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Why we have tax problems and what to do about them

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Why we have ta

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The progressive features of the Federal individual income tax are well publicized. These of course affect partnerships and fiduciaries as well as individuals, since the income of all of these entities is eventually taxed at individual rates. The corporation income tax is also more progressive than is probably generally realized. The greater importance of the $25,000 surtax exemption to the smaller corporations, and other factors such as minimum accumulated earnings credits tend to make the impact of the corporate income tax much more severe on the corporations with larger earnings.

All of this emphasis on progressive rates means that tax problems really arise when one entity has a large amount of ordinary income. Lowering these progressive rates then becomes a matter of having more taxable entities, having the income taxed to the most advantageous entities, or using statutory advantages, such as tax exempt income, capital gain rates, etc. Before discussing in detail methods of paying tax at lower rates, however, we should consider the importance of deferring the payment of tax.

Deferral of Tax

The first preference of any taxpayer would be to pay no tax at all. The only legal way I know to accomplish this, however, is to have no

roblems—

do about them

by Durwood L. Alkire
Seattle

income, and this is not generally a satisfactory solution! It is probably not generally realized, however, that the indefinite deferral of the payment of tax is nearly as good as not paying the tax at all.

Perhaps you can see the importance of deferring the payment of tax, if you consider how desirable it would be to you personally if someone should offer you the use of $100,000 interest-free for an indefinite period. When you go on from this to considering the importance business, in general, places on working capital, the growth of sales and leasebacks and other methods to conserve cash, it becomes apparent that the indefinite deferral of a payment is extremely important. Some methods of deferral of tax available to most taxpayers are the use of fiscal years, the choice of depreciation methods, and the choice of methods of accounting, and we will consider these three methods now.

Use of fiscal years

Internal Revenue Service statistics show that about one-third of corporations filing income tax returns are now on a fiscal year rather than a calendar year basis. This percentage has been steadily increasing, since in recent years about three-fourths of the new corporations are adopting fiscal rather than calendar years. Actually, it has always

seemed to me that there is no reason for more than one-twelfth of corporations being on the calendar year basis, with the exception of some types of corporations, such as those in regulated industries, that may be required to report on a December 31 basis.

Those flexible fiscal years

I realize that as certified public accountants, we can readily be accused of some bias on this question, as we must admit we are interested in filling out the "valleys" and pushing down the "peaks" in our own practice. Nevertheless, it still is generally in the interest of the client to be served by us at a less rushed time of year. We have had two gratifying experiences along this line recently in Seattle. The first was a partnership client considering incorporating, who asked us what fiscal year the corporation might adopt that would be most convenient for us; the second was a new corporation adopting an October 31 fiscal year, principally so that we could get our work done ahead of our busy season, and probably complete our work and give the client results for the year's operations in less time after the end of the client's year.

The tax advantage of a fiscal year from a deferment viewpoint will come principally in a seasonal business when a fiscal year can be selected that ends just before the peak income season. For example, we have an agricultural client on a May 31 fiscal year whose income is principally received during the summer months. The result is in general that expenses are deducted in one year and the income deferred to the next, so that there is a more or less permanent deferral of tax on one year's income.

In addition to the tax deferral possibility, fiscal years offer some flexibility in dealings with individual officer-stockholders of closely-held corporations, who are generally on a calendar year basis. There seem to be less problems in dealing with accrued salaries, interest on loans, etc. when the individuals and corporation are not all closing their years at the same time. A nontax benefit resulting from fiscal years is the elimination of extra work for employees at the holiday season, which generally comes with the use of a December 31 closing.

Choice of depreciation methods

There is considerable thinking that the accelerated methods of depreciation introduced by the Internal Revenue Code of 1954 are

of no real benefit to taxpayers, as "you can only get your cost back once." This argument completely overlooks the value of deferring the payment of tax, the basic question we are discussing. In most companies, the use of these accelerated methods results in a more or less permanent deferral of tax. It is true that as to any individual asset or group of assets, larger depreciation deductions in the early years of the life of the asset will be offset by reduced deductions in the later years. In the normal situation, however, the reduced deductions in the later years of the lives of 1955 additions, for example, will be offset by increased deductions in the early depreciable years of the 1960 or 1965 additions.

