the maximum marital deduction allowable. The entire value of the property is then deductible, as follows:

- 50 percent portion representing the interest given to the university in 1980.
- 50 percent portion representing the balance of the property that automatically passes to the university, as surviving joint tenant, upon Client's death.

3101.5 Transactions Within Three Years of Death

Section 2035 generally requires all gifts made within three years prior to a taxpayer's death to be included in the gross estate, whether or not the gifts were made in contemplation of death. The Tax Court has confirmed that deathbed charitable gifts brought back into the estate under sec. 2035 increase the estate tax marital deduction and qualify for the estate tax charitable deduction, despite the fact that the individual also reaps an income tax benefit from the gifts.[5] The Tax Court described the result as a possible "loophole," but one that would require legislation to change.

The Revenue Act of 1978 amended sec. 2035 to exclude gifts within three years of death from the gross estate if they are subject to the $3,000 annual exclusion—but to include gifts that are required to be shown on a gift tax return.[6] Charitable gifts are subject to the $3,000 annual exclusion—but otherwise must be

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5. *Est. of Thomas C. Russell*, 70 T.C. 6 (1978), acq. 1979-8 I.R.B. 6.

6. This exception does not apply to any transfer with respect to a life insurance policy (§2035(b)).

reported on a gift tax return, even though there is no taxable gift, as a result of the gift tax deduction for charitable gifts pursuant to sec. 2522.[7]

It may be desirable to make charitable contributions in excess of $3,000, so that they will be included in the gross estate if death occurs within the following three years.

Example An individual made $3,000 worth of charitable contributions to a single donee in December 1980 and 1981. The individual died in January 1982. His adjusted gross estate is $1 million, and the maximum marital deduction is $500,000. If the individual had instead donated $6,000 in either 1980 or 1981, his adjusted gross estate would be increased by $6,000 but offset by a $6,000 charitable deduction; however, the maximum marital deduction would also be increased by $3,000, thus reducing his taxable estate.

Consequently, an individual should consider making large gifts to an organization such as the United Way rather than making gifts of $3,000 or less directly to a number of separate charities.

3101.6 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. Income tax deductions are denied, however, if the reservation of an interest in the policy causes the contribution to be treated as a contribution of less than the taxpayer's entire interest in the property under sec. 170(f)(3)(A) and regs. sec. 1.170A-7.[8]

The IRS has ruled that an irrevocable assignment of the cash surrender value of a life insurance policy to a college was nondeductible for both income tax and gift tax purposes because the taxpayer retained the right to designate the beneficiary and assign

7. See gift tax return, Form 709, and related instructions. Also see §6019(b) for special deferred reporting of charitable transfers deductible under §2522.

8. See S.S. Weithorn, *Tax Techniques for Foundations and Other Exempt Organizations* (New York: Matthew Bender, 1964), §69.03; E.S. Schlesinger, "Charitable Transfers of Life Insurance," *Estate Planning Selections From the Tax Adviser* (New York: AICPA, 1973), selection 27. See also T.L. Geer, "Charitable Contributions of Employee Life Insurance," *Estates, Gifts and Trusts Journal* (November-December 1978): 28.

the balance of the policy, subject to the college's right to the cash surrender value.[9]

This may be distinguishable from the situation in which the taxpayer merely retains the right to allocate among different charitable beneficiaries. The service has permitted charitable contribution deductions under sec. 170 to charitable remainder trusts in cases in which the donor retained the right to substitute charitable organizations.[10]

Weithorn states the following:

> If an attempt is made to utilize this technique (gifts of life insurance with strings to gain a current charitable deduction and increase the maximum estate tax marital deduction), it is suggested that the incident of ownership retained be one which could have no economic impact on the taxpayer, e.g., the right to name the charitable donees, the right to allocate among named charitable donees, the right to accelerate the date on which charitable donees may take, etc. See, in this connection, Rev. Rul. 72-552, 1972-2 CB 525.[11]

If the taxpayer wants to be assured of the tax consequences of such a gift, it may be appropriate to request a private ruling with respect to such a proposed plan.

Life Insurance Charitable Trusts

An individual 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:[12]

- To designate and change particular charitable recipients and their proportionate shares.
- To surrender policy.
- To reinvest proceeds. (Presumably, indenture would require proceeds either to be paid to charity or to be applied for the benefit thereof.)
- To accumulate or distribute income and corpus.

The transfer of the policy to the trust and the individual's later payments of premiums may qualify for income tax charitable de-

9. Rev. Rul. 76-143, 1976-1 C.B. 63; Rev. Rul. 76-200, 1976-1 C.B. 308.

10. Rev. Rul. 76-8, 1976-1 C.B. 179; I.R.S. Ltr. Rul. 7928014.

11. See Weithorn, *Tax Techniques for Foundations*, §69.18, nn. 4 and 8, herein.

12. But see *Thomas L. Awrey*, 25 T.C. 643 (1955), in which the charity received no more than a nondeductible "expectancy" with respect to the insurance arrangement.

ductions, despite his reservation of powers.[13] The risk of losing the income tax deduction increases as the taxpayer retains more powers, and he should consider requesting a ruling on the income and gift tax consequences of such a gift.

The taxpayer's reserved powers should cause the trust to be included in his gross estate, in accordance with any of the following three theories:

- Retention of an incident of ownership over the policy.[14]
- Retention of the power to alter, amend, or terminate.[15]
- Retention of the lifetime right to designate who will possess or enjoy the income or corpus.[16]

The *Winthrop* opinion casts some doubt on this procedure, stating that "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 class of charitable beneficiaries."[17] The opinion 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. 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.

Charitable Remainder Trusts

The possible use of charitable remainder trusts funded with life insurance to gain both current charitable contribution deductions and a greater estate tax marital deduction may be illustrated by IRS Letter Ruling 7928014. This private ruling dealt with a taxpayer who funded a charitable remainder unitrust with a permanent insurance policy on his life. The policy was then owned by an independent trustee, and premium payments were made directly by the donor to the insurance company. The trust was to pay annually to the donor's wife, as income beneficiary, for her lifetime the "lesser of the trust income for such taxable year or 5 percent of

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13. See §170(f)(2)(D), regs. §1.170A-6(a)(1), I.R.S. Ltr. Rul. 7928014, and Rev. Rul. 76-8, 1976-1 C.B. 179.

14. Regs. §20.2042-1(c).

15. §2038; *Lober*, 346 U.S. 335 (1953).

16. §2036; *Struthers v. Kelm*, 218 F.2d 810 (8th Cir. 1955). See also Rev. Rul. 72-552 and Ltr. Rul. 7844041.

17. *Winthrop v. Meisels*, 281 F.2d 694 (2d Cir. 1960).

the net fair market value of the trust assets valued as of the first day of such taxable year." The taxpayer reserved the right to revoke the wife's interest by will and the right to designate an alternate charity to the one named, but otherwise he waived the right to change the beneficiary.[18] The ruling held that the taxpayer could deduct each premium payment to the extent of the attributable charitable remainder interest, using table E(2) of regs. sec. 1.664-4(b)(5).

Although the ruling does not address the estate tax consequences of such a trust, it would appear that the insurance would be includible in the donor's estate, thus increasing the maximum marital deduction, with a full or partial offset by the estate tax charitable deduction, depending on whether the charity received a remainder interest or the entire proceeds at the donor's death.[19]

3102 Outright Gifts

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 the taxpayer's consideration of (1) appreciation versus decline in value of potential gift property, (2) the consequences of giving capital assets versus ordinary income assets, and (3) bargain sales to recover donor's cost.

3102.1 Appreciated vs. Declined-in-Value Property

A contribution of appreciated property enables the client to benefit financially from the appreciation in value without having to pay any tax (at capital gain rates) on the increment. This admirable result is caused by the following authorized treatment:

- The full fair market value of donated property usually is taken into account in determining the amount of deductible charitable contributions.
- A gift of property, whether charitable or otherwise, is not a taxable event giving rise to recognized gain or loss.

By the same token, property that has declined in value should not be contributed to charity. Instead, the donor should first sell

18. See regs. § 1.664-3(a)(4) and Rev. Rul. 76-8, 1976-1 C.B. 179.

19. See Shelmerdine, 261 *Tax Management, Estate Tax Charitable Deduction*, p.A-5 and Cum. Supp.

the property in order to recognize the loss (usually a capital loss) for income tax purposes. The cash proceeds realized from the sale can then be contributed to charity. This procedure does not diminish the amount of the charitable contribution deduction, since the cash donated equals the property's fair market value.

3102.2 Capital Gain vs. Ordinary Income Assets

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 (that is, unrealized or potential ordinary gain). Consequently, a donor can only deduct the cost or other basis of donated ordinary income property, which includes such assets as the following:

- Short-term capital assets.
- Inventory.
- Works of art created by the donor.
- Letters, memoranda, and so on, prepared by the donor or for the donor.[20]
- Section 306 stock (briefly described in 1302.2).

The service recently held that a taxpayer raising ornamental plants as a hobby and donating large quantities to charities each year was engaged in activities "substantially equivalent" to those of a dealer, so the plants had to be considered ordinary income property.[21] It reached the same conclusion with respect to a taxpayer, not an art dealer, who purchased a substantial part of a limited edition of a lithographic print and then donated the prints to museums.[22] Consequently, it may be advisable to make gifts of various types of property, rather than many gifts of a particular type of asset, to blunt an IRS challenge on dealer status.

If contributed property would produce both ordinary and capital gain if sold instead of donated, the contribution deduction is reduced by only the ordinary income portion of the hypothetical

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20. See § 1221(3).

21. Rev. Rul. 79-256, 1979-35 I.R.B. 5, which warned that the IRS position regarding "dealer" status does not imply that the taxpayer is in a trade or business for other code section purposes. Cf. Rev. Ruls. 80-69, 1980-11 I.R.B. 5, and 80-233, 1980-35 I.R.B. 6.

22. *Ibid.* In December 1979 the IRS further attacked art tax shelters through Rev. Ruls. 79-419, 1979-52 I.R.B. 95, and 79-432, 1979-53 I.R.B. 20.

gain. 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. Such mixed results (ordinary and capital gain) are caused by various statutory recapture provisions, and they pertain to such property as depreciable personal and real property.

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 40 percent of the potential long-term capital gain (as shown in figure 31-4). This reduction is comparable to recognition of the appreciation as a long-term capital gain.

Figure 31-4

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 40%)	360
6. Amount of deductible contribution (subject to overall limitations)	$ 640

No such reduction is required for appreciated capital assets donated to the following three types of private foundations:

- Distributing foundations
- Operating foundations
- Community foundations

On the other hand, contribution deductions for certain kinds of capital gain property are reduced, regardless of the type of donee involved, under prescribed circumstances.

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 40 percent of the potential gain if the property is contributed to any charity, public or private, and 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 usually affects contributions that the charity resells, as shown in figure 31-5.

Figure 31-5

Type of property	Donee	Donee's use	Reduced contribution 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

Note Based on *Congressional Record,* 12/23/69, p. H13038. Also see regs. sec. 1.170A-4(b)(3)(i).

Evaluation and Summary

The full fair market value of appreciated capital gain property can be deducted, without any recognition of income, if it is contributed to public charities or qualifying private foundations. This favorable treatment applies to intangible property (such as securities), real property (land), and tangible personal property used by the donee in a manner related to its exempt purpose.

On the other hand, the donor can deduct only 60 percent of the appreciation (plus cost or other basis) for any capital asset given to nonqualifying private foundations or for tangible personal capital gain property used by any donee in an unrelated manner.

Finally, the donor cannot deduct any appreciation to the extent that the property would yield ordinary income if it were sold instead of contributed. 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 on adjusted gross income, which are considered in 3105.

3102.3 Bargain Sales to Recover Donor's Cost

A bargain sale at cost is a variation of the contribution-in-kind technique.[23] 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 on the fair market value of each portion. Therefore, a bargain sale of appreciated property cannot be made without recognizing gain.

The taxpayer can still obtain a contribution deduction for the part of the property given to charity. The deduction is based on the property's appreciation only—not its entire fair market value. The deduction is also subject to the same reduction applicable to outright gifts of appreciated property.

In figure 31-6, below, the contribution taken into account is $4,000, which is equal to the property's appreciation.

Figure 31-6

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		

*The 60% capital gain deduction is a tax preference for alternative minimum tax purposes.

23. Charitable contributions of appreciated, mortgaged realty also trigger gain under the bargain sale rule. See *Working With the Revenue Code 1979*, ed. I.F. Diamond and M. Walker (New York: AICPA, 1979), p.68. See also Rev. Rul 79-326, 1979-42 I.R.B. 14, dealing with an installment sale of mortgaged property to a charity at a bargain price.

If, instead, the property is sold to a nonoperating or nondistributing private foundation, the contribution deduction would be reduced by $640, which is 40 percent of the $1,600 hypothetical gain ($4,000 less $2,400) allocated to the portion given.[24]

This allocation only applies if a contribution deduction results from a bargain sale.[25] Thus, a bargain sale of ordinary income property (for example, 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 for the same price two months later, when its fair market value is $15,000, does not generate any gain or deductions. The bargain sale provisions do not apply if a taxpayer reaps no charitable deduction because of the percentage limitations of sec. 170(b), unless the bargain sale gives rise to a contribution carryover, even though no deduction may be allowable in the subsequent years.[26]

Gift Annuities

In some circumstances, the donor may be able to arrange to receive an annuity from the charity.

> The advantages of a gift annuity on the donor's side are the immediate charitable deduction, the assurance of life income for himself or his beneficiary (a substantial portion of which is tax free), and in some cases, the opportunity to obtain these benefits without immediately having to recognize a large capital gain. . . .[27]

3102.4 Other Planning Considerations

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.

Determination of Value for Gift and Estate Tax Purposes

Gifts of closely held corporate stock may cause the stock to be valued by the IRS upon examination (or by the courts upon dispute). Such official determinations may be of precedental value for

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24. Regs. § 1.170A-4(c)(2)(i) and (d), example (8).
25. § 1011(b).
26. Regs. § 1.1011-2(a)(1) and (2).
27. J.G. Tidd, "Gift Annuities: How to Use Them Effectively to Obtain Income and Estate Tax Advantages," *Journal of Taxation* 49 (August 1978): 74.

gift and estate tax purposes and for estate planning. (For further discussion, see 3604.)

3102.5 Definitions of Certain Types of Foundations

Deductions for contributions of appreciated capital gain property to private foundations are reduced unless the foundation falls within one of the following three categories:

- Distributing foundations
- Operating foundations
- Community foundations

Distributing Foundation

A distributing foundation distributes to public charities or private operating foundations, within 2½ months after the end of the year in which contributions are received, an amount out of its corpus equal to 100 percent of the contributions. The donor must obtain sufficient evidence of such distributions from the foundation (sec. 170(b)(1)(D)(ii)).

Operating Foundation

A foundation that spends substantially all (at least 85 percent) of its income directly for the active conduct of activities representing the purpose or function for which it is organized and operated is an operating foundation. It must also meet *any one* of the following tests.

Asset Alternative Test Substantially more than 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).[28]

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 on a 3.33 percent rate of

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28. U.S., Congress, Senate, 91st Cong., 1st sess., 1969, S.Rep. 552, p.61, explaining §4942(j)(3).

return, must be no more than adequate to meet its current operating expenses. (This 3.33 percent rate will always be two thirds of the 5 percent minimum payout requirement necessary to avoid the 15 percent excise tax for failure to distribute income that is imposed on certain private foundations.) This alternative test is intended to apply to foundations that actively conduct charitable activities, as distinguished from merely making grants, and whose personal services are so great in relation to charitable assets that the cost of those services cannot be met out of small endowments. Examples of such foundations include research organizations, Sleepy Hollow Restoration, and Longwood Gardens.[29]

Support Alternative Test All the following conditions must be met for the support alternative test:

- Substantially all support (at least 85 percent), except gross investment income, is received from the general public and from five or more exempt organizations that 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 half of the foundation's total support is derived from gross investment income.

This support alternative test is intended primarily for special-purpose foundations, such as learned societies, library associations, and organizations that provide for the independent grant of funds and direction of research in certain specialized substantive areas.[30]

Community Foundation

A foundation that pools all contributions into a common fund but permits the donor to designate the ultimate recipients from among public charities is a community foundation. All income from the common fund must be distributed to the recipients within two-and-one-half months after the end of the year in which it was realized; and all corpus attributable to any donor's contribution likewise must be 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.[31]

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29. *Ibid.*
30. *Ibid.*
31. § 170(b)(1)(D)(iii).

3103 Gifts of Partial Interests

Under prescribed conditions, a donor can obtain contribution deductions without relinquishing all interest in the gift property. If a donor does not wish to surrender all rights and benefits emanating from his property, he may find gifts of either partial or limited interests desirable—depending on his overall economic and tax situation.

Generally, no deductions are allowable if a taxpayer gives less than an entire interest in property 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 a nondeductible gift of a partial property interest.[32]

No income (for example, rent) is imputed for the value of such rights.[33]

There are significant exceptions to this general rule, which make some gifts of partial interests attractive when 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:

- Remainder interests in personal residences (including vacation homes) or farms.[34]
- Outright gifts of undivided interests. A gift of an open space easement in gross in perpetuity is considered a gift of an undivided interest in property.[35]
- Leases, options to purchase, and easements, regarding real property granted in perpetuity prior to June 14, 1981, exclusively for conservation purposes (as defined in sec. 170(f)(3)(C)). It has been suggested that conservation easements may be advantageously combined with noncharitable gifts:

> In coastal areas or where the easement creates a park, the long-term effect will probably increase the value for the donor's noncharitable beneficiaries, since the existence of the restriction benefits the retained as well as the neighboring property. However, the grant of the easement simultaneously with a gift of the balance of the property will, at the gift date, materially reduce the reportable gift . . . .[36]

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32. §170(f)(3)(A).

33. U.S., Congress, House, 91st Cong., 1st sess., 1969, H.Rep. 413, part 1, p.58.

34. Regs. §1.170A-7(b)(3); Rev. Rul. 75-420, 1975-2 C.B. 78.

35. Regs. §170A-7(b)(1)(ii).

36. C. Darling, "Predeath Transfers, Pros and Cons of Gifts, Use of Charitable Remainder Trusts, Educational Trusts, etc., Pros and Cons of Private Annuities," *N.Y.U. Institute on Federal Taxation* 37 (1979): chap. 37, §37.02(9).

- Contributions of remainder interests in real property granted prior to June 14, 1981, exclusively for conservation purposes.
- Gifts of partial interests that would have been deductible if made in trust. Since annual payments to beneficiaries are required for both remainder and income-interest charitable trusts, this exception appears relevant only for gifts of assets that are sufficiently income-producing or liquid to meet these requirements.

In valuing gifts of remainder interests in real property, the taxpayer must (1) take straight-line depreciation (and cost depletion) into account and (2) discount the value of the gift at a rate of 6 percent per annum. (The IRS can prescribe a different rate on the basis of changed economic conditions.)

3104 Gifts of Limited Interests

Again, under certain conditions, donors can claim contribution deductions without surrendering all interests in the property through gifts of limited interest, which consist of either remainder or income interests, and which are usually made in trust. Both types of limited interests have tax and financial advantages and disadvantages.

3104.1 Remainder Interests

A charitable gift of a remainder interest in property permits the donor to obtain the following benefits:

- An immediate income tax deduction for the present value of the remainder interest.
- Continued income, use, or other enjoyment of the property throughout any future period he selects—including his entire lifetime.
- Removal of the property from his taxable estate without the incurrence of gift tax.
- Further reduction of his taxable estate if the maximum marital deduction is available (as described in 3101).

Section 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 (such as securities) or real property (such as a personal residence) are eligible for current charitable contribution deductions.

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 may be more prudent to retain complete ownership of liquid assets to cover unforeseen personal needs.

A charitable remainder trust may permit capital gain deferral and diversification. The diversification may be into investments with a greater income yield than present investments, thus possibly increasing the income of the donor, who may also be the income beneficiary of the charitable remainder trust.

