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Tax Conference for Business Executives (New York)

American Institute of Certified Public Accountants (AICPA)

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TAX PLANNING
IN
BUSINESS POLICY

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Foreword

The TAX CONFERENCE FOR BUSINESS EXECUTIVES was held in New York City on October 31 and November 1, 1955. The theme of the conference was "Tax Planning in Business Policy."

No formal papers were presented during the conference. Instead of papers, a question and answer approach was followed, with carefully selected, basic questions presented to each panelist by a moderator.

Following the completion of these discussions covering all the subjects on the program, an entire afternoon was devoted to a discussion of questions submitted by the registrants at the conference. Questions pertaining specifically to subjects on the program were answered by the panelist who had made the original presentation. In this record of the conference all questions have been grouped by subjects, whether covered in the original presentation or submitted by registrants. A detailed index has been prepared to facilitate location of questions dealing with particular problems.

Questions and comments by the moderators appear in bold face type. Replies by the panelists appear in light face type. Where there was a change in the moderator or the panelist within a particular subject, the change has been indicated in the text.

All of the panelists and moderators are members of the American Institute of Accountants and serve on the tax committees of either the Institute or the New York State Society of Certified Public Accountants.

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Timing Income and Deductions for The Right Years

PANELIST—THOMAS J. GREEN

MODERATOR—LESLIE MILLS

The first subject is timing income and deductions for the right years. I need only mention the importance of planning business transactions so as to get the tax incidence in the most advantageous fiscal period. Under our progressive tax rate system, based on an annual fiscal period, such tax planning can pay off in real cash dollars, and while the effects are sometimes more spectacular for unincorporated taxpayers, corporations have the problem too in that they have different tax brackets also. Furthermore, as in the case of depreciation and research and experimental expense, the cost of capital by itself is an important factor in business planning and anything we can do to defer the taxation of income or accelerate the recognition of deductions is a real contribution to the business capital.

Here is a general leading question. Over-all, intelligent planning of transactions to arrange the control of items in the most effective manner must be governed by some basic principles. What are these principles?

There are two basic, over-all principles that determine the importance of timing income and deductions. Those are the choice of accounting periods and the choice of accounting methods.

I would like you to elaborate on the choice of a taxable year or an accounting year.

It is highly important to make a proper choice of your taxable period, whether an individual, a corporation, or a partnership. Particularly is that choice important in the first fiscal year of a company's activities. The bunching of losses or the bunching of expenses can have a very important effect by reason of seasonal activities on the taxpayer's income. In that case, it is highly advisable in most instances to consider the adoption of a proper fiscal year. Generally speaking, this should be the natural business year.

I want to come back to that in somewhat more detail. But now, give me the same over-all appraisal of the significance of the choice of the two principal accounting methods (the cash receipts and disbursements method and the accrual method) for tax purposes.

It makes a great difference which accounting method a taxpayer chooses. The cash basis taxpayer, generally speaking, has substantial control over expenditures. He just doesn't have to pay his bills until he is ready within the general province of business exigencies. He does not have the same control over receipts because his customers will send the money in as they please.

However, the accrual basis taxpayer finds himself generally in a reverse position. He does have control over the income side by the use of selling campaigns, and other factors which we will develop later, but he has little control over the expenditure side since expenses as they are incurred under the accrual basis are not completely controlled by the taxpayer.

What opportunity is there to do tax planning on the basis of either method, using the accrual method for some of your business transactions and going over to the cash method for others?

There are other methods besides the cash method and the accrual method. The hybrid method is one that is specifically approved in the 1954 Revenue Code. That is the method, for instance, of being on the cash basis, except perhaps for the additional use of receivables. The hybrid method has posed some interesting questions, particularly in the transition changeover where a supposed accrual basis taxpayer has been on a cash method. Generally he has not used an inventory and has not accrued his receivables. The question has been asked at a great many tax forums: Can a taxpayer escape tax by setting up the inventory at the opening of the next period when he desires to change over, and by setting up accounts receivable? I have heard answers ranging all the way from "possible" to "impossible." My own view is that the prior use of the hybrid method can create such a problem that a taxpayer will be deemed to have been on a hybrid method all along. Therefore he is not considered to be making a change and accordingly is ineligible for the transitional adjustment benefits. Or he may be deemed to be making the kind of change requiring permission, and such permission may be

withheld by the Treasury until such time as to nullify transitional adjustment benefits.

In other words, you do not think there is any particular advantage in tax planning to get into an unusual method like that?

No, it is far better to stick to one of the conventional methods.

I would like to go back to a point I forgot to bring up on the accounting period. You mentioned the taxpayer should select the natural business year. What do you mean by that? What is the advantage?

The natural business year is, generally speaking, a fiscal period at the end of which the receivables and inventories are at a low point. Of course, the advantage is that it is much easier at the end of that cycle to count the inventories, thereby having a saving in labor costs. Your receivables also being at the low point, you find yourself in a good cash position. By reason of choosing that period, a better working capital position is present and a company is in a far better position to meet its tax liability. It avoids the excesses due to bunching of seasonal income or loss.