The deferral of tax from the accelerated methods will generally end only with the liquidation of the company or the lack of additions to depreciable assets. This lack of additions is not likely with our present technical obsolescence, growth of business, inflation, and other factors.

When accelerated methods are inadvisable

We can conclude that the use of accelerated methods is generally advantageous, but there may be special situations where their use is inadvisable. These would generally be where a taxpayer was now paying low rates, could see the "end of the road" on its acquisition of assets, and hopes to have higher income, which of course means higher tax rates, later. For example, I discussed with an attorney his situation with a corporate client who was constructing a drive-in theatre. The capital asset acquisitions in the first year were quite substantial, but it was not expected that there would be substantial additions to fixed assets for some years to come. On the other hand, earnings were expected to be low or nonexistent in the early years, as in most new businesses, with the hope that they would grow as the business became established and attracted patronage. In this situation, the straight-line method would definitely be preferable to the usual declining balance or sum-of-the-years-digits methods.

This drive-in theatre might be a good place to use an "other consistent method" as allowed in section 167 (b) (4). Any consistent method is allowable if the total deductions in the first two-thirds of the useful life of the property do not exceed the total allowable under the declining balance method. Assume the theatre cost $60,000 and had a 30-year useful life. The total depreciation allowable under the declining balance method for the first 20 years would be approxi-

mately \$45,000. An "other consistent method" would be a modified, or two-step, straight-line method, with depreciation computed as follows:

$$\text{First 20 years} - \frac{\$45{,}000}{20} \text{ or } \$2{,}250 \text{ a year}$$

$$\text{Next 10 years} - \frac{\$15{,}000}{10} \text{ or } \$1{,}500 \text{ a year}$$

In general, the use of accelerated depreciation methods can be a tremendous help in building capital. Depreciation deductions have increased substantially in the last five years and now in effect furnish more funds by far than any other source, retained earnings, new securities issued, etc.

The additional first year depreciation of 20 per cent on assets acquired in any year up to a cost of \$10,000, introduced by the Technical Amendments Act of 1958, is of course a special statutory kind of acceleration. It is generally not too significant because of the \$10,000 limitation on the cost of assets, but may be interesting to a partnership with a large number of partners, as the \$10,000 limitation applies to each partner, and not to the partnership as a whole.

Choice of methods of accounting

The adoption of the most advantageous method of accounting furnishes another opportunity to defer tax indefinitely. For example, both the cash basis and the completed contract basis offer interesting possibilities along this line. By the use of the cash basis of accounting, a service organization may in effect use its accounts receivable as tax-free capital. A client of our Seattle office in a service business has remarked that it "seems illegal and *is* impossible" to build capital these days—but he goes on to say that his accounts receivable, on a cash basis, really represent his capital. These two methods of accounting, which may result in sharply fluctuating income, are particularly useful to corporations, as they have less of a problem with fluctuating tax rates than individuals who do not have steady incomes.

Any method of valuing inventory which results in lower valuations may result in an indefinite deferral in tax. The two principal possibilities are of course LIFO and cost or market, whichever is the lower. Cost or market, whichever is the lower, will of course only result in

a lower valuation if there is some down turn in prices so that market becomes lower than cost. An interesting note on the cost or market, whichever lower method is the significance of indicating the election on the first return of a taxpayer. One author has recently suggested that a taxpayer might be in trouble if it filed returns for several years valuing inventory at cost, since market was higher than cost, and then wanted to use the valuation at market in a year when market dipped below cost. His thinking was that the Internal Revenue Service might well contend at this point that the original election of inventory valuation on the first return had been valuation at cost. Some years ago, corporate tax returns used to contain a line for indicating the method of valuing inventories. Since this has been dropped, it might be well for us to consider on the first return of new taxpayers indicating that the election was being made to value inventories at cost or market, whichever lower.

