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Recent Developments in Corporation Income Taxes

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The year 1959 did not produce major income tax legislation such as was produced in 1954 when the currently applicable Internal Revenue Code was adopted, or as was produced in 1958 under the Technical Amendments Act. However, there have been some important and significant developments brought about by legislation and judicial decisions, and by the Treasury Department in the administrative area of regulations, rulings, and other releases. This discussion will be limited to some of the 1959 developments that are believed to be of concern and application to corporations.

LEGISLATION

There were several developments in the legislative area that affected life insurance companies, state taxation of interstate commerce, Subchapter S, and corporation income tax rates.

LIFE INSURANCE COMPANY INCOME TAX ACT

The *Life Insurance Company Income Tax Act* (PL 86-69) signed into law by the President on June 25, 1959, furnished a new formula for the taxation of life insurance companies, which is the culmination of seven years of temporary legislation. As the Act is of very limited interest, an analysis has not been considered as being within the scope of this discussion.

INTERSTATE INCOME LAW

The new *Interstate Income Law* (PL 86-272) signed by the President on September 14, 1959 was emergency legislation to deal with the expanding problems brought about by attempts of various states to tax net income derived from interstate commerce. It is intended to lessen the impact of the United States Supreme Court's historic decision in February 1959 in the cases of *Northwestern States Portland Cement Co.* v. *Minnesota* and *Williams* v. *Stockham Valves & Fittings, Inc.* (358 U. S. 450, 79 S. Ct. 357). The *Northwestern-Stockham* cases were concerned with the constitutionality of state net income tax laws

that levied taxes on the income of foreign corporations earned within the states solely in interstate commerce. The taxpayers contended that the Minnesota and the Georgia statutes, as applied, violated both the due process and the commerce clauses of the United States Constitution.

Northwestern (an Iowa corporation) had its home office and plant in Iowa. It maintained a leased sales office in Minnesota under a district manager-salesman who supervised another salesman and a secretary. Two other salesmen used the office as a clearing house. The corporation had no warehouse, owned no real estate, and had no bank account in Minnesota. All orders for merchandise were approved, filled, and delivered from the plant in Iowa.

Stockham's situation was similar. It was a Delaware corporation with its principal office and plant in Alabama. It maintained a sales-service office in Georgia which served five states, and which was the headquarters for one salesman who devoted about one-third of his time to solicitation of orders in Georgia. The corporation maintained no warehouse or storage facilities in Georgia, and other than office equipment, supplies, etc., it had no property and deposited no funds there. All orders were approved in and shipped from Alabama.

The United States Supreme Court upheld the application of the Minnesota and Georgia statutes in these situations and concluded that net income from the interstate operations of a foreign corporation may be subjected to state taxation provided three conditions exist:

1. The levy is not discriminatory.
2. It is properly apportioned to local activities within the taxing state.
3. There is sufficient "nexus" to support the tax.

The Court determined that the first two requirements were met and that the local activities of these corporations were sufficient to form a "definite link" or "minimum connection" to satisfy the "nexus" requirement.

Subsequently, the United States Supreme Court in the case *E. T. & W. N. C. Transportation Co.* v. *Curie* (359 U. S. 28, 79 S. Ct. 602) approved the imposition of the North Carolina income tax on an interstate motor carrier. In this case the taxpayer had no offices in North Carolina but maintained motor freight terminals at several places in the state for its purely interstate operations. It owned in North Carolina, necessary furniture, fixtures, and equipment, as well as

pick-up and delivery trucks incident to the operation of the motor freight terminals. The Court merely cited the *Northwestern-Stockham* decision as its authority.

The United States Supreme Court went a step further in approving the taxation of two foreign corporations engaged exclusively in interstate business in Louisiana, even though the corporations maintained no sales offices in Louisiana. The Louisiana Supreme Court had upheld the imposition of the state income tax in the following situations:

> In *Brown-Forman Distillers Corp.* v. *Collector of Revenue* (234 La. 651, 101 So. 2d. 70), the corporation's only activity or "nexus" in Louisiana was the presence of "missionary men" who visited wholesale dealers and sometimes assisted the wholesalers' salesmen in displaying merchandise in retail stores. Actually, the "missionary men" were not even authorized to solicit sales. In the appeal to the United States Supreme Court, the motion to dismiss filed by the Collector was granted.
>
> In *International Shoe Co.* v. *Fontenot* (236 La. 279, 107 So. 2d. 640), the corporation employed fifteen salesmen who solicited shoe retailers in the State. The salesmen displayed samples in rooms of hotels, etc., but all orders were approved and filled outside Louisiana. The United States Supreme Court denied certiorari in this case which in effect held that the mere solicitation of orders by these out-of-state salesmen was sufficient to justify the imposition of Louisiana income tax.