If the taxpayer wished to change to the natural business year, would it have to ask permission? How does it go about asking this permission?

If the taxpayer meets certain conditions (which I will enumerate in a moment), no permission is necessary from the Commissioner; that is not statutory, that is a matter of right of a carryover ruling which was promulgated under the 1939 Code. A taxpayer deciding to change over to a natural business year can do so if no change in accounting period had been made within the previous five years, and if the short period income when annualized, equals 80% of the income for the preceding year. Furthermore, the change can be made only to a period terminating within the next three months, or to a period beginning at least nine months from the end of the old period. Most people wonder why that creates a situation where the middle five months are left out as being eligible for changeover. As I understand it from the Internal Revenue Service, that is based on the desire to even out their collections over a period and for no other reason.

In other words, it is an automatic right for them to set a period during which you need permission.

Within the confines of those rules, the taxpayer can make its own change voluntarily.

If it needed permission of the Commissioner, don't you suppose however that a demonstration of trying to get to a natural business year would be an adequate reason?

The choice of the natural business year is probably the most acceptable reason to the Internal Revenue Service, but it is not necessarily a guaranteed reason.

I want to go back to accounting methods for tax purposes, which can have an effect on tax liability because of timing opportunities. Can you give me a very brief summary of what you had in mind as to what these are?

While there were just two general over-all methods, there are a number of other methods that might be called sub-methods of accounting, such as the use of the installment method of reporting, the use of the bad debt reserve method as against the charge-off method, and perhaps the use of Lifo inventory, which might be termed a method all by itself.

I would like to ask some specific questions about some of these and I would like to hear about the installment method first. How can that be used to obtain a tax advantage in timing?

It is quite obvious that the spreading out of income from the year in which the sale is made to the years in which that sale is collected is certainly going to result in a saving of working capital. Whether it results in the saving of taxes or not is another matter, but generally it does that, too. By spreading income into the subsequent periods, tax advantages will certainly result where the taxpayers are individuals or where they get into the graduated rate bracket situation.

In using the installment method we run into two problems. One is the use of the installment method for an isolated transaction, and the other, which may be of more importance, is the use of the installment method for a general business—a department store, for example. Prior to last year one of the problems of such an enterprise in adopting the installment method was the changeover. I had understood that the new law removed the excessive costs of the changeover. Would you care to comment on that?

Yes. It is now possible, of course, to make a changeover from the accrual method to the installment method. Generally, that can be done and still have tax relief afforded. The general rule is that if you were on the accrual method and took in all your sales on the accrual basis in the preceding year, you are still required to again take into account, in the year of the changeover, income from installment sales. But Congress saw fit to afford a measure of relief by eliminating the duplication of tax that would result from taking up of the installment income in the succeeding year. However the formula provided is not working out too well, since ratio limitations put in the formula create a result where selling expenses of the installment sale in the original year, for example, would cause a diminished gross profit in the year of sale. This gross profit,

as the numerator for the ratio limitation, can act as a severe limiting factor. Complete relief is not afforded by reason of the relief formula and, therefore, that must be watched very carefully.

As I understand the problem, we have a department store that has $100,000 accounts receivable at the end of the year on the accrual basis. It has paid tax on that, and now it wants to go over to the installment basis. That $100,000 as it is collected would go into income as collected in the next year, and the relief that the Congress gave was apparently not adequate. Now I would like to ask this: Since it is a problem to know how to deal with the accounts receivable at the end of the year when a change is made would it be possible to eliminate the problem by selling these accounts as a group?

The easy and theoretical answer is that it would be possible. However, there have been cases (not particularly in this area but in analogous areas) which have held that the reduction of receivables to cash by reason of a sale to a finance company—if there are strings attached such as a guarantee–might result in the company being deemed not to have sold its installment accounts in a given period. Therefore such income would be taxed again in the year of collection. I would have great doubt, as a result of that type of court reasoning, that we are altogether safe in concluding that sales of all installment accounts might afford relief from duplication.

There may be a way out, anyway. I assume that if the government disagrees it would be on the grounds that it was not a sale, and they would have to say the accounts were collected the next year. The taxpayer then would be elegible for such relief as the law provides.

That would be the ground rules of the test. But the so-called relief is a snare and a delusion.

You mentioned Lifo, which is a popular subject. How can the Lifo method of inventory be used as a tax saving procedure in terms of timing?

Lifo is undoubtedly one of the greatest boons to tax planning in terms of timing. That has been particularly true in the past fifteen years when we have had a rising economy. Lifo offers greatest benefits in a period of rising prices. However, many taxpayers have been in a position, where, after reviewing the economic level at the end of a given year, they have been afraid to adopt Lifo because of being frozen at a high point. This Congress has not seen fit as yet to adopt the cost or market Lifo technique, and thus they might find themselves in a position whereby the market would be lower than their Lifo cost, and that would mean a tremendous disadvantage. However, even those taxpayers who have gone on Lifo since 1950 in many industries have found that, by reason of the

fact that prices continue to rise, they were parceling out their cost per sale on an increasingly high basis and thereby were getting the benefit of higher cost per sale with a low frozen inventory both beginning and end.