Use of More Taxable Entities

Leaving the matter of deferment of paying tax, and assuming a tax must be paid currently, our goal is to pay tax at the lowest possible rates. One significant area for discussion is having more taxable entities, together with having income taxed to the entities in the lowest tax brackets.

The benefits of more taxable entities are obvious—the more pieces the income pie is cut into, the lower the over-all average tax rate. To secure more taxable entities, we think of multiple corporations, division of income with members of families, trusts, etc.

Estates

Consider estates in the process of administration. It is generally desirable to keep an estate "open" as long as possible, from an income tax viewpoint, so that it will furnish another taxable entity for division of income. This is not universally true, as there may be situations in which the estate has a sizeable income and there are several residuary legatees, all in low tax brackets, who will divide the income when administration of the estate is completed. In the more usual situation, however, of total family income being divided to some extent between the estate and either a surviving spouse or a surviving child, prolonging the administration of the estate is generally a desirable tax objective. Of course, an estate cannot be kept "open" indefinitely merely

to save taxes—there must be some valid reason. Often awaiting audit of Federal estate and State inheritance tax returns is a good reason.

One interesting possibility of keeping estates "open" arises from section 6166 of the Internal Revenue Code, providing for installment payments of estate tax over a period of ten years if the estate meets certain qualifications. There are good indications that the estate may be "kept open" for ten years as an income tax-paying entity, in order to have it alive to make these installment payments. It may be difficult to qualify under section 6166 and comply with the rather involved requirements as to acceleration of payments of estate tax under certain circumstances. The income tax savings, however, can well warrant the bother of qualifying and continuing to qualify for installment payments. Assume, for example, that an estate and surviving widow have combined income subject to tax of $40,000, which is equally divided between them during the period of administration, but will all belong to the widow when the estate is closed. As long as the estate is in process of administration and is a taxpayer, the combined tax under present rates would be $14,520. When all of the income becomes taxable to the widow, her individual tax would be $20,154. Certainly the saving of over $5,600 a year is worth a little paper work!

Multiple corporations

The use of multiple corporations has been an attractive method of lowering the over-all corporate tax rate. Organizing with a number of corporate entities, instead of only one, can result in a saving of up to $5,500 a year for each additional corporation due to its surtax exemption. In addition, each corporation is entitled under the 1958 amendments to the Internal Revenue Code to a minimum accumulated earnings credit of $100,000, which may be reassuring if there are uncertainties as to whether it can be satisfactorily proved that all funds are utilized in the business. It is important to consider *at the time of incorporation* whether multiple corporations might be useful at any time in the future—once assets have been placed in one corporation, it may be difficult, or impossible, to transfer some of the assets to new corporations and secure any additional surtax exemptions or minimum accumulated earnings credits.

In organizing into multiple corporations, it is well to follow some logical division, such as geographical areas, separate retail locations, separate functions such as manufacturing, selling, etc. The recent

Minnesota District Court case of James Realty Company, 59-2 USTC para. 9660, decided September 1, 1959, is quite disturbing to multiple corporation cases. In this case, the government was upheld in disallowing a corporation's surtax exemption, on the ground that there was no business purpose for the creation of the taxpayer corporation. This corporation was one of about a dozen organized by an individual to conduct his real estate development business. The operations among the related companies were of a type quite common in the real estate business. If this decision is upheld at higher levels, it can well mean difficulty to many multiple corporate organizations, particularly if the added corporations are mere bookkeeping entities, with no differences in management, transactions, etc.