> The IRS has refused to issue rulings approving unitrusts where unproductive real estate is involved unless there is a certification that the property being transferred to the trust is capable of generating enough income to make the required annual payments . . . .[37]

Example X has 10,000 shares of stock, selling at $100 per share, with a basis of zero.[38] X would like to sell the stock and diversify but is concerned about the capital gains tax. If X sets up a charitable remainder annuity trust payable to himself at the rate of 10 percent of initial value each year for fifteen years, the trust can sell the stock without any tax liability because of sec. 664(c). There must not, however, be any express or implied obligation imposed on the trustee to make such a sale.[39]

The $1 million will be reinvested, and X will get $100,000 every year for fifteen years. At the end of the fifteen-year trust term, the small remaining balance will go to charity.

The deduction is not large, but X has achieved, in effect, a nonrisk installment sale and has had money working for him that would otherwise have gone immediately to pay the capital gains tax.

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37. M.A. Moore, "Split Interest Charitable Trusts," *Use of Trusts in Estate Planning 1979* (New York: Practising Law Institute, 1979), p.218.

38. This example has been adapted from M. Kalik and J. Kartiganer, "Charitable Split-Interest Trusts," *Income Taxation of Estates and Trusts 1978* (New York: Practising Law Institute, 1978), pp.387–88, 390.

39. See Rev. Rul. 74-53, 1974-1 C.B. 60.

A similar arrangement can be used to accomplish similar goals, such as spreading a tax liability arising from a redemption of closely held stock when the redemption proceeds would otherwise be treated as a dividend.[40]

The charitable remainder should not be too small. Revenue Ruling 77-374 holds that a charitable remainder annuity trust will not qualify as such for purposes of sec. 2055 if the probability that the noncharitable income beneficiary will survive the exhaustion of the fund exceeds 5 percent.[41] This depends on the amount of the annuity and the age of the life tenant. The ruling uses a 6 percent return regardless of the actual expected return on money.

Recently, a donor wished to provide for a 9 percent payout in a trust for the support of a dependent, with the balance going to charity at the dependent's death. To avoid Rev. Rul. 77-374, a unitrust was proposed, which provided for a 9 percent annuity, but one that could not exceed the annual income. Limiting the annuity to the annual income of the trust is permitted by regs. sec. 1.664-3(a)(1)(i)(b) and Rev. Rul. 72-395, sec. 7.01, for a unitrust but not for an annuity trust.

A private ruling was requested in regard to whether the proposed trust qualified as a charitable remainder unitrust under sec. 664. Since in this case there was no possibility that the principal could be invaded to pay the annuity, the service had no trouble in ruling favorably on the trust.[42]

Also, IRS Ltr. Rul. 7724017 indicated that the size of a unitrust remainder interest is not determinative for qualification under sec. 664, as it is for deductibility for income tax purposes.

It has also been suggested that unitrusts and annuity trusts should consider investing in tax-exempt securities so that the noncharitable beneficiaries are only taxed on capital gains. "The capital gain might never be taxed if the trust's ordinary income was sufficient to meet the unitrust or annuity percentage (or if an income-only unitrust was used). . . ."[43]

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40. See *DeWitt v. U.S.*, 74-1 U.S. Tax Cas. ¶9369 (Ct. Cl. 1974).

41. Rev. Rul. 77-374, 1977-2 C.B. 329.

42. M.A. Mead, "Charitable Remainder Trusts: Unitrusts v. Annuity Trusts," Tax Clinic, ed. S.R. Josephs, *Tax Adviser* 10 (May 1979): 290–91.

43. Moore, "Split Interest Charitable Trusts," p.205.

3104.2 Statutory Requirements for Charitable Remainder Interests in Trust

Deductions are allowable for charitable gifts of remainder interests in a trust with noncharitable income beneficiaries only if the trust is a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund.

Charitable Remainder 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.

Charitable Remainder Unitrusts

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. The value must be determined annually. The trust indenture may provide for payment of actual trust income, determined under local law, to the income beneficiary when this income is less than the stated payout. This flexibility of payment, not available to annuity trusts, cannot be at the discretion of the trustee.[44]

The indenture can also provide that any deficiencies in income distributions (when the trust income is less than the stated 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.

3104.3 Common Characteristics of Charitable Remainder Trusts

The income interest in either an annuity trust or a unitrust can be for a term of years (not exceeding twenty) 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.[45]

The term of the trust may be for the life or lives of the income beneficiaries or for a term of twenty years, but a combination of

44. U.S., Congress, House, 91st Cong., 1st sess., 1969, H.Rep. 782, p.296; regs. § 1.664-3(a)(1)(i)(b)(1).

45. See, e.g., Rev. Rul. 79-243, 1979-32 I.R.B. 8.

these two alternatives that creates the possibility of the term's exceeding the longer of the alternatives is not permissible. For example, income payable to A for his life and then to B for a term of years is not permissible, but B can be paid for the period of his life or a term of years (not to exceed twenty)—whichever is shorter.[46]

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).[47] The remainderman must be a charity, although multiple charitable remaindermen are also permissible.[48]

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.[49] On the other hand, the accumulated income or corpus gains are not generally taxed, since these trusts are exempt from income taxes on all but unrelated business income. Regulations section 1.664-1(c) states that if the trust has any unrelated business income, the trust is no longer tax-exempt. Instead, it must rely on the sec. 661 distribution deduction to reduce or eliminate its taxable income.[50]

Finally, distributions to income beneficiaries are treated as consisting of the following layers: current and accumulated ordinary income, current and accumulated short-term capital gains, current and accumulated long-term capital gains, current and accumulated exempt income, and corpus.[51]

This contrasts with the treatment of income beneficiaries of noncharitable trusts, whose distributions are deemed to consist of only proportionate amounts of ordinary income, capital gain, ex-

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46. Regs. § 1.664-2(a)(5) and -3(a)(5).

47. Rev. Rul. 76-270, 1976-2 C.B. 194.

48. Regs. § 1.664-2(a)(6) and -3(a)(6).

49. If state law permits principal invasion, the trust will not qualify unless the instrument overrides state law (Rev. Rul. 77-58, 1977-1 C.B. 175).

50. For a discussion of income tax treatment of charitable trusts, see M.A. Moore, "Income Taxation of Charitable Trusts," *N.Y.U. Institute on Federal Taxation* 37 (1979): chap. 41.

51. See B. Barnett, "The Taxation of Trust Distributions Revisited After the '76 Act," *Tax Adviser* 9 (January 1978): 34–35.

empt income, and corpus.[52] In comparison, the taxation of ordinary income and capital gains to income beneficiaries of charitable remainder trusts is accelerated while nontaxable distributions are deferred.

Distributions in kind to pay unitrust or annuity amounts to a noncharitable beneficiary are considered amounts realized by the trust, and the basis to the recipient is the property's fair market value.[53]

> [Any] gain will not be taxed to the trust (since it is exempt). However, it could affect the tax liability of the noncharitable beneficiary since once all ordinary income is deemed distributed, further distributions will be deemed to come from capital gains including those generated by distributions in kind.[54]

Pooled Income Funds

Pooled income funds are trusts that must meet all of the following conditions:

1. The fund must be a transferee of property in which an irrevocable remainder interest is given to a public charity and the income interest is retained for the *life* of one or more beneficiaries then living.[55]
2. The fund cannot have investments in tax-exempt securities.
3. Neither the donor nor the 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 on 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.

While pooled income funds are not exempt from income tax, as are charitable remainder annuity trusts and unitrusts, they are allowed an unlimited deduction for any amount of gross income

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52. See §662(b).
53. Regs. §1.664-1(d)(5).
54. B. Barnett, "The Taxation of Trust Distributions Revisited," p.35.
55. As *public charity* is defined in §642(c)(5)(A).

attributable to long-term capital gains that is permanently set aside for charitable purposes.[56] In addition, under sec. 661(a) a fund can also deduct the distributions to its income beneficiary that in effect consist of its current ordinary income. Therefore, such funds usually have little or no taxable income.

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).[57] These trusts are not subject to restrictions on excess business holdings and improper investments.[58] Charitable income trusts are subject to similar restrictions.

Unlike charitable remainder annuity trusts or unitrusts, pooled income funds are subject to the following restrictions:

- Investments in tax-exempt securities are not permitted.
- A term for years is prohibited.
- Only individuals, apparently, can be income beneficiaries, as implied by condition (1), which is based on the language of sec. 642(c)(5)(A).

Under all three varieties of trusts, the donor himself can be an income beneficiary.[59]

3104.4 Valuation of Remainder Interests

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.[60]

Example A donor makes a completed gift of $100,000 to a trust, providing for a $5,000 annuity to A for life, with the remainder to charity. Using a 6 percent discount rate, the present value of the income interest is calculated by determining A's life expectancy and discounting the annual payments by 6 percent. This amount,

56. §642(c)(3).
57. See §§508(d)(2)(A) and 4947(a)(2).
58. §4947(b)(3)(B).
59. See, e.g., Rev. Rul. 79-243, 1979-32 I.R.B. 8.
60. §664(e).

when subtracted from the total value of the gift, is the present value of the charitable remainder.[61] If A is the donor's sixty-year-old wife, the present value of her annuity interest is approximately $52,700.[62] The present value of the charity's remainder interest is $47,300 ($100,000 less $52,700).[63]

The valuation of remainder interests in unitrusts is prescribed by regs. sec. 1.664-4.

Pooled Income Funds

In determining the charitable contributions deduction, the donor computes the income interest, which is subtracted from the total fair market value of the property to arrive at the remainder interest, 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 three prior years, a 6 percent rate is presumed, unless otherwise specified by the IRS.[64]

The valuation of pooled income fund remainder interests is described in greater detail in regs. sec. 1.642(c)-6. These different valuation rates offer a donor flexibility in determining the amount of his contribution deduction, which, of course, varies inversely with the amount of income that he receives. 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. This can be advantageous if the actual earnings rate is higher, since greater income can be obtained without diminishing the contributions deduction. A relatively new fund may present increased investment risk, however.

If the facts and circumstances indicate that the taxpayer has manipulated the highest yearly rate of return in order to obtain an excessive charitable contributions deduction, regs. sec. 1.642(c)-6(b)(2) states that such a rate cannot be used. Instead, the presumed rate (now 6 percent) is substituted.

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61. H.Rep. 91-413, part 1, p.59, on the Tax Reform Act of 1969.
62. Estate Tax Regs. §20.2031-10(f), Table A(2).
63. Regs. §1.664-2(c).
64. §642(c)(5).

Example A fund that has yielded 4 percent for the past three years is currently converted into properties earning 8 percent. Would a donor be able to use the 4 percent rate to value his contribution deduction, notwithstanding the higher current yield?

If the income interest is reserved for a sixty-year-old female, the regulations provide a factor of 0.49484 in valuing the remainder interest in a pooled income fund with a yearly rate of return of 4 percent, as opposed to a factor of 0.28251 if the yearly rate of return is 8 percent.[65] Thus, the higher rate of return would reduce the deduction for a transfer of $100,000 to a pooled income fund from $49,484 to $28,251, a decrease of more than $21,000.

3104.5 Income Interests

Charitable gifts of income interests have the following economic characteristics:[66]

- The donor is deprived of income for the period specified by the gift.
- At the conclusion of this period, the underlying property can revert to the donor or to remaindermen selected by him.

For income tax purposes, no deduction is allowable unless the trust income is taxable to the donor.[67] Thus, the only income tax advantage gained by such a gift is a shifting of income through the obtainment of 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 must retain certain powers or interests, such as a reversionary interest, in order to be taxed on the trust's income (which is required for obtainment of the income tax deduction). Such retention prevents removal of the remainder interest from the donor's gross estate.

If the donor releases such powers or interests in order to reduce future estate tax, the charitable contributions deduction will be recaptured for income tax purposes. Of course, if not detrimen-

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65. Regs. § 1.642(c)-6(d)(3), Table G(2).

66. See also A.B. Muchin et al., "Charitable Lead Trusts Can Provide Substantial Estate Planning Benefits," *Journal of Taxation* 49 (July 1978): 2; Darling, "Predeath Transfers," § 37.08; W.H. Behrenfeld, "Coming Into Their Own—Identifying and Planning for the Emerging Estate," *N.Y.U. Institute on Federal Taxation* 36 (1978): 241–42.

67. § 170(f)(2)(B).

tal 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.

No income tax deduction will be allowable if the reversionary interest cannot reasonably be expected to take effect until more than ten years after the gift is made, since, under these circumstances, the trust's income will not be taxed to the donor.[68]

Although the deduction requirements of sec. 170(f)(2)(B) are not met, the donor obviously is 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 that govern charitable contribution deductions, including the 20 percent limitation generally applicable for gifts to private foundations.[69] (These limitations are further explored in 3105.)

Tax is also eliminated on the income reportable by the trust, to the extent that the income is expended for charitable purposes, since a trust is allowed an unlimited deduction for such payments.[70] Moreover, unlike other taxpayers, a trust (or estate) can also deduct payments to foreign charities.[71]

Statutory Requirements for Income Interests

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 a guaranteed annuity; or	Required	Required
The income interest is a fixed percentage of fair market value of trust property (determined annually), distributed annually, as specified in indenture.	Required	Required

68. See §673(a).
69. See Rev. Rul. 79-223, 1979-30 I.R.B. 7.
70. *Ibid.*
71. See §642(c)(1).

Section 170(f)(2)(C) denies additional deductions to the grantor or any other person (for example, the trust itself) for any contributions made by the trust with respect to the income interest. Presumably, this disallowance to the trust persists even if the trust, instead of the donor, is subsequently taxed on the income (in the event that the donor's ownership powers or interests are relinquished). This result is especially detrimental because the donor is also required to recapture his own prior deduction.

There is no minimum percentage distribution requirement for split-interest charitable income trusts.[72] This is in contrast to the 5 percent minimum distributions required for charitable remainder annuity trusts and unitrusts. The noncharitable beneficiary of a pooled income fund must receive income distributions based on the fund's current rate of return.

No deduction is allowable for contributions to a split-interest charitable income trust 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).[73] 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.[74] Charitable remainder trusts are subject to similar restrictions.

Recapture of Excess Deductions

When a 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

3105 Working With Income Limitations

Knowledge of various limitation and carryover rules will generally enable the tax planner to maximize the tax benefits obtained through charitable contributions. Particular techniques include (1) avoidance of private charity contributions when excess public charity contributions exist, (2) avoidance of gifts "for the use of" charity if the 50 percent

72. §170(f)(2)(B).
73. See §§508(d)(2)(A) and 4947(a)(2) and regs. §1.170A-6(c)(1).
74. §4947(b)(3)(A).

limitation and/or carryovers are necessary to obtain deductions, and (3) election of the 50 percent limitation for contributions of certain appreciated property. In addition, maximum limitations can be bypassed through short-term trusts (of more than ten years duration).

Short-term trusts are discussed in 3104.5

3105.1 Income Limitations

Charitable contributions made by individuals after 1969 are subject to the following limitations, based on a *contribution base* (adjusted gross income without regard to any net operating loss carryback).

Public Charities

Contributions to public charities are subject to income limitations that differ with the type of property, as categorized below:

- Nonappreciated property, such as cash—50 percent.
- Appreciated ordinary income property—50 percent. However, as indicated in 3102.2, no deduction is allowable for the portion of the property's fair market value that represents untaxed ordinary income.
- Appreciated capital gain property—30 percent.

This lower limitation applies even if the appreciation is nominal (for example, one percent of the property's total value); however, the 50 percent limitation can apply if the donor elects to reduce the contribution by 40 percent of the appreciation.

For these purposes, private foundations classified as distributing, operating, or community foundations (see 3102.5) are considered public charities.

Types of Appreciated Assets Subject to 30 Percent Limitation

The 30 percent limitation applies to contributions of the following types of appreciated property:

- Long-term capital gain property (which would give rise to a long-term capital gain if sold instead), such as stocks or bonds.
- Section 1231 property (generally depreciable property or land used in a business, as set forth in 1203).

This limitation may also apply to a bargain element (the portion of property deemed given) in a bargain sale of capital gain or sec. 1231 property (see 3102.3).

On the other hand, the 30 percent limitation does not apply if the contribution is reduced by 40 percent of the potential long-term capital gain.[75] (This reduction is discussed in 3102.2.) Thus, the 30 percent limitation is generally not applicable to contributions or bargain sales of capital assets or sec. 1231 property to private charities (nondistributing private foundations). Moreover, 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. In this case, however, either the 50 percent or the 20 percent limitation applies, depending on whether the donee is a public or private charity.

Of course, ordinary income properties, including short-term capital assets, are not subject to the 30 percent limitation, since their appreciation is not deductible at all. Here, too, either a 50 percent or a 20 percent limitation is applicable, depending on the nature of the donee. (See 3102.2 for a further description of ordinary income property and its treatment.)

Private Charities

The income limitation on contributions to private charities is 20 percent, which is subject to a ceiling, illustrated as follows.[76]

Example Client's 1980 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 (not 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) and regs. sec. 1.170A-8(c) and (f), example (2).)

If the $20,000 gift is nevertheless made, the $10,000 portion in excess of the ceiling is not currently deductible. Moreover, it cannot be carried to any other year.

75. §§170(b)(1)(C)(i) and (e)(1)(B).

76. To reiterate: Private charities are private foundations other than distributing, operating, or community foundations.

Application of Various Limitations

The sequence of applying the various limitations is summarized in IRS Publication 526, as follows:

> Gifts to charitable organizations that qualify for the 50% limitation are considered first when computing your deduction. Gifts to which the 20% limitation applies are considered afterward and only to the extent of the lesser of 20% of adjusted gross income; or 50% of adjusted gross income minus the contributions to which the 50% limitation applies, without regard to the special 30% limitation.
>
> Gifts of capital gain property to which the special 30% limitation applies are considered after all other gifts.
>
> EXAMPLE. Your adjusted gross income is $50,000 for 1980. During the year, you gave to your church $2,000 cash and land with a fair market value of $30,000 and a basis to you of $10,000. You had held the land for investment for more than one year. You also gave $5,000 cash to a private foundation to which the 20% limitation applies. Since your allowable contributions to an organization to which the 50% limitation applies, disregarding the special 30% limitation, exceed $25,000 (50% of $50,000), your deductions subject to the 20% limit are not allowable. The $2,000 cash donated to the church is considered first. The deduction for the gift of land is not required to be reduced by the appreciation in value and is limited to $15,000 (30% × $50,000). The unused portion ($15,000) may be carried over to later years. Therefore in 1980 your deduction is limited to $17,000 ($2,000 + $15,000). The $5,000 contribution to the private foundation may not be carried over.[77]

3105.2 Carryover of Excess Contributions

Public Charities

Contributions to public charities (including distributing, operating, or community foundations) in excess of the prescribed 50 percent or 30 percent limitations can be carried over for five succeeding years. A special rule reduces such carryovers if the excess contributions also increase net operating loss carryovers to future years.

Private Charities

Contributions to nondistributing 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.

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77. Based on *Income Tax Deductions for Contributions*, I.R.S. Publication 526, 1979 ed.(Washington: Government Printing Office, 1979), p.7. See also regs. § 1.170A-8(f), example (5).

Example Client (without professional advice) makes cash gifts in 1980 to the following donees:

Community fund	$ 75,000
Private foundation (nondistributing, etc.)	30,000
Total cash gifts	$105,000

If his contribution base is $100,000, his 1980 deduction is $50,000. The carryover to 1981 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 determination of the carryover (and, hence, does not increase it).

Client would have been well advised not to make such a contribution in 1980. 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.

3105.3 Electing the 50 Percent Limitation for Contributions of Appreciated Capital Assets

As was indicated at the beginning of this discussion, a 50 percent limitation can be substituted for the 30 percent limitation otherwise applicable to charitable gifts of appreciated capital assets. (Both limitations, of course, are based on the contribution base—that is, adjusted gross income exclusive of any net operating loss carrybacks.) This higher limitation applies only if an election is made to reduce such contributions by 40 percent of the appreciation.

Since this election causes a permanent loss of contribution deductions (equal to 40 percent of the untaxed capital gain), it should *not* be made under the following conditions:

- The excess contribution (the portion of the full fair market value exceeding the 30 percent limitation) can be recovered within the succeeding five-year carryover period.