A tremendous reaction from medium and small businesses followed. Recognizing the urgency of the situation and the potential burden placed on businesses, Congress quickly enacted the new *Interstate Income Law.* It would appear that this legislation will at least call a temporary halt to the rapidly expanding problem. Actually, the law is limited in its application. Very briefly, it provides that interstate business cannot be taxed by a state if the *only* activity within that state is the solicitation of orders for sales of tangible personal property and if those orders are approved and filled by shipment or delivery from a point outside the state. Therefore, the use of traveling salesmen and independent brokers to solicit sales, with nothing more, will not result in taxation. However, tax can still be imposed as in *Northwestern-Stockham* situations, if a corporation maintains its own sales office within the state.

Reconsideration of a company's mode of operation in various

states may be prudent at this time. Perhaps operation by means of a sales office should be replaced by independent distributors or perhaps warehouses should be established in states that impose *no* income tax.

Certainly the new law is not a cure-all, but it is a step in a favorable direction. Congress has directed the House Judiciary Committee and the Senate Finance Committee to make a full and complete study of state taxation of interstate commerce income and to report to Congress by July 1, 1962.

SUBCHAPTER S AMENDMENTS

You will recall that Subchapter S of the Internal Revenue Code was added by the 1958 Technical Amendments Act and furnished certain qualifying corporations with an election not to be taxed as a corporation. Initially, it was generally believed that Subchapter S was the answer to the problems of small corporations. However, analyses and studies of the law quickly brought the conclusion that the election was not exactly what it was thought to be; that its advantages were definitely limited, and that an election could very easily result in unforeseen pitfalls. Taxpayers should be very cautious in making such an election and should carefully consider all conceivable alternative effects. Of course, Subchapter S does have definite advantages in specific situations, such as where a business is incorporated solely to effect limited liability for its stockholders. And, at least for the present, so-called "fringe benefits" can be availed of by stockholder-employees which are not available to partners and sole proprietors. *Public Law 86-376* (signed September 23, 1959) clarified certain of the provisions relating to the election in three respects:

1. In general, stock owned by a husband and wife as community property, or as joint tenants, tenants by the entirety or tenants in common, is to be treated as owned by one shareholder for purposes of meeting the "ten or fewer stockholders" requirement. This change is applicable for years beginning after 1959.
2. If an electing corporation has a net operating loss, a shareholder who dies during the year is no longer deprived of his pro-rata share of such loss.
3. The Act makes it clear that an election will be terminated if a corporation acquires an 80 per cent interest in a subsidiary.

In connection with Subchapter S, it is worthy of note that the Commissioner's final regulations have deleted certain restrictions

contained in his proposed regulations, including his proposal to bar an election by a liquidating corporation. The elimination of this proposal leaves the door open for the advantages that may be derived by use of an election to be a pseudo-corporation while liquidating, such as the availability of corporate losses to the stockholders during the liquidation period, which might otherwise be lost.

EXTENSION OF CORPORATE INCOME TAX RATES

1959 legislation also included the usual annual extension of existing corporate income tax rates for another year to July 1, 1960 (PL 86-75 signed June 30, 1959), and the odds are good for another extension this year.

JUDICIAL DECISIONS

The following cases selected for discussion are believed to be of general interest and application, and primarily concern tax accounting principles.

TAX ACCOUNTING PRINCIPLES

Dealer Reserves Income

The basic pattern of the "Dealer Reserves" transactions is as follows:

A taxpayer who is, for example, an appliance or automobile dealer sells his merchandise on the instalment basis, accepting a down-payment, trade-in, and the customer's note for the selling price, including a finance charge. He then sells the customer's instalment note to a finance company at a discount. The dealer usually guarantees payment by the customer and the finance company holds back or reserves a part of the balance due the dealer to secure the obligation. The dealer receives the reserve only to the extent that it exceeds a specified per cent of the aggregate unpaid balances on customers' notes sold to the finance company. The question is whether the reserve is taxable income at the time of the sale of the instalment notes or when actually received from the finance company.