Another even more recent case is Aldon Homes, Inc., 33 TC No. 65, decided December 29, 1959. In this case, involving a project for the construction and sale of 237 homes in the Los Angeles area, sixteen "alphabet corporations" (so-called because the name of each started with a new letter of the alphabet) were held not formed for substantial business purposes or to have engaged in substantial business activities. All income was therefore taxed to Aldon Homes, Inc., which actually controlled the project. Damaging facts were that the "alphabet corporations" had no employees, that the same employees in the same office kept the books for all seventeen corporations, and that Aldon Homes, Inc. and its stockholders did not deal at arms length with the "alphabet corporations."

The IRS has been very active in the multiple corporation field in Southern California, particularly in regard to real estate ventures. I have heard that there are 1,500 multiple corporation cases pending in that area alone. Aldon Homes is by no means the most extreme case—one involves *332* corporations, with a series of corporations named after flowers and another series after fish! We can hope that these extreme cases are examples of "hard facts making hard law"—we should still exercise considerable caution in the use of multiple corporations in view of the recent trends.

Subchapter S Corporations

One particular statutory method of paying lower tax rates, introduced by the 1958 amendments to the Internal Revenue Code, is the use of the Subchapter S corporation. This election gives the businessman the opportunity to choose between three methods of paying tax

on his business income. He can:

1. Pay individual tax rates, under a proprietorship or partnership.
2. Incorporate his business and pay regular corporate tax rates.
3. Have his business incorporated, but pay individual tax rates on the net income by making the Subchapter S election. He will still have any advantages of the corporate organization, such as "fringe benefits" for officer-stockholders, who would not be entitled to these as partners or proprietors.

The Subchapter S election, however, should not be made lightly, as it cannot be changed from year to year. Once an election has been made to be taxed under Subchapter S, this must be continued until the election is voluntarily revoked or involuntarily terminated. Once an election has been revoked or terminated, a new election cannot be made for five years, unless permission is secured from the Commissioner of Internal Revenue.

Requirements for qualification

Let us review briefly the requirements to qualify a corporation for the Subchapter S election. It must be a Simple, Closely-held, American, Business corporation. Keep in mind the word SCAB, and see below what each letter stands for:

S — Simple
 Not member of affiliated group
 Shareholders individuals or estates—no nonresident aliens
 Not more than one class of stock

C — Closely-held
 Not more than ten stockholders

A — American
 Domestic corporation—not more than 80 per cent of gross receipts from sources outside the U.S.

B — Business
 Not more than 20 per cent of gross receipts from investments

Interest in election

Keith Engel, our Washington tax partner, ascertained for me that there were approximately 60,000 Subchapter S elections filed up to February 1, 1959. Considering that there are something like 700,000 corporations in the country, and considering the thousands and thousands that obviously do not qualify for the election or to whom it

would have no interest, it is apparent that a large portion of the possible corporations have made this election.

Possible benefits

What are these electing corporations trying to achieve—what are they striving for? We might list some of the possible benefits, and then discuss each briefly.

1. Stockholders in lower tax brackets than corporation
2. Use of corporate losses by stockholders
3. Corporation distributing or about to distribute a substantial part of its earnings as dividends
4. "Unlocking" a large capital gain
5. Deferral of tax by use of fiscal year
6. Shifting income by a transfer of stock
7. Fringe benefits for partners and proprietors

Stockholders in lower tax brackets than corporation

There are probably thousands of incorporated drug stores, insurance agencies, gas stations, etc. around the country with stockholders in lower individual tax brackets than the minimum 30 per cent corporate tax. Many of these small corporations are paying corporate tax on a few thousand dollars of net income each year, and the remaining corporate earnings after taxes are then "locked up" and probably unavailable to the individual stockholders without a second tax. It would be advantageous for such a corporation to make a Subchapter S election, and thus have the net income of the business taxed directly to the individuals with only one tax.

Use of corporate losses by stockholders

In the past, there has been some reluctance to incorporate new business ventures. New businesses have a way of losing money until they become established, and owners have not wanted to depend solely on using such losses as carryovers against possible future corporate profits.