- The donor's tax brackets are fairly equal during the year of the gift and throughout the carryover period.

On the other hand, the election can be advantageous if the following factors are present:

- The appreciation is not substantial; so reducing the contribution by 40 percent of the appreciation does not result in a significant loss of deductions.
- Future tax brackets are expected to decline, such as in retirement situations.

Example Client contributes a capital asset to a 50 percent charity in 1980, with the following characteristics:

Fair market value	$20,000
Basis	-0-

Other contributions of appreciated capital assets ($1 appreciation) during the year have exactly absorbed the 30 percent limitation. Consequently, this particular contribution is not currently deductible. Client anticipates retirement at the end of 1980. Therefore, his projected tax brackets are 70 percent for 1980 and 24 percent for 1981.

Tax benefit without election	
1980	None
1981	$4,800 (24 percent of $20,000)

Of course, part of this $20,000 amount will likely be carried to several subsequent years because of the 30 percent limitation applied to Client's lower, post-1980 income. Hence, realization of all tax benefits flowing from this contribution may be even further postponed.

Tax benefit with election	
1980	$8,400 (70 percent of $12,000)

This $12,000 deduction is the net of (*a*) the $12,000 additional deduction derived by reducing the fair market value of $20,000 by 40 percent of the appreciation (which is also $20,000) less (*b*) the reduced deduction for the other appreciated capital assets of 40¢ (40 percent of $1 appreciation), which has been ignored. The election applies to all such property contributed during the year, pursuant to sec. 170(b)(1)(C)(iii).

Under the foregoing circumstances, the election provides an additional $3,600 tax benefit (assuming that the contribution is entirely deductible in 1980 under the 50 percent limitation). Moreover, the election permits faster enjoyment of the tax benefits produced by the contribution.[78]

The alternative minimum tax has been assumed to be inapplicable.

3105.4 Technical Discussion

Application of 50 Percent and 30 Percent Limitations

During 1980 Client's only contributions are securities (worth $60,000) and cash ($40,000). Both gifts are made to public charities. Client's contribution base is $100,000, and he does not elect the 50 percent limitation for the securities.

Client has a $50,000 current deduction and a $50,000 carryover, as shown in figure 31-7.

Figure 31-7

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

A carryover arising in these circumstances must be added to future contributions of appreciated property for purposes of applying the 30 percent limitation in the subsequent year.[79]

78. Based on L.A. Rapoport, "Charitable Contributions Under the Tax Reform Act of 1969," *Tax Adviser* 1 (March 1970):165. Also see *Working With the Revenue Code 1979*, pp. 71–73.
79. See H.Rep. 91-413, part 2, p.33.

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 "to" a charity.[80]

A charitable contribution of an income interest in property is considered made "for the use of" the charity, and thus is subject to the 20 percent limitation.[81]

A charitable contribution of a remainder interest, whether to a charitable remainder annuity or to a unitrust, or to a pooled income fund trust may be eligible for the 50 percent limitation if the remainder will be distributed to the charity rather than held in trust for the charity's benefit.[82]

Gifts of limited interests are more extensively considered in 3103 and 3104.

3106 Substantiation Requirements

Through familiarity and compliance with detailed substantiation requirements, the tax planner may avoid needless controversy over deductions for noncash contributions exceeding $200.

Regulations section 1.170A-1(a)(2) requires a taxpayer to submit detailed supporting information along with a tax return in which he claims a deduction for a noncash contribution exceeding $200. The information must include the fair market value of the property and the method used in its determination. Also, if the valuation was determined by appraisal, a copy of the appraiser's signed report must be submitted. Comprehensive appraisal guidelines, for this purpose, are set forth in Rev. Proc. 66-49.[83]

Conformity with these substantiation requirements may be especially important when the contribution consists of unique prop-

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80. Regs. § 1.170A-8(b).

81. Regs. § 1.170A-8(a)(2). The IRS has ruled that an assignment of an undivided interest in an individual's income interest in a spendthrift trust was a contribution to a charity, subject to the 50% and 30% limitations (I.R.S. Ltr. Ruls. 7921073 and 7908065).

82. Regs. § 1.170A-8(a)(2).

83. Rev. Proc. 66-49, 1966-2 C.B. 1257. See also *Valuation of Donated Property*, I.R.S. Publication 561, 1979 ed., and Rev. Proc. 79-24, 1979-18 I.R.B. 20, regarding valuation of unimproved real estate.

erty, such as real estate, art objects, literary manuscripts, and antiques.

Deductions for contributions to charitable remainder annuity trusts, unitrusts, and pooled income funds must be supported by statements attached to the return showing the computation of the present value of such interests.[84]

84. Regs. § 1.642(c)-6(a)(2) and regs. § 1.664-2(d) and -4(a)(4).

32

Income Taxes

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 transferred.

In the case of deductions for administrative expenses that arise after a person's death, the tax planner must choose whether they will be used for income tax or estate tax purposes.

This chapter is devoted to a review of these tax attributes and various planning techniques designed to achieve maximum tax benefit.

3201 Deductions and Credit in Respect of Decedents

The tax planner should not overlook the *double* deductions available for those of the decedent's debts that are deductible for both estate tax and income tax purposes.

3201.1 Accrued Expenses

Expenses that 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) permits the following categories of accrued expenses to be deducted for income tax purposes when they are paid (if they are not properly allowable to the decedent).

Type of expense	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 the 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 the obligation.

Similar treatment is granted to foreign tax credits, in the case of accrued foreign income taxes.

Periodic alimony payments are deductible when they are paid by an estate for income tax purposes (as distributions to a beneficiary under sec. 661). In addition, the commuted value of such payments is deductible for estate tax purposes as a claim against the estate, pursuant to sec. 2053(a)(3).[1]

3201.2 Percentage Depletion

If the decedent had claimed percentage depletion, a similar income tax deduction is allowable only to the person receiving the income on 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.[2]

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.

3201.3 Medical Expenses

As stated in 2405, 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.[3]

1. Rev. Rul. 67-304, 1967-2 C.B. 224.
2. Regs. § 1.691(b)-1(b).
3. Regs. § 1.642(g)-2.

3201.4 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) can be used for income tax purposes. For example, Rev. Rul. 74-175 precludes a capital loss carryover or net operating loss carryover from a decedent to his estate.[4]

3202 Estate Administrative Expenses

The tax planner must determine whether administrative expenses allocable to nonexempt income should be deducted for income tax or estate tax purposes. This comparison should include consideration of residual beneficiaries' income tax brackets. Administrative expenses can be included in determining the amount of a sec. 303 redemption, even though they are actually deducted for income tax purposes.

Unlike deductions in respect of a decedent, an estate's administrative expenses and casualty or theft losses occurring during administration cannot generate double deductions, since sec. 642(g) requires that they be allowable only for either income tax or estate tax purposes.[5] Consequently, the effective rate of both taxes should be compared, and the most advantageous alternative selected; that is, deductions should be claimed against the higher tax rate.

The effective rate applicable to administrative expenses claimed for estate tax purposes is cut in half when the maximum marital deduction, if based on the adjusted gross estate, is also claimed. (This latter deduction is discussed in chapter 33.)

An estate may time the payment of administrative expenses to allow their deduction on the income tax returns of the residual beneficiaries. Therefore, the tax planner should consider the income tax rates for fiduciaries and for residual beneficiaries (at single, joint, or head-of-household rates).

Administrative expenses include executor's commissions, legal, accounting and appraisal fees, court costs, surrogates' fees, clerical assistance, and so forth.[6] Furthermore, interest, business expenses, and other items not accrued at the date of death are also included in this category, if they are allowable as estate tax deductions only

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4. Rev. Rul. 74-175, 1974-1 C.B. 52.

5. §642(g) also provides that expenses cannot offset selling prices for income tax purposes if they are also deducted as administrative expenses for estate tax purposes.

6. Estate Tax Regs. §20.2053-3.

as administrative expenses under sec. 2053(a)(2).[7] The IRS allows the deduction, as an administrative expense, of interest on the extended payment of estate tax.[8] The service also permits the deduction, as an administrative expense, of interest on estate tax deficiencies and of post-death interest on income tax and gift tax deficiencies (to the extent allowable by local law).[9]

3202.1 Planning Considerations

Expenses Allocable to Exempt Income

Estate tax deductions should be claimed for administrative expenses that are not deductible for income tax purposes because they are allocable to exempt income.[10] Such income tax allocations are required by sec. 265 (discussed in 3003.2).

Section 303 Redemptions

Section 303 redemptions are discussed in 1302.

3202.2 Procedural Aspects

Estate tax deductions allowable for administrative expenses or for casualty or theft losses are not allowed as income tax deductions unless the taxpayer files a statement indicating (1) that such items have not been allowed as estate tax deductions and (2) that the taxpayer has waived all rights to the allowance of such estate tax deductions.

The taxpayer must file this statement, in duplicate, with the income tax return in which he claims the deductions, or he must send it to the pertinent district director for association with a previously filed return (if the statute of limitations has not expired).

Claiming estate tax deductions does not preclude claiming income tax deductions, as long as the estate tax deduction is not finally allowed and the required statement is filed. On the other hand, filing such a statement permanently prevents any estate tax deductions for the particular expenses involved.[11]

Portions of an expense can be split between the two taxes.[12]

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7. See regs. § 1.642(g)-2.
8. Rev. Rul. 78-125, 1978-1 C.B. 292.
9. See Rev. Rul. 79-252, 1979-34 I.R.B. 11, and citations therein.
10. Rev. Rul. 59-32, 1959-1 C.B. 245, clarified on another ground by Rev. Rul. 63-27.
11. Regs. § 1.642(g)-1.
12. Regs. § 1.642(g)-2.

3203 Excess Deductions and Unused Loss Carryovers Available to Beneficiaries Upon Termination of an Estate or Trust

Excess deductions and unused loss carryovers are available to residual beneficiaries upon termination of estates or trusts. Therefore, proper timing of fiduciary deductions can control their maximum tax use by shifting them to the taxpayer (fiduciary or beneficiary) in the higher bracket. Estate administrative expenses are particularly susceptible to this technique.

3203.1 Excess Deductions

The beneficiaries succeeding to a fiduciary's property (whether the fiduciary was an estate or a trust) may deduct the amount by which the fiduciary's deductions exceeded its gross income for its terminal year. 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 excess deductions, the unused balance cannot be carried to any other taxable year.

The taxpayer cannot include this deduction in computing adjusted gross income, but can only claim it in arriving at taxable income. Thus, it cannot be claimed unless the taxpayer itemizes deductions.[13]

Itemized deductions exceeding 60 percent of adjusted gross income may subject a taxpayer to the alternative minimum tax. The tax planner must consider the impact of the alternative minimum tax in determining whether to shift the deduction to the beneficiary.

> [The Revenue Act of 1978] clarified the application of the adjusted itemized deduction preference to trusts and estates. Generally, the preference for adjusted itemized deductions is equal to the amount by which itemized deductions exceed 60 percent of adjusted gross income. In the case of estates and trusts, the preference is the amount by which all deductions other than deductions allowable in arriving at adjusted gross income and certain other deductions exceed 60 percent of the estate's or trust's adjusted gross income reduced by all deductions. However, under the Act, deductions

13. Regs. § 1.642(h)-2.

> allowable in arriving at adjusted gross income were subtracted twice. In addition, unlike an (other than who is not a trust or estate) [*sic*], the personal exemption of a trust or estate does reduce the amount of adjusted gross income. . . .
>
> The bill modifies the computation of the preference for adjusted itemized deductions of a trust or estate to clarify that deductions allowable in arriving at adjusted gross income are taken into account only once. In addition, your committee adds to the House-passed bill an amendment which provides that the personal exemption of a trust or estate does not reduce the adjusted gross income of the trust or estate for purposes of computing the preference for adjusted itemized deductions of the trust or estate.[14]

3203.2 Unused Loss Carryovers

Somewhat similar treatment is provided for the transfer of net operating loss carryovers and capital loss carryovers that would be allowable to the fiduciary in subsequent years if not for its termination. For purposes of counting the seven-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 considered separate years. Capital loss carryovers transferred either to individuals or to other fiduciaries can be carried forward indefinitely (as described in chapter 14). Generally, these carryovers retain their character in the hands of the beneficiary; consequently, they are deductible in determining adjusted gross income.[15]

Note Unabsorbed net operating loss carryovers that expire in the fiduciary's final year are considered excess deductions.[16] Duplicate deductions arising from the interaction of these provisions are prevented by the aforementioned regulations. In addition, rules for allocating these items among several beneficiaries are provided in regs. sec. 1.642(h)-4.

3203.3 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,

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14. U.S., Congress, Senate, Finance Committee, *Report on the 1979 Technical Corrections Act*, 96th Cong., 1st sess., 1979, S. Rep. 498, p.71.
15. Regs. § 1.642(h)-1.
16. Regs. § 1.642(h)-2(b).

the tax planner can shift such estate deductions as administrative expenses to the beneficiary by coordinating (1) the year in which the estate should be terminated and (2) the time that the expenses are paid. The planner can also shift these deductions to higher-bracket beneficiaries by postponing payment until the estate has been terminated.[17] Naturally, this can be done only to the extent permitted by creditors and financial conditions.

Example Client is sole executor and beneficiary of the estate of his cousin, who died July 17, 1980. The estate's annual gross income is expected to be $18,000 ($1,500 received each month), in the 43 percent bracket. The taxable estate, for estate tax purposes, before deduction of any administrative expenses, is $600,000, which is in the 37 percent bracket (before any credits). Client's own annual taxable income for 1980 through 1982 is $100,000, in the 59 percent bracket (joint rates).

Projected administrative expenses are as follows:

Legal and accounting fees	$30,000
Executor's commission	25,000
Miscellaneous	5,000
Total	$60,000

Also, accrued interest was payable at the decedent's death.

In view of the various prevailing tax rates, the following steps are taken:

1. A June 30 taxable year is selected to provide a longer period for the estate's income to be taxed at its lower bracket.
2. Because the administration of an estate cannot be unduly prolonged, pursuant to regs. sec. 1.641(b)-3(a), the estate is terminated on July 31, 1982.
3. All administrative expenses and $10,000 of accrued interest are paid during the estate's last taxable period, which begins July 1, 1982, and ends July 31, 1982.
4. These payments are claimed as deductions on the final fiduciary income tax return (Form 1041).
5. The estate's excess deductions of $68,500 ($70,000 less $1,500 July gross income) are claimed by Client as an itemized deduction on his 1982 return.

17. See regs. § 1.641(b)-3(d).

Client's 1982 gross income includes his $25,000 executor's commission, so his taxable income is only reduced by the net amount of $43,500 ($68,500 less $25,000) as a result of the estate's termination. The $68,500 itemized deduction is less than $75,000 (60 percent of the assumed adjusted gross income of $125,000) and thus does not subject the client to the alternative minimum tax. The effects of claiming these commissions as income tax deductions on the executor/beneficiary's return are the following:

- It offsets their inclusion in the executor's gross income. Nevertheless, the 50 percent maximum tax rate on personal service income may apply (see chapter 3).
- It subjects them to estate tax (by foregoing their deduction on the estate tax return (Form 706)). This is appropriate under these circumstances, since the commissions would otherwise be exposed to the executor's higher income tax rates.

If 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. Revenue Ruling 66-167 prescribes conditions under which such waivers are recognized.[18] This ruling also holds that commissions waived in this manner do not constitute a gift. In *George M. Breidert* a waiver was effective even though the facts did not satisfy all the conditions set forth in Rev. Rul. 66-167 and prior rulings.[19]

Beneficiaries of Trusts

The tax privileges extended to estate beneficiaries regarding excess deductions and loss carryovers are equally applicable to trust beneficiaries.[20] Planning opportunities are much more restricted, however, since a trust usually does not allow even the moderate degree of discretion exercisable in terminating an estate. (The duration of a trust is either fixed by its indenture or depends on the longevity of its life tenants.)

Nevertheless, some modest tax leverage may be obtained if expenditures are effectively timed during the final two or three years of a fixed-term trust. Knowledge of its terminal date and a comparison of anticipated tax brackets of fiduciary and remainder-

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18. Rev. Rul. 66-167, 1966-1 C.B. 20. See also Rev. Rul. 70-237, 1970-1 C.B. 13.
19. *Breidert*, 50 T.C. 844 (1966), acq. 1969-1 C.B. 20 and 1969-2 C.B. xxiv.
20. §642(h).

men will indicate the most advantageous use of these deductions. Whether these plans can be implemented depends, of course, on the cooperation of creditors and financial factors.

If trustees have limited control over terminating a trust, they may nevertheless control the timing of expenditures so that the excess of expenses over income (often resulting from professional and trustee fees relating to termination) occurs in the same year that final distributions are made to the beneficiaries. Spreading termination expenses over two taxable periods so that the trust has an excess of expenses over income in its last two taxable periods will have the disastrous effect of wasting the excess deductions in the taxable year preceding the final taxable period.[21] The same principle applies to estates.

21. See B. Barnett, "The Taxation of Trust Distributions Revisited After the '76 Act," *Tax Adviser* 9 (January 1978): 33.

33

Estate and Gift Taxes

Marital Deductions

Federal income, estate, and gift tax consequences are frequently affected by property rights prescribed by the laws of the fifty states, which are categorized as common-law states and community-property-law states. Since these two legal systems are dissimilar in significant aspects, the same facts can produce different federal tax effects according to which state has jurisdiction over the taxpayer's affairs. In order to equalize federal tax treatment for all taxpayers, regardless of residence, the code contains the following mechanisms:

- Joint income tax returns, which allow common-law taxpayers to split taxable income between spouses in the same way as community-property residents.
- The estate tax marital deduction, which permits estate splitting.
- Gift splitting and the gift tax marital deduction, both of which serve the same purpose with regard to the gift tax.

3301 Marital Bequests

Tax planners should consider marital deductions that permit the transfer of substantial amounts of property to a spouse with reduced gift taxes, if any at all, and without any estate tax. Marital deductions may, however, produce additional future gift or estate taxes unless the property is consumed (or unless the spouse remarries and effects similar transfers). Therefore, married couples generally should be treated as one unit for transfer tax purposes in order to equalize their combined estates.

3301.1 Advisability of the Maximum Estate Tax Marital Deduction

The tax planner should consider tax and monetary factors in determining the advisability of the maximum estate tax marital deduction.

Each spouse is entitled to a unified credit of $42,500 in 1980 and $47,000 after 1980, which translates into an equivalent exemption of $161,563 and $175,625 respectively. The following discussion is based on the post-1980 unified credit and equivalent exemption (which will, for this discussion, often be rounded to $175,000). Planning during 1980 should involve the smaller unified credit and equivalent exemption, with the attendant possibility that the surviving spouse's unified credit and equivalent exemption will exceed that of a spouse who dies in 1980.

Example H owns assets of $351,250, and W owns no assets. If W dies before H, there will, of course, be no tax on her estate; but on H's later death, after 1980, his estate will incur an estate tax of $58,225 (before the credit for state death taxes).

If each spouse's estate had been equalized at $175,625, there would be no tax on either estate because both spouses' post-1980 unified credits would exempt the first $175,625 of assets from tax. Thus, each spouse would obtain the maximum benefit from the unified credit—rather than wasting W's credit—and estate taxes of approximately $58,225 would be saved.

Using W's $47,000 unified credit saves $58,225 of tax (that is, the tax saving is greater than the credit). This is because the assets are not concentrated in H's estate, where they are taxed at higher rates.

Thus, the estate tax marital deduction may make it possible to shift assets that would be taxed in the decedent's estate into the shelter of the survivor's unified credit. Under the estate equalization principle, a qualifying marital bequest may not exempt the property from estate tax but may enable it to be taxed at the lower marginal tax rate of the survivor's estate (up to the point at which the survivor's estate exceeds the decedent's estate, in which case the marginal rate in the survivor's estate exceeds the rate applicable to the decedent's estate). It is also possible to overfund the survivor's estate and subject assets that would have been sheltered by the decedent's unified credit to tax in the survivor's estate. The basic concepts associated with planning the estate tax marital deduction for estates of various sizes may be demonstrated by the following examples, which incorporate several assumptions:[1]

- The full $47,000 unified credit has been phased in so that the equivalent exemption is $175,000 (rounded from $175,625).
- There are no credits other than the unified credit (for example, the state death tax credit is ignored).
- There are no administrative expenses or other estate tax deductions.
- There is a marital bequest consisting of a fixed amount of assets passing to a surviving spouse who has no separate property, and the bequest will be included in the spouse's estate.
- There is a nonmarital bequest, either to the children or to a nonmarital trust, which gives the surviving spouse income for life and other limited rights, with a remainder interest to the children.
- The nonmarital bequest is not taxed in the surviving spouse's estate and bears the estate tax burden.[2]
- The decedent has made no post-1976 taxable gifts.