On June 22, 1959, the United States Supreme Court settled the dispute and enunciated a definite rule. It held that additions to a dealer's reserve account by a finance company or bank must be currently included in the dealer's taxable income and may not be deferred until such time as all or part of the reserve is received in cash. (*Com-*

missioner v. *Hansen, Commissioner* v. *Glover,* and *Baird* v. *Commissioner,* 79 S. Ct. 1217, 3 AFTR 2d. 1690). The Court said that when the dealer sold the instalment paper he acquired a "fixed right to receive" the reserves and on the accrual basis it is the right to receive and not the actual receipt that determines inclusion in taxable income. In this instance, the Court said the full reserve either will be received in cash or will be applied in satisfaction of the dealer's guaranty obligation to the finance company. Taxpayers also argued that the portion of the dealer reserve accounts consisting of "finance charges" was not a part of the sales price of the instalment paper and should not be regarded as accrued income to the dealers. The Court disposed of this argument on the basis of the lack of evidence. However, the Tax Court has repeatedly refused to afford any different tax treatment to that part of a dealer's reserve representing finance charges. (*Morgan,* 29 TC 63; *Edward C. Cadjew,* TC Memo 1959-148; *E. E. R. Shapiro,* TC Memo 1959-151).

Alternatives

It appears that the question of taxability of dealers' reserves is settled for the present. Taxpayers who have not been reporting this income until the reserves are withdrawn can expect the Commissioner to determine deficiencies for open tax years. Some degree of legislative relief is under consideration for taxpayers in such a situation. The *Dealer Reserve Income Adjustment Act of 1959* (H.R. 8684) was passed by the House of Representatives on September 9, 1959, and the bill is currently in the Senate. This bill as passed by the House is transitional in nature and provides two alternative methods for paying the tax due on the income that has not been previously reported. Taxpayers may elect to have such amounts treated as "required changes in methods of accounting" (for purposes of Internal Revenue Code Section 481), which would mean in general that reserves accumulated prior to 1954 need not be reported for tax purposes, and that only the excess of the current balance at the time of the change, over the 1954 balance in the reserve, would be reported. In a situation where there are open taxable years prior to 1954 which are still subject to assessment, it appears that the reserve balance at the beginning of the earliest open year would not be reported. A second alternative would permit the sum of the net deficiencies that would arise if the income had been reported in the proper years, to be paid in ten annual instalments generally beginning in 1961.

During 1959, no appreciable progress was made toward a closer coordination of accounting and tax principles.

The Tax Court has continued to hold that prepaid income must be included in taxable income when it is received if such income is subject to the unrestricted use of the taxpayer. In *Automobile Club of New York, Inc.* (32 TC 79), the taxpayer, on the accrual basis, received annual membership fees in advance and included in taxable income one-twelfth of such fees in each month. Thus a portion of the fees received was deferred to the subsequent year. The Tax Court upheld the Commissioner's inclusion of the advance annual fees as income in the year received. In effect, the Court applied the "Claim of Right Doctrine" in reaching its conclusion, but the facts of the case also closely resemble the Supreme Court decision in *The Automobile Club of Michigan* (353 U. S. 180) where the Commissioner was upheld on the ground that the method of deferral used was "purely artificial."

The Tax Court went a step further in *Mark E. Schlude* (32 TC 124). In this case the taxpayer operated an Arthur Murray Dance Studio and reported income on the accrual basis. Contracts with students covered lessons over a period of time, and payments were received in instalments which generally extended into the next year. Taxpayer included in income a pro-rata amount of the contracts based on the number of lessons actually taught during the year. In holding that the entire contract price must be included in income in the year the contract was entered into, the Tax Court seems to have improperly extended the "Claim of Right Doctrine" to amounts that were not paid in cash or notes and were not due in the taxable year.

In *Bressner Radio, Inc.* v. *Commissioner* (267 F. 2d. 520) the Tax Court was reversed by the Second Circuit Court of Appeals. The Commissioner had contended that under Supreme Court decisions amounts received without restriction on use must be reported in the year of receipt despite the fact that for accounting purposes they cannot be considered earned in that year. The Court of Appeals replied that none of the cases support the broad assertion that unearned receipts must be income in the year of receipt, but the issue is whether taxpayer's method of deferral did in fact "clearly reflect" income or whether it was "purely artificial." The Court upheld taxpayer's method of deferral of amounts received from television service contracts, which method was based on its past experience.