The Subchapter S election affords an opportunity for individual stockholders to get tax benefits from the corporate losses by taking them as individual deductions. This gives the individuals an opportunity to save tax *now,* instead of waiting for the benefits from corporate carryovers.

If the individual's share of corporate losses creates a net operating

loss for the individual, it can be carried back only to 1958 and subsequent years. This means that the possibility of benefitting from the corporate losses will be improved until 1961, the first year in which individuals will be entitled to a full three-year carryback of losses resulting from a Subchapter S election. With a full three-year carryback, the opportunities will be multiplied to offset any losses against past high income years. It should be noted that one disadvantage of losses which put the individual stockholders into a carryback or carryover position is that they may well lose the benefit of their personal deductions and exemptions in carryback or carryover years.

Corporation distributing or about to distribute a substantial part of earnings as dividends

A corporation which is now distributing a substantial part of its earnings, or expects to make substantial distributions in the near future, can do nothing but gain by a Subchapter S election. This follows because such a corporation and its stockholders are experiencing the worst of the "double taxation" we hear so much about—first a corporate tax on the earnings, and then a second individual tax when the earnings after corporate taxes are distributed in the form of dividends.

If more than a certain percentage of corporate earnings are distributed as dividends, it will always be beneficial to make the Subchapter S election. This percentage will of course vary from corporation to corporation, because of the tax brackets of stockholders and other variables, but can be computed for any corporation.

It should be noted that we have referred to not only corporations presently distributing substantial dividends but those that are about to distribute substantial dividends. The Subchapter S election may be a solution to any unreasonable accumulation problems of a corporation. When a company reaches a point where it seems it must either distribute substantial dividends or face an unreasonable risk of the accumulated earnings surtax being imposed, the Subchapter S election may well be in order.

"Unlocking" large capital gain

The statutory treatment of capital gains "passes through" from the Subchapter S corporation to its stockholders. Thus, each stockholder is taxable on his proportionate share of any capital gain realized by the Subchapter S corporation. The capital gains taxed to the stock-

holders are net, after deduction of any capital losses, and are limited to the total net income of the corporation—stockholders cannot report a capital gain from the corporation and also deduct an ordinary loss. If a substantial corporate capital gain is in prospect, a Subchapter S election may well be desirable to insure that the stockholders will be taxed on this large capital gain with only the individual capital gains tax. If the capital gain is received by a nonelecting corporation, there will be a corporate capital gains tax and then presumably a second individual tax when the capital gain, after taxes, is taken out of the corporation by the stockholders.

Until Subchapter S came along, a corporation expecting a large capital gain had to either pay the corporate capital gains tax (and have the capital gain after taxes still "locked up" in the corporation) or consider liquidating the corporation, under section 337 or otherwise. Now a Subchapter S election will eliminate the necessity of the corporate liquidation, and has one distinct advantage over a liquidation. Under the Subchapter S election, the stockholders pay capital gains tax only on the capital gains actually received from outsiders. Under the section 337 or other liquidation, the stockholders must pay capital gains tax on all increment in the value of their stock in the corporation. This may include substantial accumulated earnings from past years, and unrealized increment in value of corporate assets.

It should be noted that H.R. 9003, introduced in Congress in 1959, but not enacted, would prevent the "pass through" of capital gains to stockholders of Subchapter S corporations, unless the corporation had been an electing corporation at least three years.

Deferral of tax by use of fiscal year

A stockholder's share of the undistributed income of a Subchapter S corporation is taxed to him in his year in which a corporate year ends. For example, if a Subchapter S corporation is on a January 31 fiscal year, a calendar year stockholder would report in his 1960 return his share of the undistributed corporate income for its year ended January 31, 1960.