Estates Under $175,000 If the estate is under $175,000, there will be no tax in either estate, regardless of the marital bequest. Thus, federal estate tax considerations can be ignored.

Estates Between $175,000 and $350,000 An estate between $175,000 and $350,000 is less than the couple's combined equivalent exemptions. It is therefore possible to eliminate estate tax in both estates by keeping each estate below $175,000. The taxpayer should make a marital bequest that is sufficient to reduce the decedent's estate below $175,000 but that does not exceed $175,000, thus keeping the survivor's estate below the equivalent exemption. For example, if H's estate is $275,000, a marital bequest in the $100,000 to $175,000 range will keep both estates below the $175,000 mark.

In dealing with such a range of bequests, the conservative approach, from a federal estate tax standpoint, is to reduce the marital deduction to the point at which there is maximum use of

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1. See also G.M. Winkle, "Some Operational Rules for Estate Planning With the Marital Deduction," *Tax Adviser* 10 (July 1979): 424.

2. See, e.g., Rev. Rul. 79-14, 1979-2 I.R.B. 10, holding that a fiduciary's unexercised discretion to pay taxes from the marital bequest reduces the marital deduction.

the unified credit in the first (H's) estate. Thus, a marital bequest of $100,000 (the bottom of the range) will make full use of H's unified credit, and the bequeathed assets will not be taxed in W's estate as long as they do not appreciate by more than $75,000 by the time W dies. If, however, the marital bequest is $175,000, the top of the range, any subsequent appreciation will result in a tax on W's estate.

Estates Between $350,000 and $500,000 If the estate is between $350,000 and $500,000, it exceeds the couple's combined equivalent exemptions of $350,000. It is no longer possible to eliminate tax in *both* estates; however, up to the $425,000-taxable-estate level (the $250,000 marital deduction plus the $175,000 equivalent exemption), it is possible to defer the tax into the second estate. For example, if H's estate is $400,000, a $225,000 marital bequest to W will reduce H's estate to the level of the $175,000 equivalent exemption and will defer any tax into W's estate.

If the estate is less than $425,000, the maximum marital deduction should not be claimed, since it would underutilize the decedent's equivalent exemption. A $250,000 marital bequest in a $400,000 estate will reduce the decedent's taxable estate to $150,000 ($25,000 below the equivalent exemption) and increase the survivor's estate to $250,000 ($75,000 above the equivalent exemption level). If, however, the marital bequest is reduced to $225,000, it will reduce the decedent's estate to $175,000 (still avoiding any tax), while increasing the survivor's estate to only $225,000 (only $50,000 above the equivalent exemption level).

Thus, a possible strategy for an estate in the $350,000 to $425,000 range is to claim whatever marital deduction reduces the decedent's estate to $175,000. A taxpayer should claim the $250,000 maximum marital deduction for an estate under $500,000 only when the estate reaches $425,000 ($175,000 + $250,000 = $425,000). As the estate increases from $425,000 to $500,000, the marital bequest remains at $250,000.

Estates Over $500,000 If the estate is over $500,000, a marital bequest of 50 percent of the estate (which is the maximum deduction for estates over $500,000) will fully utilize both spouses' unified credits, will equalize the two estates, and will defer as much tax as possible. (The ability to increase the maximum marital deduction based on the adjusted gross estate via charitable gifts that return to the gross estate is discussed at 3101. A marital bequest of a lifetime interest to a spouse, with a remainder interest to charity, is discussed in 3104.)

Monetary Considerations

Bracket equalization is not the estate tax marital deduction's only function; the estate planner must also consider the marital deduction's tax postponement function. Transferring property that will be taxed at a higher rate in the wife's estate under the shelter of the husband's estate tax marital deduction may be advantageous if the investment yield on the estate tax postponed at the 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 the tax postponement will depend on the surviving spouse's longevity. The CPA must make custom-tailored projections of these factors where family wealth is already fairly evenly divided between husband and wife.

Disclaimers

> One might consider advising the surviving spouse to renounce all or part of a general power of appointment of a marital deduction trust, preserving at the same time the life estate, which will make available the Sec. 2013 credit. In many instances, one discovers after a husband's death that the wife's estate is already large enough, and her future estate tax will increase greatly as a result of the marital deduction property. Therefore, if it is desirable for a widow to renounce all or part of the general power of appointment, the tax consequences of the renunciation will be as follows:
>
> - The widow will retain a life estate, which will qualify for the Sec. 2013 credit in her estate.
> - The husband's estate will lose the marital deduction for the portion of the trust that will have been renounced.
> - The widow will neither have made a taxable gift as a result of renunciation, nor a "release" that causes the trust to be included in her gross estate at death.[3]

Gifts

Gifts are another means of transferring property to a wife. The effective estate planner must coordinate his advice regarding the

3. J. Engel, "A Look at Some Estate Planning Tools After the '76 Act," *Tax Adviser* 8 (July 1977): 408. Also see §2518(b), especially ¶(4) thereof, as amended by the Revenue Act of 1978.

maximum estate tax marital deduction with his advice in regard to a sound gift program.

Effect of the Marital Deduction on the Surviving Spouse's Estate

Since transfers to the spouse under marital deduction bequests will be subject to her highest estate tax brackets, it is advisable not to overfund the surviving spouse's estate. This consideration requires an evaluation of the spouse's probable consumption, over her life expectancy, of property that she may acquire from the decedent or from other sources and of property that she presently owns.

Consequently, the ages of both spouses are significant, since they can affect the amount of property consumed and can thus influence marital deduction provisions.

Dissipation of a married couple's wealth 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 chapter 9).

On the other hand, the spouse may desire maximum lifetime enjoyment of her property even to the detriment of her heirs—particularly if they are relative 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 will thereby be increased.

A further ramification of this problem is the extent to which generation-skipping transfers should be used to provide income for the surviving spouse while avoiding estate tax upon the death of one or more succeeding generations of beneficiaries. Trusts and similar arrangements designed to give the surviving spouse a life interest that will not be subject to estate tax at the death of the surviving spouse are not subject to the generation-skipping transfer tax. Similar arrangements designed to avoid estate tax at the death of children or younger generations generally are subject to the generation-skipping transfer tax, although there is an important exception that permits $250,000 in generation-skipping transfers to grandchildren.[4]

Other Taxes

Obviously, the estate planner must consider the effect, if any, of a marital deduction on state death taxes. In addition, the surviving

4. See §2613(a)(4), (b)(5) and (6).

spouse's existing income tax bracket also affects the amount of income-producing property to be transferred to her. It is inadvisable to transfer property whose income will be substantially consumed by income taxes. Stock passing to a surviving spouse under the shelter of the estate tax marital deduction is not eligible for capital gain treatment in a sec. 303 redemption (discussed in 1302) because no death taxes are paid from the marital share.[5]

Nature of the Property

In view of the tax postponement achieved through the marital deduction, its maximum use may be desirable if the decedent's estate is not sufficiently liquid to satisfy the estate tax that would otherwise be due.[6] This factor may be especially important if the estate consists of family business interests whose retention is paramount. The maximum marital deduction proves helpful in mitigating undesirable liquidation of these interests after the decedent's death, even though his spouse's death may precipitate increased taxes.

Personal Considerations

The estate planner must also consider the extent to which the decedent desires to place absolute control over the investment and ultimate disposition of his property in the hands of his spouse, taking into account the possibility of remarriage.

Spouse Dies First

If estate planning results in reliance on a future marital deduction, it may be advisable to insure the spouse's life as a hedge against her prior death and the loss of the anticipated deduction.

The estate planner must also consider the provisions of sec. 2056(b)(3), which, under specified conditions, do not disqualify a marital deduction that is subject to the spouse's survival. Thus, a marital deduction will not be disallowed because it could have been terminated if the spouse (*a*) died within six months after the decedent's death or (*b*) died as a result of the same disaster that

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5. §303(b)(3). See A.D. Capouano and J.F. Rinsky, "Planning Gifts to a Spouse to Obtain Maximum Tax Benefits Under the New Law," *Journal of Taxation* 46 (February 1977): 76.

6. Closely held business interests may be eligible for deferred payment of the estate tax under §6166 or §6166A. Qualified real property devoted to business or farming use may be eligible for "special use" valuation under §2032A (discussed in 3605), whose election will reduce the marital deduction. See discussion of the marital deduction and "special use" property by Capouano and Rinsky, "Planning Gifts to a Spouse," p.76.

also caused the decedent's death. (The deduction will be disallowed if the contingency does, in fact, occur.)

These provisions enable a taxpayer, under certain conditions, to bypass his spouse's estate in the event of her early death without jeopardizing his marital deduction if the event does not actually occur.

3301.2 Procedures for Obtaining the Optimum Estate Tax Marital Deduction

Optimum estate tax marital deductions should be authorized by wills carefully drawn to conform with Internal Revenue Code requirements and Supreme Court interpretations. In most situations, it is also advisable to comply with Treasury regulations (unless invalidated by the Supreme Court) and IRS rulings—unless potential tax savings make controversy worthwhile.

The optimum marital deduction is most effectively achieved through formula clauses embodied in wills. Needless to say, the drafting of wills is a legal matter that should never be attempted, on behalf of a client, by anyone other than a qualified attorney. In order to best serve the client's interest, his attorney, certified public accountant, insurance agent, and trust officer customarily conduct estate planning as a team effort. Obviously, such planning cannot ignore the manner of achieving the optimum marital deduction, which is the largest single estate tax deduction—assuming, of course, that the deduction is advantageous.

Broadly stated, a well-constructed marital deduction clause contains either a pecuniary or fractional formula for determining distributions to the surviving spouse or to a trust for her benefit (a marital trust). The selection of either formula involves a host of considerations, including the following:

- Client's wishes regarding spousal share in appreciation or depreciation of property during the estate's administration.
- Valuation and divisibility of estate assets.
- Income tax and estate tax consequences.

Pecuniary vs. Fractional Bequests

Under a pecuniary formula providing for the maximum marital deduction, an amount equal to the maximum marital deduction (the greater of $250,000 or 50 percent of the adjusted gross estate) is bequeathed to the surviving spouse, either outright or in trust. The bequest becomes a fixed and definite amount once the value of the adjusted gross estate is finally determined. Consequently, gain or loss is recognized for income tax purposes when the pecuniary bequest is satisfied with assets that have appreciated or depreciated in comparison with their bases (estate tax values).[7]

If overfunding of the surviving spouse's estate is to be avoided, the pecuniary formula clauses should prescribe appropriate adjustments for nonprobate and other property passing to the spouse.

A fractional formula providing for the maximum marital deduction is based on the following:

$$\frac{\text{M less N}}{\text{Value of residuary estate}}$$

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.

A fractional formula, unlike its pecuniary counterpart, automatically permits the marital bequest to share in appreciation and depreciation in the value of the estate. Use of this approach depends on the extent to which the estate's assets can be divided.

Maximum marital deduction formula clauses must also recognize the marital adjustment for lifetime gifts to a spouse, discussed in 3302.1.

The maximum marital deduction is not always the optimum marital deduction. The attorney should consider drafting the marital deduction formula clause in a manner that makes maximum use of both spouses' unified credits.[8]

Estate planners should also consider the equalization clause approach, which attempts to equalize the estates of the decedent and the surviving spouse; however, the service continues to adhere to its position that such transfers constitute a terminable interest, which is not eligible for the marital deduction.[9]

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7. See, e.g., Rev. Rul. 56-270, 1956-1 C.B. 325, as clarified by Rev. Rul. 60-87, 1960-1 C.B. 286. §1040, as amended by the Crude Oil Windfall Profit Tax Act of 1980, limits the taxable gain on certain distributions of property subject to special-use valuation (discussed in 3605) in satisfaction of a pecuniary bequest to postdeath appreciation (that is, basis is determined without regard to §2032A).

8. See D.A. Thomas et al., "New Variable Marital Deduction Technique Eliminates Uncertainty in Estate Plans," *Journal of Taxation* 47 (October 1977): 194.

9. See *Est. of Charles W. Smith*, 66 T.C. 415 (1976), nonacq. 1978-1 C.B. 3, aff'd *per curiam* 565 F.2d 455 (7th Cir. 1977).

IRS Requirements Regarding Pecuniary Marital Bequests

Revenue Procedure 64-19 sets forth certain conditions that are necessary for pecuniary bequests to qualify for the marital deduction but that may precipitate capital gains.[10] Although it has been suggested that distributions under Rev. Proc. 64-19 are not within the capital gains scope of Rev. Rul. 56-270 (as clarified by Rev. Rul. 60-87), the revenue service has yet to issue a ruling directly addressing this point.[11]

Revenue Procedure 64-19 is designed to prevent the estate tax avoidance that otherwise would be 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 that has declined in value after the decedent's death. Consequently, the surviving spouse would be able to receive property whose value is less than the corresponding amount allowed as a deduction in the decedent's estate. This would enable the property, to the extent of its shrinkage in value during the estate's administration, to escape transfer taxes in the hands of *both* spouses.

Similar savings of perhaps greater magnitude appear possible if trusts are established in such a manner that appreciation of principal will not be taxed at the surviving spouse's death.

3301.3 Marital Trusts

The tax planner should consider the use of marital trusts as receptacles for marital bequests.

Marital trusts must meet the following criteria established by sec. 2056(b)(5):

- The surviving spouse must be entitled to its income for life, and the income must be payable at least annually.
- She must have power, exercisable alone and in all events, to appoint the principal either to herself or to her estate.[12]

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10. Rev. Proc. 64-19, 1964-1 C.B. (part I) 682. Rev. Proc. 64-19, by its own terms (see §4.01(1) thereof), does not apply to fractional bequests.

11. See, e.g., Mark B. Edwards, "Which Marital Deduction Formula Clause Is Best for Your Client," *Journal of Taxation* 27 (October 1967): 233, which also indicates that these capital gains can be diminished by (1) funding the marital bequest as soon as possible (after the decedent's death) and/or (2) careful selection of funding assets.

12. For discussion of lifetime versus testamentary general power of appointment over the marital trust, see *Working With the Revenue Code 1979*, ed. I.F. Diamond and M. Walker (New York: AICPA, 1979), p.399.

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. This regulation was invalidated by a 1967 Supreme Court decision, which held that a partial interest can 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.[13]

The Court's dissenting opinion indicated that under this rationale a partial interest qualifies for the marital deduction when rights to both principal and income are limited to fixed amounts. Substantial tax savings may be possible in such an event:

> 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. . . .

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.

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13. *Northeastern Pennsylvania National Bank and Trust Co.*, 387 U.S. 213, distinguished in Rev. Ruls. 77-444, 1977-2 C.B. 341, and 79-86, 1979-10 I.R.B. 20.

3301.4 Estate Trusts

The tax planner should consider the use of an estate trust to accumulate income for a high-bracket spouse.[14]

Revenue Ruling 68-554 holds that an estate trust qualifies for the marital deduction if the corpus and any accumulated income will be paid to the estate of the surviving spouse, even though the spouse may not receive any, of the trust income during her lifetime.[15]

The unlimited throwback rules of secs. 665 through 668 apparently apply to the distribution of such accumulated income to the spouse's estate. The beneficiary computes the tax by using three of the years of a five-year base period (eliminating the year with the highest taxable income and the year with the lowest taxable income).

It is unlikely that the tax on the accumulation distribution will exceed the tax already paid by the trust, thus eliminating any additional tax as a result of the accumulation distribution; however, an increase in the tax rates applicable to estates and trusts (in excess of the rates during the years of the accumulation) may cause additional tax to be due on the accumulation distribution. Repeal of the character pass-through rule for accumulation distributions (other than distributions of tax-exempt interest) is another factor that may result in additional tax—for example, the loss of the dividend exclusion (and, for 1981-82, the interest exclusion).[16] The estate will, however, qualify for the $600 exemption, in contrast to the $100 exemption allowable to the estate trust. On the other hand, no refunds are possible.[17]

In any event, the throwback rules do not prevent use of an estate trust as a means of bypassing the high income tax brackets of a surviving spouse.

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14. For additional discussion of the use of estate trusts, see M.A. Wolfson, "Disposition of Specific Assets: His and Hers, Determining and Plastering Ownership; Problems Created by 'Boilerplate'; Use of Marital Deduction, Survivorship, Planning Considerations and Techniques," *N.Y.U. Institute on Federal Taxation* 33 (1975): 204.

15. Rev. Rul. 68-554, 1968-2 C.B. 412. A testamentary marital trust that effectively combines the feature of an estate trust with a life-estate-power-of-appointment trust also qualifies for the marital deduction (Rev. Rul. 72-333, 1972-2 C.B. 530, distinguished by Rev. Rul. 75-128, 1975-1 C.B. 308, in a contrary situation).

16. In connection with the accumulation throwback rules, see B. Barnett, "The Taxation of Trust Distributions Revisited After the '76 Act," *Tax Adviser* 9 (January 1978): 22; D.L. Cornfeld, "New Laws on Accumulation Trusts Require Practitioners to Take Prompt Action," *Journal of Taxation* 45 (December 1976): 331.

17. §666(e).

3301.5 Technical Background

Briefly, an estate tax marital deduction is allowable for the value of qualifying property interests passing to a surviving spouse, but it is limited to a maximum deduction of the greater of $250,000 or 50 percent of the adjusted gross estate. Prior to the Tax Reform Act of 1976, the maximum marital deduction was simply 50 percent of the adjusted gross estate. Thus, the Tax Reform Act of 1976 increased the maximum marital deduction to more than 50 percent whenever the adjusted gross estate is less than $500,000.

The change affects only the limitation on the marital deduction (that is, the maximum deduction); the actual deduction is still limited to the amount of qualifying property passing to the surviving spouse.

For example, if a decedent's adjusted gross estate is $600,000 and the marital bequest to the surviving spouse is $300,000, the estate tax marital deduction is $300,000. If the adjusted gross estate is $400,000 and the marital bequest is $300,000, the marital deduction is $250,000; however, if the marital bequest is $225,000, the marital deduction is $225,000.

If community property is not involved, *adjusted gross estate* is the gross estate less deductions claimed under secs. 2053 and 2054 for funeral and administrative expenses, indebtedness, taxes, and casualty and theft losses. For simplicity, this study uses the term *adjusted gross estate* interchangeably with *estate*.

Community property is excluded from the adjusted gross estate for purposes of computing the maximum marital deduction.[18]

The $250,000 limitation on the marital deduction is also subject to a community-property adjustment. Section 2056(c)(1)(C) reduces the $250,000 amount by the excess of the community property included in the gross estate over the secs. 2053 and 2054 deductions allocable to community property. For example, an estate of $200,000 (half of community property of $400,000) is entitled to an estate tax marital deduction of $50,000 so that it will have parity with a common-law estate, whereas there was no marital deduction prior to the Tax Reform Act of 1976 because the estate consisted entirely of community property.[19] It may be possi-

18. See, e.g., Rev. Rul. 76-349, 1976-2 C.B. 297.

19. R.L. Lerner, "Spouse to Spouse—The Gift and Estate Tax Marital Deduction," *N.Y.U. Institute on Federal Taxation* 36 (1978): 159.

ble to minimize the community-property taint and thus create a marital deduction by partitioning income-producing property.[20]

The maximum estate tax marital deduction may also be reduced as a result of lifetime gifts to a spouse.

3302 Lifetime Gifts to a Spouse

Split gifts and limited gifts to a spouse may prevent wastage of the unified credit should the spouse with a small estate, or no estate at all, die before the donor.

3302.1 Technical Background

The Gift Tax Marital Deduction

Qualifying gifts to a spouse are deductible as follows.