On January 19, 1960 the Internal Revenue Service announced in

TIR 205 that it will not follow the decision in *Bressner Radio, Inc.* v. *Commissioner* in cases including prepaid income. A ruling to be issued will state as follows:

> The Internal Revenue Service will continue its general policy of taxing prepaid income in the year of receipt. This policy applies to income from contracts to furnish services and to other types of prepaid income, such as prepaid royalties, rent, bonuses, etc., regardless of whether the period of proration is definite or indefinite, unless different treatment is specifically provided for in either the Internal Revenue Code or the regulations thereunder.

Perhaps relief from the confused situation on prepaid income may come by way of legislation similar to IRC Section 455 which permits an election to defer prepaid subscription income.

Depreciation

The importance of carefully considering at the outset the best method for a particular taxpayer to use in depreciating a property is demonstrated in the Tax Court decision in the case of *Herbert Shainberg et al* (33 TC 28). Instead of using the short-cut composite account system of costs for depreciating a newly built shopping center, the taxpayer divided the cost of its structures into group accounts. For example, the cost of one building was divided into separate accounts for plumbing, wiring, ceilings, paving, roof, air conditioning, elevator, and the building structure itself. He used a forty-year life for the building structure and appropriate shorter lives for the other assets, and the declining-balance method of depreciation. The Tax Court approved taxpayer's method which resulted in substantially larger current depreciation deductions than would have been produced using the composite account system.

While this case dealt with a new structure, the rationale would appear to apply equally to the cost of an old structure if the allocation to respective components is adequately supported. However, caution is in order as the Commissioner may accept the allocation but insist on a longer life than usual for the building structure.

TRAVEL AND ENTERTAINMENT EXPENSES

The Tax Court has been somewhat active in the area of travel and entertainment expenses of corporate employees. In situations where

the employee incurs the expense himself and is not reimbursed by his employer, a deduction has been denied to the employee in the absence of an employment agreement which contemplates that the employee is expected to incur certain corporate expenses out of his compensation. (*Earl M. Coplan,* TC Memo 1959-34; *Marvin A. Heidt,* TC Memo 1959-31; *Noland* v. *Comm.,* 58,060 PH Memo TC, affirmed CA-4).

In a situation where a corporation pays or reimburses expenses to an officer-stockholder, which expenses are not supportable from the Treasury's view, the current approach of the Internal Revenue Service results in a double tax because of the disallowance of the deduction to the corporation and the treatment of the amount as a dividend to the officer-stockholder. This treatment would appear to be arbitrary and improper, particularly in those situations where the aggregate of the disallowed expenses and compensation of the officer-stockholder could be considered to be reasonable. In one case this double-tax situation was avoided by an agreement that required an officer to repay to the corporation any amount paid to him disallowed as an excessive payment by the corporation. A deduction was allowed to the officer in the year he repaid the amount disallowed to the corporation. (*Ruben Simon* v. *U. S.,* 172 F. Supp. 953). This mode of hedging against the double tax may be helpful in some situations. However, it would appear that such an agreement might well flag for the Treasury Department the fact that disallowance is feared.

In a decision close to home a taxpayer claimed over $11,000 incurred in three years in connection with Mardi Gras activities, which he contended advertised his business. The Tax Court allowed $1,550 on the basis that some business benefit was derived through distribution of ball invitations to customers and prospective customers. (*Lucien W. Rolland,* TC Memo 1959-161).

SELECTED INTERNAL REVENUE SERVICE RELEASES

In *R.R. 59-249* (IRB 1959-31, 8), the Commissioner agreed to follow certain Tax Court decisions (*W. H. Timpkins Co.,* 47 B. T. A. 292; *Interstate Truck Service, Inc.,* TC Memo 1958-219) and allow an immediate deduction for property with a useful life of less than one year, even if such useful life extends into the year subsequent to purchase. The ruling holds that the cost of tires and tubes purchased on new commercial trucking vehicles used in motor freight transportation is deductible in full in the year of purchase if their average life is less than twelve months.

R.R. 59-58 (CB 1959-1, 17) finally ruled that holiday gifts of turkeys, hams, and other merchandise were deductible by the employer and not taxable income to employees.

R.R. 59-236 (IRB 1959-28, 14) provides that withholding of income and social security taxes is required with regard to amounts paid by an employer to or on behalf of a *newly hired* employee for expenses incurred in moving himself, family, and furniture to a new place of employment, since such amounts constitute wages. It should be noted that payments of expenses of moving an *old* employee from an *old* to a *new* employment location do not constitute taxable wages to the employee and therefore are not subject to withholding.