This affords the same opportunity for deferral of payment of tax as that used extensively in the past by partnerships. The Treasury Department obviously does not like this situation any better than they did the deferral by the use of fiscal year partnerships. They substantially curtailed fiscal year partnerships by requiring new partnerships to choose a fiscal year the same as that of their principal partners, and refusing existing partnerships permission to change to fiscal years

other than that of their principal partners, unless of course permission was secured in either case. H.R. 9003 would make the rules for Subchapter S corporation fiscal years substantially the same as those now in effect for partnerships. There may be an opportunity now to have a new corporation adopt a fiscal year which will result in some tax deferral opportunities, and a year that could not be adopted at a later time, if the proposed legislation becomes effective. There is already difficulty in changing the fiscal year of an electing corporation, under the regulations under section 442.

Shift income by transfer of stock

Since the undistributed income of a Subchapter S corporation is taxed pro rata to its stockholders on the last day of its taxable year, there are opportunities for shifting income from high bracket taxpayers to low bracket family members by gifts or other transfers of stock near the end of the corporate year. This is even better than the family partnership, where it is generally impossible to retroactively transfer income, the best that can be expected being the shifting of income to be earned in the future. It is also simpler than gifts of stock in an ordinary corporation—any shifting of income would require payment of dividends, resulting in double taxation and perhaps other undesirable features. This is another example of taxing income to the most advantageous entity, previously discussed.

Fringe benefits for partners and proprietors

In recent years, it has become more and more desirable taxwise to be an employee and less to be an entrepreneur. The Subchapter S election affords an opportunity to "have your cake and eat it too" in this area. Officer-stockholders can pay individual tax on their share of the corporate earnings, as they would as partners or proprietors, and yet be corporate employees to secure tax-free or tax-protected fringe benefits. The value of retirement plans, sick pay exclusions, accident and health insurance, plans for payment of medical expenses, group insurance, continuation of officers' salary, and other fringe benefits may add up to a sizeable package.

Here again, beware of H.R. 9003! This proposed legislation would make these fringe benefits unavailable to principal stockholders of the Subchapter S corporation, by providing that they are not considered as employees.

Possible disadvantages and problems

We should not leave Subchapter S thinking it is all good. There are disadvantages and problems—a few of them which are discussed below are as follows:

1. Inapplicability to "growth companies"
2. Problems in distributions
3. Consents by executors of estates
4. Special classes of income
5. Sales of stock
6. Restriction on use of trusts for estate planning
7. Some disadvantages in comparison with a partnership

Growth companies

Growth companies are generally organized as corporations because this is the best structure, both from a business and tax viewpoint. They generally want to plow back their earnings, their stockholders are often in high individual tax brackets, and their growth is generally most rapid by plowing back earnings after corporate taxes into expansion of the business. There may, however, be special situations of losses or capital gains where a Subchapter S election may be advisable even for these companies.

Problems in distributions

There are so many pitfalls in distributing earnings of a Subchapter S corporation that this could well be the entire subject of another paper. We can say here only that in general it is best to distribute earnings as currently as possible (preferably within the same corporate taxable year as the earnings were received), and avoid the traps one may encounter if the election is terminated or there are other changes.

Consents by executors of estates

In order for a Subchapter S election to continue, new stockholders must consent to the election within thirty days after becoming stockholders. An estate is considered a new stockholder, and the executor or administrator must consent within thirty days after qualification.

It may be well for an individual stockholder of a Subchapter S corporation to authorize his executor in his will to execute a consent

to continue the Subchapter S election. Otherwise, an executor, particularly a corporate fiduciary, may be reluctant to consent. Particularly is this true if the time for filing the consent is late in the corporate year, and by consenting the executor would subject the estate to tax on a substantial amount of corporate income, unless he could get assurance of cash from the corporation to pay the resulting income tax.

Special classes of income

The Subchapter S election loses much of its advantage when one is considering types of income not subject to the full corporate tax. Due to the dividends received credit to corporations, ordinary dividends are taxed to corporations at either 4.5 per cent or 7.8 per cent, instead of the usual 30 and 52 per cent rates. This difference may be significant when comparing the tax to be paid by an ordinary corporation with that to be paid by an electing corporation, whose stockholders would pay their full individual rates on their shares of any dividends received by the corporation. It may be particularly undesirable to elect where there are conditions of operating losses and dividend income.