Gift	Marital deduction
First $100,000	100%
Second $100,000	0%
Over $200,000	50%

Example A husband makes a one-time gift to his wife in 1980 of $150,000. The taxable gift is $50,000 ($150,000 gift less the $100,000 marital deduction).

The greatest barrier to obtaining the gift tax marital deduction is the "nondeductible terminal interest," which is defined in the Gift Tax Regulations promulgated under sec. 2523.

The gift tax marital deduction is in addition to the $3,000 annual exclusion. The Tax Reform Act of 1976 "did not change the ordering rule of Section 2524, i.e., the annual exclusion is taken into account first before a portion of the gift to a spouse is considered to be deductible under the marital deduction provision."[21]

20. This planning technique, based on Rev. Rul. 67-171, 1967-1 C.B. 274, is discussed in *Working With the Revenue Code 1979*, p.404.

21. Explanation of prior law (not changed by the Revenue Act of 1978), U.S., Congress, Joint Committee on Taxation, *General Explanation of the Revenue Act of 1978*, 96th Cong., [illegible] sess., 1979, p.431.

The Marital Adjustment

A donor's maximum estate tax marital deduction is reduced to the extent that he is allowed to deduct more than 50 percent of post-1976 gifts to his spouse (sec. 2056(c)(1)(B)). This *marital adjustment* occurs whenever post-1976 gifts to a spouse are less than \$200,000 (that is, when the gift tax marital deduction exceeds 50 percent of the gift). The marital adjustment only reduces the limitation—the greater of \$250,000 or 50 percent of the adjusted gross estate—and does not necessarily reduce the actual marital deduction.

Example A husband makes a \$100,000 gift to his wife in 1980. He dies more than three years later, leaving an estate of \$500,000, which goes to his wife to the extent of the maximum marital deduction. Without the marital adjustment, the maximum estate tax marital deduction would have been \$250,000 (the greater of \$250,000 or 50 percent of \$500,000). However, there is a marital adjustment of \$50,000 (the excess of the \$100,000 gift tax marital deduction over \$50,000, that is, 50 percent of the gift). This adjustment reduces the maximum estate tax marital deduction to \$200,000, resulting in a taxable estate of \$300,000. This is the same result as if there had been no gift (in which case, there would have been a \$600,000 estate less a \$300,000 marital deduction). The wife's estate would also be \$300,000 in either case, that is, a \$300,000 marital bequest or a \$100,000 lifetime gift plus a \$200,000 marital bequest. (The \$3,000 annual exclusion is not considered in this example.)

3302.2 Limited Gifts to a Spouse

Because the first \$100,000 of marital gifts are fully deductible, they provide a means of building up the estate of the spouse who has few assets.[22] While the estate tax marital deduction may also provide a tax-free transfer of assets to the spouse's estate, it is useful only if the wealthier spouse dies before the spouse with fewer assets.

Figure 33-1 demonstrates the use of lifetime gifts to a spouse as insurance in this situation. The following facts are assumed:

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22. See also *Working With the Revenue Code 1979*, p.411.

- The full $47,000 unified credit has been phased in, so the equivalent exemption is $175,000 (rounded from $175,625).
- No prior taxable gifts have been made.
- There are no credits other than the unified credit, and there is no $3,000 annual exclusion.
- There are no administrative expenses or estate tax deductions other than the marital deduction.
- If the donor dies before his spouse, there is a marital bequest of the maximum amount qualifying for the marital deduction. (If the donor's spouse dies before the donor, there is no marital bequest to the donor.)
- A nonmarital bequest either to the children or to a nonmarital trust gives the surviving spouse income and other limited rights for life, with a remainder interest to the children.
- The nonmarital bequest is not taxed in the surviving spouse's estate and bears the estate tax burden.

Because the first $100,000 of lifetime gifts to a spouse are fully deductible, they are not added back in the taxable-gift category of the donor's estate tax computation, nor will they be included in the gross estate unless they are made within three years of the donor's death. Thus, up to $100,000 of lifetime gifts to a spouse can successfully transfer assets that would be taxed in the donor's estate into the shelter of the spouse's unified credit. As shown in figure 33-1, when the donor is the surviving spouse the couple's combined taxes are reduced by $39,000 ($298,800 − $259,800) as the result of a $100,000 marital gift. (This is because the $100,000 escapes tax in both estates.) This suggests such strategies as gifts to a terminally ill spouse who has a small estate.[23] Such gifts may also yield an income tax advantage by permitting an increase in the basis of appreciated property under sec. 1014.

While there may be an incentive to make gifts in excess of $100,000 to assure full use of the donee's $175,000 exemption equivalent, gifts in excess of $100,000 but less than $200,000 are added back to the donor's estate tax base. As a result, such gifts may be taxed in both estates, and they may be difficult to justify. Gifts in excess of $100,000 may be appropriate, however, if the

23. See also J.N. Karasik, "New Law Offers One-Time Gift Planning Opportunities Before the Year Ends," *Estate Planning* 4 (Autumn 1976): 9, which states, "As a result, a new form of 'deathbed gift' will arise, slightly more morbid than the old one—instead of gifts *by* dying people, we will see gifts *to* dying people."

Figure 33-1

Effects of Lifetime Gifts on a $1 Million Estate

	No gifts		$100,000 gift to spouse	
	Donor	Donor's spouse	Donor	Donor's spouse
Donor is the surviving spouse				
Donor's estate	$1,000,000		$1,000,000	
Lifetime gifts	—		100,000	$100,000
Taxable estate	1,000,000	-0-	900,000	100,000
Taxable gifts	—	—	—	—
Tax base	1,000,000	-0-	900,000	100,000
Estate tax (net of unified credit)	298,800	-0-	259,800	-0-
Add donor's tax to spouse's tax		$298,800		259,800
Combined estate taxes		$298,800		$259,800
Donor is not the surviving spouse				
Donor's estate	$1,000,000		$1,000,000	
Lifetime gifts	—		100,000	$100,000
Donor's estate	1,000,000		900,000	
Marital deduction	500,000	$500,000	400,000*	400,000
Taxable estate	500,000	500,000	500,000	500,000
Taxable gifts	—	—	—	—
Tax base	500,000	500,000	500,000	500,000
Estate tax (net of unified credit)	108,800	108,800	108,800	108,800
Add donor's tax to spouse's tax		108,800		108,800
Combined estate taxes		$217,600		$217,600

*After deducting a $50,000 marital adjustment, which applies to gifts under $200,000.
Source: J.M. Pusey, "How to Get the Maximum Benefit from the Unified Credit," *Practical Accountant* (September 1978): 43 (reprinted with permission).

donor anticipates significant increases in value of the gifted property, since gifts added back to the donor's estate tax base are measured by the property's value at the date of the gift. Such gifts may also be appropriate if the tax on the surviving spouse's estate

Figure 33-1 (cont.)

Effects of Lifetime Gifts on a $1 Million Estate

	$200,000 gift to spouse		$300,000 gift to spouse	
	Donor	Donor's spouse	Donor	Donor's spouse
Donor is the surviving spouse				
Donor's estate	$1,000,000		$1,000,000	
Lifetime gifts	200,000	$200,000	300,000	$300,000
Taxable estate	800,000	200,000	700,000	300,000
Taxable gifts	100,000		150,000	
Tax base	900,000	200,000	850,000	300,000
Estate tax (net of unified credit)	259,800	7,800	240,300	40,800
Add donor's tax to spouse's tax		259,800		240,300
Combined estate taxes		$267,600		$281,100
Donor is not the surviving spouse				
Donor's estate	$1,000,000		$1,000,000	
Lifetime gifts	200,000	$200,000	300,000	$300,000
Donor's estate	800,000		700,000	
Marital deduction	400,000	400,000	350,000	350,000
Taxable estate	400,000	600,000	350,000	650,000
Taxable gifts	100,000	—	150,000	—
Tax base	500,000	600,000	500,000	650,000
Estate tax (net of unified credit)	108,800	145,800	108,800	164,300
Add donor's tax to spouse's tax		108,800		108,800
Combined estate taxes		$254,600		$273,100

is a secondary concern or if a charitable bequest may eliminate tax in the survivor's estate.

In figure 33-1 a $200,000 gift by a surviving donor did not reduce the donor's estate tax beyond that resulting from a $100,000 gift. (It is $259,800 in both situations.) In fact, the $200,000 gift increased the tax on the spouse's estate by $7,800. Figure 33-1 also shows that a $300,000 gift by a surviving donor reduced the donor's estate tax by $19,500 beyond that resulting from the $200,000

Figure 33-1 (cont.)

Effects of Lifetime Gifts on a $1 Million Estate

	$350,000 split gift		$100,000 gift to spouse +$150,000 split gift	
	Donor	Donor's spouse	Donor	Donor's spouse
Donor is the surviving spouse				
Donor's estate	$1,000,000		$1,000,000	
Lifetime gifts	350,000		250,000	$100,000
Taxable estate	650,000		750,000	100,000
Taxable gifts	175,000	$175,000	75,000	75,000
Tax base	825,000	175,000	825,000	175,000
Estate tax (net of unified credit)	230,550	-0-	230,550	-0-
Add donor's tax to spouse's tax		230,550		230,550
Combined estate taxes		$230,550		$230,550
Donor is not the surviving spouse				
Donor's estate	$1,000,000		$1,000,000	
Lifetime gifts	350,000		250,000	$100,000
Donor's estate	650,000		750,000	
Marital deduction	325,000	$325,000	325,000*	325,000
Taxable estate	325,000	325,000	425,000	425,000
Taxable gifts	175,000	175,000	75,000	75,000
Tax base	500,000	500,000	500,000	500,000
Estate tax (net of unified credit)	108,800	108,800	108,800	108,800
Add donor's tax to spouse's tax		108,800		108,800
Combined estate taxes		$217,600		$217,600

gift ($259,800 – $240,300), but at a cost of a disproportionate $13,500 increase in the couple's combined taxes ($281,100 – $267,600).

If the donor is not the survivor, the combined estate taxes resulting from a $300,000 gift are $18,500 higher than those resulting from a $200,000 gift ($273,100 – $254,600). Similarly, a $200,000 gift results in $37,000 more estate taxes than a $100,000 gift ($254,600 – $217,600).

It appears, therefore, that marital gifts in excess of $100,000 are often self-defeating, even in large estates, under the unified system. This is because gifts are added to the donee spouse's estate that are also added back, at least in part, to the donor's estate tax base. Thus, the donor should consider giving high-income-producing assets or assets that are likely to appreciate; such gifts help to build up the estate of the spouse with the smaller estate. The donor should also consider an annual gift program designed to enable him to take advantage of the $3,000 annual exclusion.

If the donor is not the surviving spouse, the marital adjustment may neutralize any advantage of the lifetime gift by reducing the donor's estate tax marital deduction. In figure 33-1 the $100,000 gift reduced the $1 million estate to $900,000; however, since the $100,000 gift was fully deductible, the $50,000 marital adjustment (50 percent of $100,000) reduced the estate tax marital deduction from $450,000 (50 percent of $900,000) to $400,000. The result is that the donor's taxable estate ($500,000) is the same as if there had been no lifetime gifts.

In addition, the combined effect of the marital adjustment and the add-back of taxable gifts to the donor's estate tax base prevents any reduction in the nonsurviving donor's estate, even as gifts increase to $300,000.[24] Moreover, as gifts by the nonsurviving donor increase beyond $100,000 (and are at least partially taxable), there is a resulting increase in the couple's combined taxes.

3302.3 Split Gifts

Split gifts are another means of avoiding waste of the unified credit of the spouse with little or no estate.[25] The spouse with the large estate makes a gift to a third party, and the other spouse consents to being treated as having made half the gift. The basic advantage of gift splitting under the unified transfer tax system is that it provides balance by transferring half the gift from the donor's estate to the spouse's estate.

Gift splitting is less effective than the first $100,000 of fully

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24. If the assumption in figure 33-1, herein, is altered so that there is a gift tax payable, there is some reduction in the donor's estate tax since the gift tax itself is removed from the tax base (except for gifts within 3 years of death).

25. See also N.X. Marx, "Split Gifts in Anticipation of Divorce," Tax Clinic, ed. S. Braun, *Tax Adviser* 10 (February 1979): 79.

deductible gifts to a spouse because $200,000 in gifts to third parties are needed to add $100,000 to the nondonor spouse's estate.

Figure 33-1 demonstrates the ability of a $350,000 third-party gift, subject to gift splitting, to make full use of the nondonor spouse's unified credit. If the donor is the surviving spouse, a $68,250 tax saving ($298,800 − $230,550) results from shifting half of the $350,000 gift into the shelter of the consenting spouse's exemption equivalent ($175,000 × the donor's 39 percent marginal tax bracket = $68,250). Thus, in the case of a terminally ill spouse with a small estate, gifts to third parties may be advantageous.

As in the case of gifts to a spouse, the ability to balance the estates by gift splitting is important, particularly if the spouse with the larger estate is the survivor. Otherwise, the estate tax marital deduction may be available to balance the estates and take advantage of both spouses' unified credits.

As can be seen in figure 33-1, if the donor is not the surviving spouse $350,000 in gifts to third parties have no effect on taxes; the taxes are no different than if no gift were made. This is because gift splitting, like the estate tax marital deduction, shifts half the assets into the consenting spouse's estate.

Gifts to third parties still have the advantages of eliminating gift or estate tax on appreciation after the date of the gift and of shifting income from the property to low-bracket family members or trusts for their benefit (see 901 and 902).

If all the assets are owned by one spouse, a combination of split gifts to third parties and marital gifts, totaling $250,000, makes it possible to fully use the nondonor spouse's unified credit. As with the $350,000 split gift, there is $68,250 in estate tax savings ($298,800 − $230,550) if the donor is the surviving spouse and no tax consequence ($217,600 in either case) if the donor is not. This combination of marital and split gifts creates less disparity in the *economics* of providing for the donor's surviving spouse than the $350,000 split gift.

Combinations of marital gifts and split gifts may also be advantageous when the objective is to eliminate tax in the first estate in anticipation of the surviving spouse's consumption of sufficient assets to avoid or minimize the estate tax in the second estate, and such combinations are advantageous when this task will be performed by a charitable bequest in the survivor's estate. It is possible to eliminate the donor's transfer taxes in an estate of $650,000 with a combined gift program.[26]

3302.4 When Both Estates Exceed the Exemption Equivalent

The principles outlined in this section generally apply when the estates of both spouses exceed the exemption equivalent. In such cases, a marital transfer or gift splitting may not exempt any property from tax but may subject it to tax in the estate with the lower marginal tax rate.

The tax rates above the level of the exemption equivalent start at a fairly high rate: 32 percent after 1979. Since the incentive for lifetime transfers often relates to the possibility that the spouse with the smaller estate will die first, lifetime transfers designed to take advantage of lower rates may increase the tax in the first estate. Thus, any advantage from lower overall estate tax rates may be offset by the disadvantage of accelerated estate tax.

3302.5 Diminution of the Estate Tax Marital Deduction

The marital adjustment generally neutralizes the benefit of lifetime gifts to a spouse if the donor dies before the other spouse (except that transfer tax on postgift appreciation is avoided in the first estate). An individual with a $1 million estate may pass $500,000 tax-free to the surviving spouse either as the result of (*a*) a $500,000 estate tax marital deduction or (*b*) a $100,000 gift tax marital deduction and a $400,000 estate tax marital deduction.

The marital adjustment is fully effective for a $600,000 estate reduced to $500,000 as the result of a $100,000 marital gift; however, the marital adjustment is not completely effective when lifetime gifts reduce the estate below $500,000. A $500,000 estate reduced to $400,000 by a $100,000 marital gift is still entitled to a $200,000 estate tax marital deduction (the greater of $250,000 or 50

26. The donor could make both a $100,000 lifetime gift to his spouse (not subject to gift tax) and a $350,000 split gift (also not subject to gift tax). The $450,000 of lifetime gifts would reduce the $650,000 estate to $200,000. The $200,000 estate tax marital deduction ($250,000 less a $50,000 marital adjustment) would then reduce the taxable estate to zero. The $175,000 post-1980 exemption equivalent is sufficient to absorb the $175,000 "adjusted taxable gifts" (50% x $350,000) included in the estate tax base and thus eliminate the estate tax.

percent of $400,000, less the $50,000 marital adjustment). Thus, the maximum fully deductible marital transfer possible for a $500,000 estate is $300,000, the same as for an estate of $600,000 (that is, $100,000 gift tax marital deduction plus $200,000 estate tax marital deduction). Without lifetime gifts to a spouse, the $500,000 estate is limited to an estate tax marital deduction of $250,000.

The following table demonstrates the ability of a $100,000 marital gift to significantly reduce the tax on the first estate with only a modest increase in the couple's combined tax.

	No gift		$100,000 gift	
	Decedent	Surviving spouse	Decedent	Surviving spouse
Estate	$500,000		$400,000	$100,000
Marital deduction	−250,000	+$250,000	−200,000	+200,000
Taxable estate	250,000	250,000	200,000	300,000
Post-1980 estate tax	23,800	23,800	7,800	40,800
		23,800		7,800
Combined taxes		$ 47,600		$ 48,600

The table assumes that the survivor's estate consists only of assets received from the other spouse and that the nonmarital bequest bears the estate tax burden.

The tax planner must appreciate the effect of marital gifts that reduce the estate below $500,000. It may be appropriate to review will provisions of moderate-sized estates to determine whether any adjustment to the marital bequest for lifetime gifts to a spouse is consistent with the estate plan. When the donor is survived by the donee spouse, the range in which there will be a significant tax incentive for such gifts may be rather limited. The estate tax marital deduction and post-1980 exemption equivalent make it possible to eliminate any tax in the first estate if the estate is $425,000 or less ($250,000 estate tax marital deduction plus $175,000 post-1980 exemption equivalent). An estate of $600,000 making a $100,000 gift is not affected by the gift. Nevertheless, there is a range in which a moderate-sized estate may gain additional marital deductions as a result of inter vivos gifts to a spouse, even if the donor is survived by the donee spouse.[27]

27. See *Working With the Revenue Code 1979*, p.411.

Planning in connection with the marital adjustment is also possible with respect to the $3,000 annual exclusion. The $3,000 annual exclusion applies before the individual claims any gift tax marital deduction; however, in computing the marital adjustment, the individual subtracts from the gift tax marital deduction the excess of 50 percent of the value of any gifts that must be reported on a gift tax return.[28]

Example A and B both make $100,000 gifts to their spouses (ignoring the annual exclusion). For the next ten years, A makes subsequent gifts of $2,000 each year, and B makes gifts of $3,030 each year.

At the time of their deaths (three years after the last gifts), their estates would compute the marital deduction as follows.[29]

Gifts to spouse	Estate of A	Estate of B
1. Initial gift	$100,000	$100,000
2. Subsequent gifts reported	none*	30,300
3. Total gifts reported	100,000	130,300
4. Gift tax marital deduction	100,000	100,000
5. 50% of gifts	50,000	65,150
6. Excess gift tax marital deduction, which reduces estate tax marital deduction.	50,000	34,850

*Gifts of $3,000 or less need not be included in a gift tax return (sec. 6019(a)).

B's estate has an additional estate tax marital deduction of $15,150, resulting from additional gifts of only $10,300 and taxable gifts of only $300. Thus, although it requires thirty-three years at $3,030 per year to obtain a full estate tax marital deduction, each gift that is reported reaps some benefit.[30]

28. § 2056(c)(1)(B)(ii).

29. § 2056(c)(1)(B) specifically provides that if a gift is includible under § 2035 it is not taken into account in computing the adjustment to the marital deduction. This favorable adjustment in the estate tax marital deduction is the opposite of the result under § 2035: Gifts made within 3 years of a taxpayer's death are added back to the gross estate unless the donee was not required to file a return for the gifts. If the donor dies within 3 years of having made a gift for which a gift tax return was required, the gift must be added back to his gross estate.

30. Adapted from D.S. Rhine, "Marital deduction: The Code Loveth a Cheerful Giver," Tax Clinic, ed. S.R. Josephs, *Tax Adviser* 10 (May 1979): 296.