In *R.R. 59-221* (CB 1959-1, 225) with reference to a "Subchapter S" corporation (IRC Secs. 1371-77), it was ruled that a stockholder's share of "undistributed taxable income" does not constitute net earnings from self-employment for purposes of the self-employment tax.

In *R.R. 59-185* (CB 1959-1, 86) an employees' pension, profit-sharing, or stock bonus plan was held to be a qualified plan under IRC Section 401 (a) even though it provided for voluntary contributions by employees of up to ten per cent of their compensation. But, employer contributions to the plan or the benefits under the plan must not be geared to employee contributions. Under this ruling a qualified plan containing a voluntary contribution provision for employees permits them to accumulate considerably more after-tax income for their retirement years. The earnings accumulated by the plan are not taxable currently and the employees are not taxed until the funds are withdrawn, which may be at favorable capital gain rates if withdrawn in a lump sum on retirement or other separation from employment.

On December 29, 1959, in *Technical Information Release No. 198,* the Commissioner outlined a new enforcement program to deal with tax abuses in entertainment and employee expense accounts. For some time the Internal Revenue Service has been concerned with the use of travel and entertainment expense accounts under circumstances intended to provide indirect benefits to employees. The first attempt to flag expense accounts by inclusion of a line on 1957 individual returns requiring employees to report them was abandoned because of strong objections to the record-keeping difficulties. In 1958 tighter regulations on expense allowances were issued (Regulations 1.162-17), which in effect require employees to account in detail either to their employers or on their tax returns. However, the Commissioner states that a large number of employees who are required to report expense

allowances and reimbursements on their returns do not do so and do not properly answer the questions relating to these expense accounts on their individual income tax returns. There has been increased activity in the expense account area by Internal Revenue Agents examining returns. However, the time and effort necessary for a Revenue Agent to completely weed out and check the propriety of all expense advances, allowances, and reimbursements presents a very practical problem. Now under *TIR 198,* while there will be no change in the reporting requirements of employees, the Commissioner has decided to approach the problem through the employer's records and tax returns for years beginning in 1960. The record-keeping required under the new rules will certainly be no less than those objected to in 1957, but there appears to be little likelihood of a reduction in reporting requirements, as the program has been publicized well in advance of the time the information will be required.

The new enforcement program consists of four phases:

1. Tax returns will be expanded to include a section dealing with expense items. For corporations, on the schedule of "Compensation of officers," separate totals of expense payments will be necessary for the twenty-five highest paid officers.
2. Returns will contain questions aimed at certain fringe benefits, such as hunting lodges, ranches, fishing camps, hotel rooms, and apartments, yachts or boats, etc., used either for the entertainment of customers or the personal use of officers, employees, or their families.
3. During the course of the examination of a return, the examining officer is to investigate and determine if the taxpayer's method is adequate in the accounting he requires for expense accounts by his employees. If the method is determined not to be in accordance with "acceptable business practices," the officer will make a list of employees who received expense allowance or reimbursements. The employees' returns will then be examined, unless they have included the expense account allowances in income.
4. All field officers have been instructed to place increased emphasis on the examination of returns concerned with entertainment, travel, and similar expenses with particular attention to expenses claimed for yachts, lodges, club dues, and business trips that are in fact vacations.

The Commissioner suggests that employers keep their records beginning January 1, 1960, so as to enable them to report the type of information presently contemplated. The following statement of the Commissioner in effect forecasts possible legislation if the new program is not successful:

> The Internal Revenue Service has neither the authority nor the desire to tell businessmen how they should spend their money. It does, however, have a responsibility to enforce the tax laws; and it intends to do so in this area, as in all others. If this cannot be done within existing laws, the Service will propose such changes in the laws as it thinks necessary to permit adequate equitable enforcement. Under no circumstances does the Internal Revenue Service intend to allow taxpayers, whether they be few or many in number, influential or unknown, petty chiselers or large-scale evaders, to escape their just taxes.

PROSPECTS FOR MAJOR TAX CHANGES

On December 18, 1959, the House Ways and Means Committee completed five weeks of hearings on future comprehensive revision of the tax laws. The Committee feels that the groundwork has been laid for future overhauling of the law to permit a general reduction of tax rates without sacrificing revenues. This would be achieved by broadening the taxable base and eliminating many tax preferences, deductions, and loopholes. Since these "Tax Reform" discussions were primarily an exploratory stage, it may be several years before a definite program emerges.

Although election-year pressures for popular tax cuts will be present, it appears very unlikely at this time that income taxes will be reduced in 1960.