Sales of stock

In any sale of stock of an electing corporation, careful analysis is required by both the buyer and seller and their representatives. It should be noted first that the "previously taxed income" is personal as to each stockholder, and is not transferable. Therefore the purchaser of stock of an electing corporation will secure no benefit from the fact that the person from whom he bought the stock might be entitled to receive substantial distributions from the corporation on a tax-free basis.

Other problems arise in connection with earnings or losses of the current year. Since the holder of stock on the last day of the corporate year pays individual income tax on his pro rata share of the entire year's earnings, a purchaser may well get in a situation of paying for corporate earnings up to the date of the purchase of the stock, and then paying income tax on these same earnings a short time thereafter. On the other hand, losses are allocated in proportion to the time stock is held by each owner, where ownership changes during the year, *but* the loss allocated is the loss of the corporation for the

whole year—no consideration is given to what the amount of the loss, if any, might have been as of the date of sale of the stock. Inequities may well arise, therefore, since a seller may secure the tax benefits of a portion of a loss arising after he sold his stock, and contrariwise, a seller might be harmed if the corporate loss up to date of sale was computed and taken into account in fixing the selling price, and then the loss was substantially reduced by the end of the corporate year.

Restriction on use of trusts for estate planning

Since trusts cannot be stockholders of electing corporations, problems arise if individual stockholders of electing corporations attempt to set up trusts in their wills. Also, of course, individuals cannot make gifts of stock of an electing corporation to trusts during their lifetime. The result is a limitation on the use of what may otherwise be a very desirable estate planning technique.

Disadvantages in comparison with partnership

Electing corporations have often been likened to partnerships. In comparison with partnerships, however, electing corporations have some disadvantages, two of which are as follows:

1. On any tax-free contribution of appreciated property to an electing corporation by a stockholder, the other stockholders are "stuck" with a low corporate tax basis for the property, with no opportunity for any election such as may be made by partnerships.
2. There is no new tax basis for corporate *assets* on the death of any stockholder of an electing corporation, as there would be on the death of a partner. A new, and presumably "stepped up" tax basis, applies only to the *stock* of the electing corporation. The corporation is still a separate taxable entity, and its tax basis for its assets is unchanged.

Conclusion

When one entity is expected to have a large amount of ordinary income in one year, progressive rates create tax problems. To solve these problems, tax deferral possibilities should be utilized to the

maximum—then consideration should be given to dividing the income with other entities, by utilizing trusts, multiple corporations, or having income taxed to low-income members of the family. The Subchapter S election offers a special statutory method of having income taxed to the most advantageous entities.

We should keep in mind that any reductions of taxes we help our clients accomplish by planning save "100-cent dollars"—any costs of the planning are deductible, so are paid with "9-cent" to "80-cent" dollars, depending on tax brackets.

Durwood L. Alkire
Seattle

Durwood L. Alkire has a B.A. from the University of Washington and is a partner in our Seattle Office. He is active on committees of the Seattle Chamber of Commerce, the Municipal League of Seattle and King County, and the United Good Neighbor Fund.

What Are "Ordinary and

Reviewed by John S. Crawford, Portland

ONE OF THE RESULTS of high income tax rates has been the importance placed upon the deductibility of expenditures made by individuals as well as by business entities. Ordinary and necessary expenses meet the tests of deductibility. The problem faced by tax practitioners and businessmen is that of distinguishing expenditures which qualify as ordinary and necessary from those which do not. The theme of the subject book is to differentiate for the reader the expenditures which qualify from those which do not and to point up ways of assuring that proper deductions are not lost by careless record keeping or lack of proof. The authors commence with the general rule that Congress intended the income tax laws to tax earnings and