34

Estate and Gift Taxes

Satisfying Estate Tax Liability With Par Value of Certain U.S. Bonds Acquired at Discount

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 they are 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.[1] Other federal regulations require that these "flower bonds" be part of the "estate," which means that the bonds must be part of the probate estate.[2]

Whether bonds of a particular issue may be redeemed for this purpose depends on the terms of the offering circulars cited on the face of the bonds.[3] No bonds with this redemption feature could be issued after March 3, 1971, but there are still substantial amounts of such bonds outstanding.

Bonds acceptable as estate tax payments have recently been selling at attractive discounts of approximately 20 to 25 percent. The gross economic gain realized upon redemption of the bonds must be reduced, however, by the increased estate tax attributable

1. Estate Tax Regs. §20.6151-1(c).

2. 31 C.F.R. §306.28 (1978). B.W. Kanter, "Marketable Securities: Some Estate Planning Techniques and Approaches," *N.Y.U. Institute on Federal Taxation* 35 (1977): 1217.

3. A current list of eligible issues can be obtained from any federal reserve bank or branch or from the Bureau of Public Debt in Washington, D.C.

to their inclusion in the decedent's gross estate at par value instead of the lower value based on selling price.[4] Par value valuation also applies to the extent that the bonds *may* be used in payment of estate taxes.[5] Of course, this estate tax valuation results in a stepped-up basis, which eliminates any taxable gain for income tax purposes.

The lower fair market value applies to the extent that the bonds cannot be so used in payment of estate taxes. This value may differ for state death tax purposes.[6]

Par value valuation applies to all Treasury bonds that *may* be used for estate tax payments, *regardless of whether or not they are actually so used.*[7] Therefore, failure to use such bonds as estate tax payments can be financially unfortunate unless the holder expects the future market value to exceed par value.

Par value valuation also applies to the extent of estate tax deficiencies and resulting interest, even if the flower bonds are sold, and the proceeds reinvested for higher yield, in the interim between the filing of the estate tax return and the assessment of the deficiency.[8] "It now appears . . . that 'excess' flower bonds should not be disposed of until the IRS waives audit of the Form 706, or any issue resulting from an audit is finally resolved."[9]

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4. Because of their lower estate tax rates, smaller estates may actually enjoy a greater return on investment from flower bonds than larger estates (C.L. Herting, "Deathbed Estate Planning for the Investor," *Tax Adviser* 5 (June 1974): 346).

5. Rev. Rul. 69-489, 1969-2 C.B. 172; Rev. Rul. 76-312, 1976-2 C.B. 262; *Banker's Trust Co.*, 284 F.2d 537 (2d Cir. 1960), rev'g district court, cert. den. 366 U.S. 903; *Charles H. Candler, Jr.*, 303 F.2d 439 (5th Cir. 1962), aff'g district court; *Seattle-First National Bank (Est. of H.V. Laucks)*, 63-1 U.S. Tax Cas. ¶12,137 (D. Wash. 1963); *Est. of W.M. Buchholtz*, 70 T.C. 814 (1978).

6. "In New York, California and Ohio, for example, bonds eligible for redemption are valued at par. In Illinois, and Montana, for example, because of the local statutory language of 'clear market value,' the bonds would be valued only at their market value" (Kanter, "Marketable Securities," pp. 1216–17). Also see n. 4, above.

7. Rev. Ruls. 69-489 and 76-312; *Banker's Trust Co.*, 284 F.2d 537 (2d Cir. 1960). I.R.S. Ltr. Rul. 7934060 held that flower bonds must be valued at par, regardless of whether they are allocated to a residuary trust obligated to pay the estate tax or to a marital deduction trust (see 3301.3, herein). In the ruling a revocable trust provided that at the taxpayer's death the trust would be divided into three separate trusts. The trustee had the authority to select which assets would be allocated to each trust. The ruling states: "In the event that there are flower bonds in excess of the amount that may be applied at par in payment of the Federal Estate Tax, an interrelated computation is necessary to determine the value of the gross estate. In that event, we will be happy to furnish the computation upon receipt of a ruling request. . . ."

8. *Buchholtz*, 70 T.C. 814 (1978), and *Est. of E.G. Simmie*, 69 T.C. 890 (1978).

9. Tax Trends, ed. E.S. Linnett, *Tax Adviser* 9 (June 1978): 372.

The tax planner must be especially careful in a community-property state:

> In a community property state care must be taken to insure that sufficient bonds are purchased. IRS ruled in Rev. Rul. 76-68 that only one-half of bonds purchased with community funds could be used to pay death taxes at par. The case of *Coletta Lake Ray* (1976) provides a method whereby all bonds purchased on the separate credit of the decedent may be utilized.[10]

The appellate court commented in the *Ray* case:

> The tax savings plan effectuated by a loan secured by the separate property of the spouse in the terminal days of the decedent's mortality was ingenious if not entirely ingenuous. Nevertheless, as the perceptive opinion of the trial court cogently demonstrates, the transaction was secure from the tax gatherer's scythe. . . ."[11]

3401 Use of Powers of Attorney or a Revocable Trust

As a possible means of assuring an adequate supply of acceptable Treasury bonds in case of incapacity prior to death, a taxpayer may execute powers of attorney in advance to authorize purchases by designated agents. Bonds purchased by a trustee of an existing revocable trust may also be used for this purpose.

3401.1 Powers of Attorney

There are no provisions preventing the redemption of flower bonds at par value in payment of estate taxes, even if 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. Such powers authorize designated persons in a close personal or business relationship with an individual to make bond purchases in the event of his disability. This procedure safeguards against the possibility that the supply of bonds will be insufficient to extinguish estate tax liability.

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10. *Working With the Revenue Code 1979*, ed. I.F. Diamond and M. Walker (New York: AICPA, 1979), p.428.

11. *Ray*, 538 F.2d 1228 (5th Cir. 1976), aff'g 385 F.Supp. 372 (D. Tex. 1975).

It has been suggested that in crucial situations, such as those involving substantial estates or precarious health, agents (banks, trust companies, and so forth) located in Hawaii be included in a power of attorney to permit maximum time, because of zone differences, in which to purchase bonds in case of an emergency.

The government has resisted the acceptance of such bonds pursuant to powers of attorney granted by incompetents, even though the powers of attorney were granted prior to incompetance. Taxpayers have had some success in countering the government's position.[12] The taxpayer should consult legal counsel about the legal status of any power of attorney and about whether the bonds will be considered "owned by the decedent" at his death.[13]

3401.2 Revocable Trusts

The payment privilege is available not only for bonds owned directly by the decedent but also for bonds that are otherwise includible in his estate. Thus, bonds owned by a revocable trust may qualify. Powers of attorney are not needed when 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.

Bonds held by a trust will only qualify under the following conditions:

> (a) if the trust actually terminated in favor of the decedent's estate, or, (b) if the trustee is required to pay the decedent's Federal estate tax under the terms of the trust instrument or otherwise, or (c) to

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12. See *Est. of A.K. Watson*, 77-2 U.S. Tax Cas. ¶13,214 (D. N.Y. 1977), rev'd for lack of jurisdiction by 586 F.2d 925 (2d Cir. 1978); *Est. of Pfohl*, 69 T.C. 405 (1977); *Est. of Pfohl*, 70 T.C. 630 (1978); *Est. of Pingree*, 78-1 U.S. Tax Cas. ¶13,238 (D. Me. 1978); *Est. of B.S. Stevenson*, 79-1 U.S. Tax Cas. ¶13,285 (D. D.C. 1979).

13. In regard to *Watson*, note the following comments by the editors of the *Journal of Taxation*: "Subsequent to the granting of the power of attorney in this case, New York, the state where the decedent was domiciled, enacted a law that provides that a power of attorney may survive the incompetency of its principal, if the instrument by which the power of attorney is created indicates the principal's intention that it so survive. Several other states, including Alaska, Arizona, Idaho, Kentucky, Maryland, New Jersey, Oregon, and Virginia have similar laws.

"Thus, purchase of flower bonds under a power of attorney including this provision would appear to negate any Treasury attack. In states that have not enacted such a provision, a court petition for the appointment of a conservator-to-collect might be filed and court authority obtained for the conservator to buy the bonds" [48 (January 1978): 26].

However, see the discussion in *Pfohl*, 70 T.C. 630 (1978), regarding the effect of local law.

> the extent the debts of the decedent's estate, including costs of administration, State inheritance and Federal estate taxes, exceed the assets of his estate without regard to the trust estate.[14]

Only very limited changes in ownership after death, such as transfers to representatives of the owner's estate, are permitted.[15] This is an important factor to consider in using a revocable trust to acquire flower bonds.[16]

3402 Sustaining Capital Losses Through Sales and Repurchases in a Declining Bond Market

In a declining bond market, the taxpayer should consider sales and repurchases of Treasury bonds in order to recognize capital losses and to maintain his position in regard to future estate tax payment. To prevent disallowance of losses, the taxpayer must avoid purchasing replacement bonds that are "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. Selling declined-in-value bonds in order to sustain capital losses. (See chapter 14 for the effect of such losses.)
2. Purchasing other Treasury bonds that are acceptable in payment of estate taxes in order to preserve the economic benefit afforded by these securities when they eventually are used for such payment.

A deduction is not allowed, generally, for loss from sale of bonds or other securities if, within either thirty days before or after the sale (within a sixty-one-day period), substantially identical property is reacquired.[17]

Substantially identical is not defined in either the code or the regulations; however, some elaboration has been provided by sev-

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14. 31 C.F.R. §306.28(b)(iii) (1978).
15. 31 C.F.R. §306.28(c) (1978).
16. For a discussion of the use of revocable trusts to acquire flower bonds, see Kanter, "Marketable Securities," pp. 1219–23. See also *Working With the Revenue Code 1979*, p.428.
17. §1091.

eral revenue rulings. For example, Rev. Rul. 60-195 stated the following:

> 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, C.B. 1958-1, 529, at 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 of bonds are considered to be a material feature. . . .[18]

Accordingly, the ruling held that 3.45 percent bonds are not substantially identical to 4.5 percent bonds.

Revenue Ruling 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.[19]

There is no disallowance of a wash sale loss if substantially identical property is acquired either more than thirty days prior to the sale or more than thirty days after the sale. Nevertheless, it does not appear prudent for a client to rely on this exception, since death could occur during this sixty-one-day period, at a time when he must be devoid of this particular bond investment.

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18. Rev. Rul. 60-195, 1960-1 C.B. 300.

19. See also Rev. Rul. 76-346, 1976-2 C.B. 247, indicating that annual interest rates, maturity dates, and status as flower bonds are all material factors for purposes of the wash sale rules. See also Rev. Rul. 58-210, 1958-1 C.B. 523.

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Estate and Gift Taxes

Jointly Held Property

3501 Maintaining Adequate Substantiation

3501.1 Jointly Held Property in General

To avoid unnecessary double estate taxation, a taxpayer should maintain proper records in regard to the financing of certain jointly owned property.

Section 2040(a) requires the total value of all jointly held property, except tenancies in common, to be included in the gross estate of a co-owner, regardless of his legal share of ownership.[1] The estate need not include the value of jointly held property to the extent that it is attributable to consideration in money or money's worth furnished by the surviving owners. This rule applies to jointly owned property of married couples, unless certain exceptions apply. 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.*"[2]

Example Messrs. Smith and Jones jointly own property that they acquired in 1944 at a total cost of $20,000. Smith believes they each contributed half the purchase price, but this fact can no longer be substantiated. Smith dies in 1980, when the property is worth $100,000. Since Jones's consideration cannot be sufficiently shown, the entire value is included in Smith's gross estate. Jones succeeds to full ownership of the property, which he retains until his death in 1991. At that time, its entire value is again subjected to estate tax.

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1. Estate Tax Regs. § 20.2040-1(b).
2. Estate Tax Regs. § 20.2040-1(a); emphasis supplied.

Co-owners of property held in joint tenancy or in tenancy by the entirety (applicable to married couples) should definitely maintain adequate records and sufficient corroboration to meet the substantiation requirements of regs. sec. 20.2040-1(a). The availability of such data will prevent estate taxation of more than the decedent's financially proportionate share of ownership.

As a practical matter, a taxpayer should also maintain such information with regard to tenancies in common in order to avoid gift and estate tax treatment that is inconsistent with actual facts but that may be asserted by the taxing authorities.

Estate planners should evaluate the most desirable form of property ownership as part of an overall estate plan.

3501.2 Business or Farm Property

If a spouse "materially participates" in a business or farm, this fact should be documented for all years. Also, the tax planner should consider material participation by a spouse who previously has been inactive in the business or farm.

For estates of decedents dying after 1978, sec. 2040(c) provides the following:

> a special elective rule for excluding a portion of the value of certain jointly owned property used in a farm or other business in which the surviving spouse materially participated. The exclusion is based on the number of years the surviving joint tenant materially participated in the business. Material participation is to be determined in a manner similar to that used under section 1402(a)(1), relating to net earnings from self-employment. The provision applies only to a joint interest in property held by a husband and wife.
>
> The amount excludable is equal to the sum of the amount determined by applying a percentage rate of 2 percent for each year the surviving spouse materially participated in the business (not to exceed 50 percent) to the excess of the value of the joint interest (as determined for estate tax purposes) over the amount attributable to the original consideration furnished by both spouses and the amount attributable to the original consideration furnished by the surviving spouse. For this purpose, the amount attributable to the original consideration consists of the amount of that consideration plus assumed appreciation at the rate of 6 percent simple interest for the period of investment of the consideration.
>
> The aggregate amount by which the value of the decedent's gross estate may be reduced by exclusions under this provision is $500,000, and the provision may not result in the inclusion in the decedent's gross estate of less than 50 percent of the value of the eligible joint interest.

> The provision applies if elected by the executor of the estate not later than the time for filing the estate tax return (including extensions) and in the manner prescribed under Treasury regulations.[3]

Under this formula, it is possible for less than the decedent's adjusted consideration, or the portion of the value attributable to the decedent's adjusted consideration, to be included in the decedent's gross estate if the total appreciation in the property has been less than the assumed 6 percent increase in the original consideration. The 1979 Technical Corrections Act "correct[s] this result by providing that the special rule would not apply if the sum of the adjusted consideration provided by both spouses equals or exceeds the value of the property on the date of the decedent's death."[4]

An individual should take steps that will enable his executor to prove the scope of the activities of the surviving spouse for each year of material participation. The criteria apparently relate to physical work performed and participation in management decisions.[5] Presumably, pre-1979 years of material participation are considered. The type of documentation and other evidence needed to support material participation by the surviving spouse depends on the circumstances. Possible items include diaries of hours worked, retention of correspondence and notes of meetings, and communications informing bankers and others of the spouse's material participation in the farm or business.

To be eligible for the material participation rules, the property must be an interest in real or tangible personal property that is used as a farm or for farming purposes or that is used in any other trade or business.[6] There must also be an *eligible joint interest*, which is defined as any property held by the decedent and the decedent's spouse as joint tenants or as tenants by the entirety, but only if both of the following are true:

- The joint interest was created by the decedent, the decedent's spouse, or both.

3. U.S., Congress, Joint Committee on Taxation, *General Explanation of the Revenue Act of 1978*, 96th Cong., 1st sess., 1979, p.287. See also R.A. Sugar, "How New Section 2040(c) Alters the Estate Tax Burden on Jointly-Owned Property," *Journal of Taxation* 50 (May 1979): 270.

4. U.S., Congress, Senate, Finance Committee, 96th Cong., 1st sess., 1979, S.Rep. 498, p.75.

5. See regs. §1.1402(a)-4(b).

6. §2040(c)(4).

- In the case of a joint tenancy, only the decedent and the decedent's spouse are joint tenants.

3502 Electing Gift Treatment for Creation of Certain Joint Tenancies

The tax planner should consider compliance with sec. 2040(b), including the sec. 2515(c) election, to avoid double estate taxation of a married couple's jointly owned property.

Section 2040(b) provides an exception to the general sec. 2040(a) rule. If jointly owned property of a husband and wife constitutes a qualified joint interest, the value included in the gross estate with respect to the interest is limited to half the value of the qualified joint interest. Although lifetime gifts are now included in the computation of the donor's estate tax, compliance with sec. 2040(b) ensures that postgift appreciation attributable to the nondonor spouse's interest will not be included in the donor's gross estate.

A *qualified joint interest* is defined as any interest in property held by the decedent and the decedent's spouse as joint tenants or as tenants by the entirety, but only if the following are true:

- The joint interest was created by the decedent, the decedent's spouse, or both.
- In the case of personal property, the creation of the joint interest was a completed gift for gift tax purposes.
- In the case of real property, an election under sec. 2515 applies with respect to creation of the joint interest.
- In the case of a joint tenancy, the only joint tenants are the decedent and the decedent's spouse.

3502.1 Valuation

To value the gift when one spouse created joint ownership with the right of survival in the other spouse, it was formerly necessary to make actuarial calculations if the right of survival was destructible only by mutual consent.[7] Recent legislation generally eliminates the need for such actuarial calculations.[8] The value for gift tax

7. U.S., Congress, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976*, 94th Cong., 2d sess., 1976, p.534.

8. In regard to real property, see §2515(c)(3) and the *General Explanation of the Tax Reform Act of 1976*, p.536. In regard to personal property, see §2515A(a) and the *General Explanation of the Revenue Act of 1978*, p.438.

purposes of both real and personal property is generally half the value of the joint interest, including half the value of additions and payments on indebtedness.[9]

3502.2 Personal Property

A qualified joint interest requires a completed gift. Thus, if the joint tenant who furnished all the consideration is permitted to withdraw all the joint property, as in the typical joint bank account, there is no completed gift.[10] Similarly, a transfer of funds to a joint brokerage account in which securities are held in a "street name" is not a completed gift.[11]

Section 2040(b) treatment requires an election with respect to real property. Because the provision is of relatively recent vintage (the Tax Reform Act of 1976) and regulations have not been proposed, it is not clear whether affirmative action is necessary for personal property to be eligible for sec. 2040(b) treatment. It may be advisable to file a gift tax return to establish that the creation of a joint interest in personal property was a completed gift, even though a gift tax return would not otherwise be required.

3502.3 Real Property

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*) a joint tenancy between husband and wife in real property with right of survivorship and (*b*) a tenancy that accords to the spouses rights equivalent to (*a*), regardless of the term by which such a tenancy is described in local property law.)[12] 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.

Section 2515(a) provides that the contribution made by either or both spouses in the creation of such a tenancy during calendar

9. §2515A(b) contains an exception for personal property if the fair market value of the interest or the property (determined as if either spouse had a right to sever) cannot reasonably be ascertained except by reference to the life expectancy of one or both spouses.

10. *General Explanation of the Tax Reform Act of 1976*, p.536.

11. Rev. Rul. 69-148, 1969-1 C.B. 226.

12. See Gift Tax Regs. §25.2515-1(b) for circumstances creating tenancies by the entirety.

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 the transition as a gift in the calendar quarter in which the transaction is effected. This treatment applies only to tenancies created in real property. There is, however, a gift upon termination of the 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). Thus, a sec. 2515(c) election may exempt postelection appreciation attributable to the nondonor spouse's interest from the donor's estate if the property is held until death, or it may exempt postelection appreciation from gift tax if the property is later sold at an appreciated value and the proceeds are divided equally between the spouses. Any transfer tax savings must be balanced against any financial costs arising from immediate gift tax payments.

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 between the co-owners, an election is advisable, 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

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 renders an election distinctly disadvantageous.

3502.4 Old Joint Interests

Section 2040(d) provided a procedure to qualify pre-1977 joint tenancies as qualified joint interests without formally severing the joint tenancy and recreating it.[13] It was necessary to make a sec. 2040(d) election on a timely filed gift tax return for a calendar quarter in 1977, 1978, or 1979.[14]

It is still possible to qualify an "old" joint tenancy as a qualified joint interest if the formalities of severance and recreation are observed. Sec. 2040(e) sets forth the following requirements:

- Before 1977 the husband and wife must have had a joint interest in the property with the right of survivorship.
- After 1976 the joint interest is terminated.
- After 1976 a joint interest must be recreated in the property.
- The election under sec. 2040(d) must be made by filing a gift tax return for the calendar quarter in which the creation occurs (after 1979).[15]

The tax consequences, if any, of the severance or partition of the existing joint interest are governed by the general rules. For example, no gift is considered to have been made if the property interests or proceeds are distributed or reinvested in proportion to the consideration furnished by either spouse.[16]

The measure of the gift from recreating the severed joint tenancy is 50% $\times$ (A $\times$ B $\div$ C), where A represents the value of the property on the date of the gift less the value at the time of the creation of the pre-1977 joint interest, B represents the consideration furnished by the donor toward the original pre-1977 joint tenancy less the consideration furnished by the donor's spouse toward the original pre-1977 joint tenancy, and C represents the total consideration furnished by both toward the creation of the original pre-1977 joint tenancy.[17]

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13. See *General Explanation of the Revenue Act of 1978*, p.439.

14. On December 29, 1979, the president signed into law Pub.L. 96-167, which extends the fourth-quarter gift tax return due date to the following April 15. The new provision applies to gifts made in calendar years after the date of enactment. The §2040(d) election can be made in a timely filed gift tax return, *including extensions* (see supplementary information accompanying temp. regs. §23.1, filed March 19, 1980, as T.D. 7687). Under §6075(b)(3) an income tax return extension also extends the time for filing a fourth-quarter gift tax return. Gift tax return extensions may also be obtained under §6081. In either case, the maximum extension is six months. Thus, it may have been possible to make the §2040(d) election for the fourth quarter of 1979 as late as October 15, 1980.

15. The deadline for making the election under §2040(d)(2) (i.e., a timely filed return for 1977, 1978, or 1979) does not apply, pursuant to §2040(e)(2)(A), if the requirements of §2040(e)(1) are satisfied.

16. For example, see the *General Explanation of the Tax Reform Act of 1976*, p.535.

17. §2040(d)(4) and (5), as modified by §2040(e)(2)(B).

If the original creation was with respect to real property and no sec. 2515(c) election was made, or was made with respect to personal property, and a gift tax return was filed but the gift was not reported (and the statute has expired), then the value of the property at the creation of the pre-1977 joint tenancy is considered to be zero.

Example A couple purchased a home for $50,000 in 1969 as joint tenants with rights of survivorship. The husband has furnished all consideration, including house payments. No election under sec. 2515(c) was made. The original ownership is severed and recreated in June 1980, when the value of the home is $200,000. The measure of the gift from recreating the joint tenancy with rights of survivorship is $100,000:

$$50\% \times \left(\$200{,}000 \times \frac{\$50{,}000}{\$50{,}000} \right)$$

3502.5 Income Tax Effect

Income from property held in joint ownership is generally taxable to both co-owners in proportion to the income that they are entitled to receive under applicable local law. The usual rule in most states is that the income inures equally to both co-owners (Massachusetts and North Carolina are among the exceptions).[18] This treatment is inconsequential if joint returns are filed.

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18. Mertens, *Law of Federal Income Taxation* (Chicago: Callaghan & Co.), §§ 17.03 and 17.04. See also Rev. Rul. 76-348, 1976-2 C.B. 267.

36

Estate and Gift Taxes
Additional Techniques

3601 Effect of Gifts Included in Gross Estate

Gifts that are ineffective for estate tax purposes can nevertheless achieve tax savings. Deathbed gifts to a dying spouse with a small estate may also be advantageous.

Ineffective gifts that are brought back into the gross estate under secs. 2035 through 2038, and removed from the taxable gift category in the estate tax computation, may subject the postgift appreciation to transfer (estate) tax (see 901.4). On the other hand, such gifts may increase the estate tax marital deduction (discussed in 3301) when it is based on the adjusted gross estate. Ineffective charitable gifts may be particularly advantageous, since they may increase the estate tax marital deduction and thereby decrease the taxable estate (see 3101).

3601.1 Gifts Within Three Years of Death

Post-1976 gifts made within three years of the donor's death, plus the related gift tax, are now automatically included in the donor's gross estate.[1] This contrasts with the previous rule, which applied a subjective contemplation-of-death test and contained no gross-up for the related gift tax. The purpose of the gift tax gross-up is to eliminate the incentive for deathbed transfers that would otherwise remove the gift tax from the transfer tax base; however, the statutory gross-up for gift taxes is limited to the federal gift tax, and deathbed gifts may still have the advantage of removing state gift taxes from the gross estate.[2] Also, gift taxes on gifts made more

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1. See §2035(c).
2. U.S., Congress, Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1976*, 94th Cong., 2d sess., 1976, p.529.

than three years before the donor's death have the advantage of removing the gift tax from the transfer tax base. (This is illustrated in 901.4.)

Revenue Ruling 75-63 requires state gift taxes on a transfer in contemplation of death, which constitute prepaid state inheritance taxes, to be included in the donor's gross estate.[3] The Tax Court, however, has twice rejected this ruling.[4]

3601.2 Deathbed Gifts

Except for gifts of life insurance, gifts that are not reportable, due to the donor's $3,000 annual gift tax exclusion, are not added to the donor's gross estate. Thus, deathbed gifts designed to take advantage of the $3,000 annual exclusion can remove significant amounts from the gross estate. (See the discussion of ineffective gifts in 901.5.)

Deathbed charitable gifts may also yield income and estate tax charitable contribution deductions. If the estate tax marital deduction is based on the adjusted gross estate, it will be increased by inclusion of the charitable gift in the gross estate under sec. 2035.[5]

Deathbed gifts *to* a dying spouse with a small estate that are made under the shelter of the donor's $100,000 gift tax marital deduction, as well as split gifts in contemplation of the death of the spouse with a small estate, may save transfer tax to a donor-spouse surviving more than three years beyond his spouse's death. (For further discussion, see 3302.)

3602 Split Gifts by Married Couples to Third Parties

The tax planner should consider whether a gift to a third party should be split between a donor and his spouse.

Gift splitting is another measure designed to achieve federal tax parity between residents of common-law and community-property states. Gift splitting to avoid waste of the unified credit of the

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3. Rev. Rul. 75-63, 1975-1 C.B. 294.

4. *Est. of George E.P. Gamble*, 69 T.C. 942 (1978), government's appeal to 9th Cir. dismissed; *Est. of G.E. Lang*, 64 T.C. 404 (1975), aff'd on this issue by 9th Cir., 80-1 U.S. Tax Cas. ¶13,340.

5. See *Est. of T.C. Russell*, 70 T.C. no. 6 (1978), acq. 1979-8 I.R.B. 6. See also the related discussion in 3101.5, herein.

spouse with little or no estate and to shift assets into the estate of a spouse with a lower marginal tax rate is discussed in 3302.3 and 3302.4.

3602.1 Gift Splitting by Spouses in Different Gift Tax Brackets

When spouses are in different gift tax brackets, the tax planner should suggest that gifts be judiciously timed.

Because under regs. sec. 25.2513-1(b)(5) the gift-splitting election is available on a quarter-by-quarter basis and cross-consents are mandatory, significant tax savings are possible when one spouse is in a higher gift tax bracket than the other spouse and both spouses plan to make substantial gifts. The spouse in the lower gift tax bracket should make gifts in a quarter during which the first spouse makes no reportable gifts, and the couple should not elect gift splitting for that quarter. The other spouse may make gifts in a later quarter, in which gift splitting is elected, and in which the benefits of a lower combined tax accrue.[6]

3602.2 Providing for Postmortem Consent

The wills of both spouses should specifically instruct the executors to consent to gift splitting if it is advantageous to the combined interests of husband and wife. This consent, however, may not always be advisable.

The executor or administrator of a deceased spouse may signify the consent required by sec. 2513(a)(2) in order to obtain gift splitting.[7] Of course, the advisability of providing for, and exercising, such consent should also be reviewed with legal counsel.

Decedent Was the Donor

For situations in which gifts for the year of death have been made only by the decedent, the repeal of the subjective contemplation-of-death rule and the mandatory inclusion in the donor's estate of all reportable gifts made within three years of the donor's death should eliminate any benefit that gift splitting might have for the donor's estate.

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6. For further discussion and illustration, see *Working With the Revenue Code 1979*, ed. I.F. Diamond and M. Walker (New York: AICPA, 1979), p.409.

7. See Gift Tax Regs. §25.2513-2(c).

> Under the 1976 act, where the donor spouse dies within three years of making a "split gift," the entire gift is included in the donor spouse's estate and any gift tax actually paid by the consenting (nondonor) spouse on the gift is allowed as a credit in determining the estate tax for the estate of the donor spouse. . . .[8]

Even split gifts within three years of death that would merely take advantage of the nondonor spouse's annual exclusion will be ineffective, under the three-year rule, in avoiding inclusion of the property in the donor's estate.

> A gift of a present interest in property valued at $3,500 which is made within 3 years of death would be includible in the donor's gross estate even though the gift was fully excludable because the other spouse consented to be treated as the donor of one-half of the gift. . . .[9]

Despite the inclusion of the entire property in the donor's gross estate, the election may nevertheless be advantageous in reducing the estate tax of the surviving spouse. The Revenue Act of 1978

> provides for the reversal of the transfer tax consequences of gift splitting to the estate of the consenting (nondonor) spouse if the gift is included in the gross estate of the donor spouse as a transfer made within three years of death. In computing the estate tax for the consenting spouse, the Act excludes the gift in determining the amount of lifetime transfers under the unified transfer system. However, the gift tax paid by the consenting spouse would not be taken into account as a credit against the estate tax of the consenting spouse if it had been allowed as a credit to the estate of the donor spouse.[10]

Thus, while the credit for the gift tax paid by the nondonor spouse is lost to that spouse (and shifted to the donor spouse), the gift tax paid by the nondonor spouse does not appear to be subject to estate tax in the estate of the nondonor spouse, at least if the nondonor spouse survives the gift by three years.[11] The gift tax

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8. Explanation of prior law (which was unchanged by the Revenue Act of 1978), U.S., Congress, Joint Committee on Taxation, *General Explanation of the Revenue Act of 1978*, 96th Cong., 1st sess., 1979, p.433. The inclusion of the gift in the gross estate removes it from the taxable-gift portion of the estate tax computation. See §2001(b).

9. *General Explanation of the Revenue Act of 1978*, p.429. See the discussion of gifts within 3 years of death in 901.5, herein.

10. *General Explanation of the Revenue Act of 1978*, p.433.

11. §2035(c) includes in the gross estate any gift taxes paid by the decedent or his estate on any gift made by the decedent or his spouse during the 3-year period ending on the date of the decedent's death. See also J.J. Cowley and S.L. Jones, "The New Estate and Gift Tax Provisions Concerning Unified Rates and Credits, Marital Deductions and Joint Interests," *Univ. of Southern Calif. Tax Institute* 29 (1977): 243.

paid by the nondonor spouse also is not subject to tax in the donor's estate because the gross-up for gift taxes within three years of death does not apply to any gift tax paid by the decedent's spouse.[12]

To summarize, the effects of gift splitting in this situation include the following:

- The consenting spouse incurs a gift tax expenditure, which is utilized as a credit against the donor spouse's estate tax.
- The cash used to pay the consenting spouse's gift tax is removed from her gross estate if she survives for more than three years after the gift.

In determining the advisability of gift splitting for the family unit, the tax planner must also consider such factors as the impact of the expenditures and credits on different family members and the time value of money. Obviously, a CPA can only evaluate all factors through detailed calculations geared to the specific circumstances of a particular client.

Postmortem consent is inadvisable if the donor's estate is so small that it would not benefit from the credit for the gift tax paid by the nondonor spouse. The donor spouse's estate would not appear to be entitled to a refund if the subtraction for gift taxes payable in the estate tax computation exceeds the estate tax.[13]

Decedent Was Not the Donor

If only the surviving spouse has made gifts for the year of death, the reverse situation may prevail. The executor's duty, in general, may preclude such consent, since it may increase the decedent's transfer taxes, even if the increased tax would be more than offset by savings to the surviving spouse.[14] Even more dramatic savings are possible when the executor's postmortem consent does not result in transfer tax because of the decedent's unified credit. Figure 33-1 in chapter 33 demonstrates the use of split gifts to take advantage of the unified credit of a spouse with a limited amount of separate property.

The estate of the nondonor spouse is not able to deduct the

12. *General Explanation of the Tax Reform Act of 1976*, p.529.

13. §2001(b).

14. §2513 treats the nondonor spouse as making half the gift for purposes of chap. 12 (gift taxes), so such gifts may not be subject to §2035. Thus, such gifts are includible in the taxable gift category of the estate tax computation rather than in the gross estate, a factor that affects the valuation of such property. See Cowley and Jones, "The New Estate and Gift Tax Provisions," p.243. The IRS recently held to this effect in Ltr. Rul. 8023021.

gift tax paid for estate tax purposes, since the executor's postmortem consent does not retroactively create an enforceable obligation at the date of death.[15]

3603 Possible Depreciation or Amortization Deductions for Gift Tax Applicable to a Gift of Income Interest in a Limited Term Trust

In appropriate circumstances, it may be desirable for income beneficiaries to claim depreciation or amortization deductions for gift tax attributable to the gift of their income interest.

In accordance with the IRS Experimental Revenue Rulings Program, in April 1967 the American Institute of Certified Public Accountants Committee on Federal Taxation suggested the matter of such gift tax amortization as a 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. . . .[16]

Note Within a month, the service indicated that it would not rule on this matter because it could find no legal basis to do so.

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15. *Proesel Trustees et al.*, 585 F.2d 295 (7th Cir. 1978), aff'g D., cert. den. May 21, 1979; Rev. Rul. 70-600, 1970-2 C.B. 194.

16. The Tax Reform Act of 1976 amended § 1015 to provide that gift tax paid with respect to such a gift is limited to the "gift tax attributable to the net appreciation on the gift" (*General Explanation of the Tax Reform Act of 1976*, p. 561).

Nevertheless, authority for this position may be found in the following:

- Regs. sec. 1.167(a)-3, which allows depreciation deductions for intangible assets.
- Mertens, *Law of Federal Income Taxation*, which states that depreciation or amortization of the purchase price of an outstanding life estate is allowable over the life expectancy of the measuring life (for example, the life of an income beneficiary).[17]
- The Virginia district court decision in *Thomas A. Grant*, in which 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.[18]

In the case of accumulation trusts, depreciation appears to be allowable to the income beneficiary even if 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 that a holder of a life or terminable interest acquired by gift cannot "set up the value of the expected future payments as corpus or principal and claim deduction for shrinkage or exhaustion thereof due to the passage of time."

A taxpayer might claim a deduction in his income tax return in the following manner.[19]

Total basis of taxpayer's interest	$12,100
Term	121 months
Monthly depreciation	$ 100
Annual depreciation	$ 1,200

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 are likely upon examination (which may be precipitated by claiming such deductions). Thus, profes-

17. See Mertens, *Law of Federal Income Taxation* (Chicago: Callaghan & Co.), §23.63(a) and the cases cited at n.84, therein.

18. *Thomas A. Grant*, 202 F.Supp. 608 (D. West. Dist. Va. 1962).

19. An income beneficiary of property held in trust may claim deductions for § 167 depreciation in determining adjusted gross income. See §62(6); regs. § 1.62-1(c)(9).

sional advice to a client should include an evaluation of the risks and consequences of an IRS audit.

The benefits to be derived from the effective use of short-term trusts are discussed in 902.2.

Sec. 1001(e)(1) provides that in the computation of gain or loss from the sale or other disposition of a term interest in property; that portion of the adjusted basis "which is determined pursuant to section . . . 1015 . . . shall be disregarded."

3604 Controlling Estate Tax Values

Whenever it is permissible, an individual should act to control or determine estate tax values in order to obtain the best combination of results for present estate tax and for successor owners' possible future income taxes.

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 on the property for federal estate tax purposes. The estate tax value is determined as of the date of death or as of the alternate valuation date granted by sec. 2032. While a higher value tends to produce additional estate tax, it also secures a higher basis for income tax purposes and thus serves to reduce future income taxes.

In measuring the impact of the relationship between present estate taxes and possible future income taxes, the tax planner should consider the following factors:

- The effective estate tax rate.
- The likelihood of the property's future disposition in a transaction subject to income tax.
- The estimated income tax rate that will be effective at that time, and for earlier years if the property is depreciable.
- The cost of using money to pay additional estate taxes presently in order to reduce a possible future income tax.

The tax planner should weigh the interrelationship between present estate taxes and possible future income taxes in those situations in which the valuation of property is not entirely ascertainable in an objective manner. He should advise the taxpayer to take appropriate action to control or determine estate tax values. In any event, the taxpayer should not report unrealistic values because of apparent tax advantages.

The following are examples of situations in which valuation can be affected by subjective judgment:

- An executor's evaluation of a closely held corporation's goodwill.[20]
- Prior administrative or judicial determinations, as discussed in 3604.1.
- An execution of a binding buy-and-sell agreement.[21] Such an agreement restricts the seller's opportunity to dispose of the property in any other manner. These agreements have not judicially been given such controlling effect in valuing property for gift tax purposes.

> 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. . . .[22]

Also, see 802.3, "Freezing the Estate Through Stock Ownership."

3604.1 Effect of Prior Determinations

The estate tax valuation of closely held stock and other such gray-area property can be affected by final Internal 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 official estate tax valuations can be a factor in a decision about whether gifts should be made, and it may be a factor in the evaluation of any revenue service proposals in regard to their value.

A final determination of the value of closely held stock given to charity and claimed as an income tax deduction may 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 that are still open for income tax refunds or

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20. Rev. Rul. 59-60, 1959-1 C.B. 237.
21. *Est of O.B. Littick*, 31 T.C. 181, acq. 1959-2 C.B.5.
22. Mertens, *Law of Federal Gift and Estate Taxation*, §9.06.

credits can have some deterrent effect on 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.

Conversely, the allowance of such a charitable contribution as an income deduction can establish a minimum valuation for estate tax purposes, which may be difficult for an executor to overcome. Hence, the tax planner should not overlook 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.

A prior determination regarding the value of both taxable and charitable gifts of closely held stock and other such property can also provide some degree of certainty about the worth, in the eyes of the taxing authorities, of the remaining property to be valued for estate tax purposes. This knowledge can help the tax planner to estimate the estate tax liability and to plan for its satisfaction.

Further aspects of taxable gifts and their relationship to estate taxes are discussed in 901 and 3601.

3604.2 A Technical Glimpse at Section 2032

Under sec. 2032 all properties in the gross estate can be valued as follows:

- Property disposed of within six months of an individual's death is valued as of the date of disposition.
- Property not disposed of within six months of an individual's death is valued as of the date six months after death.

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 that are not due to the time lapse.

Required Election

Section 2032(c) requires the taxpayer to exercise an election on Form 706 in a timely filed estate tax return. All election designations should be completed as provided on Form 706.

The tax planner should be aware of Rev. Rul. 61-128, in which the taxpayer did not use the "general information election box," although property values were shown under the "alternate value" captions and the tax was based thereon.[23] The service permitted the use of sec. 2032 in these circumstances.

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23. Rev. Rul. 61-128, 1961-2 C.B. 150.

3605 Special-Use Valuation for Farms and Closely Held Business Realty

Where appropriate, a tax planner should attempt to plan to meet the requirements for valuing farm and business realty according to its farm or business use and to avoid its highest-and-best-use value (for example, as a real estate development).

Under sec. 2032A if certain conditions are met, certain real property may be valued for estate tax purposes at its farm- or business-use value rather than on its "highest-and-best-use" value. This special-use valuation cannot reduce the gross estate by more than $500,000.

> To qualify for the special use valuation rule, several requirements must be satisfied. First, the real property must have been owned by the decedent (or a member of his family) and used for farm or business purposes for five of the eight years preceding the decedent's death. Second, a substantial portion of the adjusted gross estate must consist of qualified property, i.e., 50 percent must consist of real and personal property used in the business and 25 percent must consist of real property used in the business. Third, the qualified property (the portion satisfying the 50- and 25-percent tests) must pass to members of the decedent's family (known as qualified heirs). Also, the decedent or a member of his family must have materially participated in the business in which the property is used for five of the eight years preceding the decedent's death.[24]

If, within fifteen years after the decedent's death but prior to the death of a qualified heir, the qualified heir disposes of the property to other than a family member, or the original use of the property changes, then all or part of the tax benefit of the special-use valuation must be recaptured.

If special-use valuation is desired, the individual should plan to do the following:

- Dispose of qualified property to qualified heirs. Qualified heirs include a spouse, lineal descendants, ancestors, lineal descen-

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24. Explanation of prior law in the *General Explanation of the Revenue Act of 1978*, p.421. In regard to the definition of *material participation*, see prop. regs. §20.2032A-3(d). The Revenue Act of 1978 clarified that real property is eligible for special-use valuation only to the extent that it passes to qualified heirs (*General Explanation*, p.421), specified that property is not ineligible for special valuation merely because it satisfies a pecuniary bequest (p.422), limited the recognition of gain when special-use-valuation property is used to satisfy a pecuniary bequest (p.423), and clarified that the special-use valuation is to apply to community property in the same manner as property owned in an individual capacity (p.425).

dants of a grandparent (aunts and uncles and their descendants), and spouses of such descendants.[25]

- Satisfy the 50 percent and 25 percent tests, which may involve lifetime gifts of nonqualified assets. (Gifts are discussed in chapter 9.)
- Substantiate material participation by the individual or a family member.

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25. §2032A(e)(1) and (2).

Appendix

Checklist of Tax Planning Techniques For Individuals

The Assumed Economic Life Cycle

This checklist is presented in the form of a questionnaire that serves as a summary of various tax planning techniques presented in the text according to the following assumed economic life cycle of an individual.

Phase of cycle	Economic processes	Tax planning techniques	Chapters
I	Gross income is encountered and exposed to taxation.	Minimizing income subject to tax.	5-22
II	Expenditures incident to ownership of wealth.	Maximizing income tax deductions.	23-30
III	Further disbursement of wealth.	Transfers and other inter vivos transactions that may reduce income, estate, gift, and generation-skipping transfer taxes.	31-36

Moreover, individual taxpayers can be categorized as (1) executives and other employees, (2) investors, and (3) professional and other self-employed persons. Since tax planning for each of these groups cannot be uniform, the following designations will be used to indicate the categories to which a technique will apply:

E — Executives and other employees
I — Investors
P — Professional and other self-employed persons

Initial Considerations

Minimum Taxes and Tax Rate Mitigation

	See in text	Tax planning for
1. Is the effect of the 15 percent add-on minimum tax considered in arranging transactions involving tax preferences?	101	E I P
2. Is the effect of the alternative minimum tax considered in arranging transactions involving long-term capital gains, excess itemized deductions, and credits (other than the foreign tax credit)?	102	E I P
3. Can income be shifted to a year in which a favorable income-averaging computation applies?	Chap. 2	E I P
(*a*) Is base-period data always readily available?	201	E I P
(*b*) Is general income averaging more beneficial than		
• 50 percent maximum tax rate on personal service income?	Chap. 3	E P
• Special ten-year-averaging computation for certain lump-sum distributions from qualified retirement plans?	Chap. 11	E P
4. Will the 50 percent maximum tax rate on personal service income be reflected in planning for such matters as		
(*a*) Incorporating a personal service business?		
(*b*) Restricted property compensation?		
(*c*) Deferred compensation?		
(*d*) Personal service income versus nontaxable fringe benefits?		
(*e*) Utilization of tax losses?		
(*f*) Documenting "reasonable compensation"?	Chap. 3	E P

	See in text	Tax planning for
5. Can steps be taken to avoid undue fluctuations in annual taxable income?	Chap. 4	E I P
6. 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	401	E I P
7. Have nontax considerations, such as monetary factors, been properly evaluated in planning for the shifting of income or deductions?	402	E I P
8. Can proper timing of income or deductions be effectively used to absorb expiring carryovers?	403	E I P

Minimizing Income Subject to Tax

Exempt Income

	See in text	Tax planning for
9. Are any or all of the following fringe benefits desirable? • Life insurance protection • Other death benefits • Medical plans • Wage continuation (disability) plans • Educational assistance programs • Qualified group legal service plans • Cafeteria plans • Meals and lodging furnished for the employer's convenience • Courtesy discounts to employees • Qualified commuter transportation • Rental value of parsonages	Chap. 5	E P
10. Should incidents of life insurance ownership be assigned?	501.1	E P

	See in text	Tax planning for
11. Are split-dollar life insurance arrangements desirable if group coverage is not feasible?	501.2	E
12. Should a life insurance trust be considered for the sake of deriving additional estate tax savings at the beneficiary's death?	501.3	E P
13. Are contractual death benefits advisable?	502.2	E
14. Can a sale of a residence be arranged to minimize tax?	601	E I P
15. Should a residence or vacation home be rented for less than fifteen days in order to exclude rentals from income?	602	E I P
16. Is insurance coverage for certain tax-exempt extraordinary living expenses desirable?	603	E I P
17. Are investments in municipal bonds advantageous?	701.1	I
18. Is it advisable to secure multiple dividend exclusions (as well as interest exclusions for 1981–82)?	701.2	I
19. Should otherwise wasted carryovers be salvaged through wash sales that would allow a tax-free increase in the basis of property?	702	E I P
20. Can appreciation on property held by fiduciaries permanently escape tax?	703	E I P
21. Can appreciated and declined-in-value properties be astutely handled prior to death?	704	E I P

Deflected Income

22. Will it be worthwhile to channel income to related entities?	Chap. 8, 9, 10	E I P
23. Should income-producing properties be incorporated?	Chap. 8	E I P

	See in text	Tax planning for
24. How can personal-holding-company classification be avoided?	801	E I P
25. Are there any estate and gift tax advantages or disadvantages to incorporating property?	802	E I P
26. Should gifts be made to family members?	Chap. 9	E I P
27. Are outright gifts always advisable?	901.1	E I P
28. What are the collateral income tax effects, if any, of outright gifts?	901.2	E I P
29. Can gift taxes be minimized?		
(*a*) Are staggered or partial gifts practical?	901.3	E I P
(*b*) Should maximum exclusions always be obtained for gifts to minors?	901.3	E I P
30. Are gifts also beneficial for estate tax purposes under the unified transfer tax system?	901.4	E I P
31. Should ineffective gifts, such as the following, be avoided? • Retained life estates • Revocable transfers • Gifts taking effect at death • Gifts within three years of death	901.5	E I P
32. Should gifts be made net of gift taxes? Can advantageous income tax consequences be obtained for net gifts in trust?	901.6	E I P
33. Can trusts be effectively used for income or transfer tax purposes?	902	E I P
34. Can a trust for the benefit of grandchildren be utilized to take advantage of the $250,000 exemption from the generation-skipping transfer tax?	902.1	E I P
35. Can a ten-year-plus (Clifford) trust be used to advantage?	902.2	E I P

	See in text	Tax planning for
36. Are joint savings accounts desirable to split income without making taxable gifts of the savings accounts?	903	E I P
37. 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?	1001	E I P
38. Could interest-free loans also be made to employees as a nontaxable fringe benefit?	1002	E

Long-Term Capital Gains

	See in text	Tax planning for
39. Have the consequences of the various alternatives for distributions from qualified plans been analyzed?	Chap. 11	E P
40. Are lump-sum distributions from qualified employees' trusts desirable? Is the ten-year-averaging computation advantageous (when available)?	1101	E P
41. Should the taxpayer elect to treat all years as post-1973 years of participation in the plan?	1102	E P
42. Should a lump-sum recipient waive favorable income tax treatment to obtain an estate tax exclusion?	1103	E P
43. Should such distributions include appreciated employer securities, which would provide further tax benefits?	1104	E
44. Should a plan provide that its covered employees may elect to receive annuities in lieu of lump-sum settlements?	1105	E
45. Can capital gain treatment be obtained for sales of subdivided real property? (*a*) Is it possible and desirable to comply with the requirements of sec. 1237? (*b*) If not, can ordinary income still be avoided?	1201	I

	See in text	Tax planning for
46. Should recapture of depreciation on real property subject to sec. 1250 be completely avoided by use of straight-line depreciation, or use of other permissible methods for certain other properties, and the holding of such properties for designated holding periods?	1202.1	E I P
47. Can ordinary income resulting from depreciation recapture be eliminated, curtailed, or deferred by such means as (*a*) Multiple asset accounts? (*b*) Installment sales? (*c*) Sales of stock instead of property? (*d*) Reliance on statutory exceptions?	1202.2	E I P
48. What steps should be taken, when practicable, to avoid matching sec. 1231 gains and losses?	1203	E I P
49. Are capital gain opportunities advantageous with regard to such natural resources as (*a*) Oil and gas? (*b*) Cut timber? (*c*) Timber, coal, and domestic iron ore royalties?	1204	I P
50. Can transfers of patent rights qualify for capital gain treatment under sec. 1235? If not, can such favorable treatment be attained through other means?	1205	E I P
51. Are capital gain opportunities maximized with respect to securities?	1301	I
52. Can capital gain treatment be obtained upon complete or partial disposition of shareholder equities? (*a*) Will collapsible corporation status be an obstacle in fulfilling this objective? If so, would statutory relief measures provide a satisfactory solution? (*b*) Can sec. 306 stock be disposed of without generating ordinary income?	1302	I

	See in text	Tax planning for
53. 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 long-term losses be applied against net short-term capital gains? (*c*) Is it possible to convert some capital losses into ordinary losses?	Chap. 14	I

Deferred Income

	See in text	Tax planning for
54. Is it possible and desirable to defer income in order to avoid immediate tax payments?	Chap. 15-22	E I P
55. Can such deferment be perpetual?	Chap. 15-22	E I P
56. Is the sale, exchange, or involuntary conversion of a residence handled in the most advantageous manner?	Chap. 15	E I P
57. Has consideration been given to the establishment of qualified retirement plans?	1601	E P
58. Has the establishment of nonqualified retirement plans been considered?	1602	E P
59. Is restricted property advisable as a means of timing compensatory income?	1603.1	E P
60. Should an employee or other provider of services exercise the election to be taxed immediately (under sec. 83(b)) regarding restricted property?	1603.2	E P
61. Should the employer restrict property with a substantial risk of forfeiture?	1603.3	E P
62. Should the employer cancel a restriction that will never lapse? If so, should it treat the cancellation as compensatory?	1603.3	E P

	See in text	Tax planning for
63. What are the opportunities for limited income shifting?	1603.3	E P
64. Are phantom stock plans advisable as a means of timing compensation?	1603.4	E
65. Are stock options beneficial?	1604	E P
66. Can individual retirement accounts be used as a means of deferred compensation?	1605	E P
67. Are simplified employee pensions mor advantageous than other forms of deferred compensation?	1606	E P
68. Are rollovers of plan distributions advisable as a means of income tax deferral and possible estate tax exclusion?	Chap. 17	E P
69. Can unwanted income be avoided through such means as		
(*a*) Installment sales?	Chap. 19	E I P
(*b*) Deferring actual or constructive receipts?	1801	E I P
(*c*) Restricted receipts, including • Bona fide loans? • Certain deposits? • Substantive escrow or trust arrangements? • Nonnegotiable contractual obligations?	1802	E I P
70. Are installment sales desirable in order to (*a*) Control timing of income for tax purposes? (*b*) Equate tax payments with cash collections? (*c*) Mitigate effects of depreciation recapture?	1901	E I P
71. Can installment sales to related parties be used to advantage?	1902	E I P

	See in text	Tax planning for
72. Can the following installment method pitfalls be overcome? • Imputed interest • Election requirements • Payments in year of sale • Minimum number of installment payments • Contingent sales price • Disposing of installment obligations	1903	E I P
73. Should short sales be used to (*a*) Equalize tax brackets? (*b*) Offset existing short-term gains against any subsequent capital losses? (*c*) Postpone or completely avoid tax payments?	2001	I
74. Can comparable objectives be accomplished through the following:		
• Options to sell property	2002	I
• Executory contracts	2003	I
75. Can stock or other securities be exchanged tax-free?	2101	I P
76. Are like-kind tax-free exchanges of eligible property always desirable? (*a*) Can taxable boot be reduced when mortgaged properties are involved? (*b*) How can advantageous three-way exchanges be arranged?	2102	I P
77. What planning considerations are involved upon the involuntary conversion of property?	2103	I P
78. Is it desirable and possible to designate loan repayments as either principal or interest?	2201	E I P
79. Are returns of capital distributions considered in investment decisions?	2202	I

	See in text	Tax planning for

Maximizing Income Tax Deductions and Credits

Generally Applicable Deductions and Credits

	See in text	Tax planning for
80. Are any tax savings available by working with the zero bracket amount?	2301	E I P
81. What steps should be taken to preserve dependency exemptions? Are there any particular problems concerning exemptions for parents or children? When can multiple support agreements be used?	2302	E I P
82. Are maximum deductions claimed for medical expenses, including insurance, travel, capital expenditures, and less obvious types of expenses?	Chap. 24	E I P
83. Are medical expenses of dependents properly handled? Can multiple-support agreements increase medical deductions?	2402	E I P
84. Is substantiation for medicine and drugs effectively controlled?	2403	E I P
85. Can medical payments be properly timed to overcome the income limitations? Would separate returns for married couples also be advisable for this purpose?	2404	E I P
86. 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?	2405	E I P
87. Can an otherwise nondeductible loss on the sale of a personal residence be converted into a limited deductible loss?	2501	E I P

	See in text	Tax planning for
88. When can depreciation and maintenance expenses be deducted on an abandoned residence?	2502	E I P
89. Is it possible to meet the tests for deductibility of expenses for the partial business use of a residence?	2503	E P
90. Has consideration been given to taking advantage of residential energy credits?	2504	E I P
91. Are tax shelters advisable in either or both of the following investment areas?		
(*a*) Real estate?	2601	E I P
(*b*) Oil and gas?	2602	E I P
92. Will such shelters be "engaged in for profit" to prevent denial of deductions under sec. 183?	2603	E I P
93. Are charges for professional services carefully itemized and allocated to deductible functions, capital expenditures, and personal expenses?	2701.1	E I P
94. Can satisfactory indemnification agreements be executed upon the sale of a business?	2701.2	I P
95. Are the most advantageous tax consequences negotiated in divorce proceedings?	2702	E I P
96. How can wasting carryovers be effectively used?	2703	E I P

Specific Expenses

	See in text	Tax planning for
97. Should contributions be made to an individual retirement account for income tax and possible estate tax advantages?	2801	E P
98. To what extent can unreimbursed or reimbursed moving expenses be deducted?	2802	E P
99. Are certain expenses more favorably claimed as deductions "toward" (as op-		

	See in text	Tax planning for
posed to "from") adjusted gross income?	2803	E P
100. Can certain employees conserve working capital through delayed additional withholding?	2804.1	E
101. Are travel and entertainment expenses properly substantiated?	2804.2	E I P
102. Are deductions claimed, where permissible, for such common activities as		
(*a*) Travel away from home?	2804.3	E I P
(*b*) Travel of spouses?	2804.4	E P
(*c*) Education?	2804.5	E P
(*d*) Partial business use of the home?	2804.6	E I P
103. Has consideration been given to all advantages and disadvantages of self-employed retirement plans?	Chap. 29	P
104. Can the limitation on deducting investment interest be avoided?	3001	I
105. Has personal use of rental property been minimized to avoid provisions designed to limit deductions for property used for personal and rental purposes?	3002	I
106. Are all allowable investment expenses claimed as deductions against ordinary income or capital gains?	3003.1	I
107. Is a reasonable formula used to allocate deductions to exempt income?	3003.2	I
108. Can some investment losses give rise to ordinary deductions?	3003.3	I

Further Lifetime Advance Planning for Income, Estate, and Gift Tax Purposes

Income Taxes

109. Are lifetime gifts to charity preferable to testamentary transfers?	3101	E I P

	See in text	Tax planning for
110. Should such lifetime gifts be incomplete for estate tax purposes so that additional estate tax savings may be possible through an increased marital deduction?	3101	E I P
111. Should gifts be made outright, or should they consist of limited interests in property, such as gifts of income or remainder interests?	3102	E I P
112. 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.	3102	E I P
113. Are gifts of the following types of partial interests advisable? • Remainder interests in personal residences (including vacation homes) or farms. • Outright gifts of undivided interests. • Leases, options to purchase, or easements with respect to real property granted in perpetuity prior to June 14, 1981, exclusively for conservation purposes. • Remainder interests in real property granted prior to June 14, 1981, exclusively for conservation purposes.	3103	E I P
114. What benefits can be derived from gifts to the following varieties of charitable remainder trusts? • Annuity trusts • Unitrusts • Pooled income funds	3104	E I P

	See in text	Tax planning for
115. What are the advantages and disadvantages of charitable gifts of income interests?	3104	E I P
116. What can be done to prevent permanent loss of charitable contribution deductions through operation of the income limitation and carryover rules? In particular, should the following kinds of contributions be avoided? • Gifts to private foundations where excess public charity contributions exist. • Gifts "for the use of charity" if the 50 percent limitation and/or carryovers are desired.	3105	E I P
117. When will it be advantageous to elect the 50 percent limitation for contributions of certain appreciated property?	3105	E I P
118. Are short-term trusts, of more than ten years' duration, advisable as a means of bypassing the income limitations on charitable contributions?	3105	E I P
119. Is there proper substantiation for noncash contributions exceeding $200?	3106	E I P
120. Will a decedent's debts be deducted for both estate and income tax purposes?	3201	E I P
121. Should administrative expenses allocable to *nonexempt* income be deducted for *either* income tax or estate tax purposes? Does this comparison include consideration of residual beneficiaries' income tax brackets?	3202	E I P
122. Is it possible to time fiduciary deductions, such as estate administrative expenses, so that they may be deducted by either the fiduciary or the beneficiaries, whichever is in the higher income tax bracket?	3203	E I P

Estate and Gift Taxes

	See in text	Tax planning for
123. Is the maximum estate tax marital deduction always advisable?	3301.1	E I P
124. How can the optimum deduction be obtained?	3301.2	E I P
125. Has consideration been given to the use of marital trusts as receptacles for marital bequests?	3301.3	E I P
126. Can an estate trust be used to bypass a surviving spouse's high income tax bracket?	3301.4	E I P
127. Can limited gifts to a spouse, as well as split gifts, avoid waste of the unified credit in the event that the spouse with the smaller estate predeceases the other spouse?	3302	E I P
128. Can U.S. bonds be acquired at a discount and used in payment of estate tax at par value?	Chap. 34	E I P
129. 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 a trustee of an existing revocable trust?	3401	E I P
130. Are sales and acceptable repurchases of U.S. Treasury bonds advisable in a declining bond market?	3402	E I P
131. Are adequate records maintained, prior to death, to prevent unnecessary double estate taxation of certain jointly owned property?	3501.1	E I P
132. If a spouse "materially participates" in a business or farm, has this fact been documented; and if not, should such participation be considered?	3501.2	P

	See in text	Tax planning for
133. Should the taxpayer comply with sec. 2040(b), including the sec. 2515(c) election, to avoid unnecessary double taxation of a married couple's jointly owned property?	3502	E I P
134. Can gifts that are ineffective for estate tax purposes nevertheless provide tax savings?	3601	E I P
135. Is it feasible to make gifts in contemplation of imminent death to save estate tax?	3601	E I P
136. Is gift splitting by married couples always advantageous?	3602	E I P
137. Can gifts be judiciously timed when spouses are in different gift tax brackets?	3602.1	E I P
138. Should provision be made for postmortem consent to gift splitting?	3602.2	E I P
139. Are there circumstances in which such consent should be refused by a surviving spouse?	3602.2	E I P
140. 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?	3603	E I P
141. In determining estate tax values, has the planner considered the impact on both present estate tax and possible future income tax?	3604	E I P
142. Is it possible to meet requirements for valuing farm and business realty at its value when used for that purpose rather than at its highest-and-best-use value (for example, as a real estate development)?	3605	P

The tax planner should also be aware of other tax planning considerations that have not been discussed in this tax study, such as private annuities, powers of appointment, and disclaimers.

Internal Revenue Code Sections

Treasury Regulations

Proposed Regulations

Revenue Rulings, Letter Rulings, and Revenue Procedures

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