That is particularly pertinent in this year of 1955 with respect to copper. Many companies which have not gone on Lifo up to this point are seriously considering going on Lifo because of the rising price of the commodity.

We will now cover sections 462 and 452. Accrual basis taxpayers just had certain rights and privileges under these sections taken away from them. Does this mean that there are no longer available any tax deferments for advance collections of income or any deductions for expense reserves?

I regard the repeal of sections 452 and 462 in somewhat the same vein that I regard the Bercu decision concerning accountants in tax practice. It looked pretty bad at the time, but most people have been able to live well within the confines of it. A number of opportunities are still afforded taxpayers for doing what was permissible under sections 452 and 462. In the area of prepaid income, the Senate Finance Committee has given specific language, even in its report on the repeal of section 452, which would permit prepaid subscriptions, as in publishing, not only for those who have previously been on the deferred income method, but those who had not been on that method before and are now contemplating going on it. Additionally, of course, there are opportunities with respect to prepaid income on containers. The repeal of section 452 would apparently not take away those privileges, and something can still be worked out to defer income on containers.

On the other side, additionally, the old claim of right doctrine has had a number of cases covering its area recently which would permit some deferred income. We will cover this in more detail later.

In the area of reserves for estimated expenses, there are still numerous opportunities. Vacation pay is certainly one item which can be handled, at least through this year, on the old accrual method.

Do you feel that despite the repeal of section 462 there can be accruals during 1955 for vacation pay?

Yes, indeed, and that even goes into the non-vested areas. When section 462 was first enacted, the Treasury Department brought out a revenue ruling which in effect said that where the rights of an employee were not completely vested at the end of the tax year, due to the fact that he had to be on hand as an employee of the company at the time his vacation began, the old accrual provision would no longer be available, since that type of item would be taken care of under the reserve for estimated expenses. However, by reason of the repeal of section 462, the Treasury

has modified the ruling to provide that the old rule in effect prior to the new revenue ruling will be in effect throughout 1955. Beginning in 1956, the prinicple of vesting will be recognized and taxpayers will have to be on the watch beginning in 1956 for what happens with respect to their vesting arrangements. They may have to change union contracts in that year, if that can be done. As to non-union employees, a written contract is not necessary. If there has been an oral understanding and there is some notice to the employees that they are on a vacation basis, the same right would accrue to the employer.

You mentioned the problems of advance collection, and you used the term "receipts subject to restriction." You also talked about "claim of right principle," and I am afraid I did not get either one altogether. More specifically, what did you have in mind about receipts subject to restriction? This is a point as to whether you can defer taxation of income.

In some cases income is received which has certain strings attached to it, as for instance, where a public utility company wins a rate increase on a temporary basis and is allowed to charge higher rates. The income from these higher rates is then required by the regulatory body to be put in escrow, so that the public utility company would get no use whatever and would have no claim of right to the income during that period. In that case, the company is not required to take the income into account during the current year. However, if the company wins a rate case and the money is not put in escrow but is available, despite the fact that there may be further legal contest with respect to it, the old rule would apply and the company would be required to report the income.

Going from the specific to the more general, have you any comment as to how a sales promotion could be planned to give the most timing advantages?

When you come to the end of a fiscal year, depending on whether you have income or loss, you can hold back your selling campaign until the next year if your income is too high during the current period. On the other hand, if you show a loss, you are in a position to push your sales. This planning is all, of course, within the confines of proper economic necessity.

What about bad debts? You mentioned this subject as a sub-method. How can a taxpayer plan that with respect to timing?

The choice of a bad debt method is quite an important thing in timing. As we know, the charge-off method permits a write-off of those bad debts which actually occur during the year. Under the reserve method a reasonable provision may be set up for an estimate of what the bad debts will be depending on circumstances in a given company. Some

interesting problems occur with respect to the changeover from the actual write-off method to the reserve method. Where there is such a changeover, it is possible not only to set up the provision for the reserve in a given year, but those bad debts which actually went bad during the given year can also be claimed. In that sense there is the possibility of a double deduction. The reverse situation—going from the reserve to the actual write-off—might necessitate taking into income account the amount of the balance in the reserve account.

Suppose the taxpayer has a business debt which is not altogether bad but is partially bad. Has he any opportunity there?

Probably there is the greatest opportunity for tax saving in the area of partial bad dets. A partial bad debt can be taken, within the judgment of the officials of the corporation. It is not necessary, as in a wholly worthless bad debt, to take it at a given point in time when the debt is completely worthless. Up to the point where a bad debt becomes completely worthless, there is complete pliability within the taxpayer's jurisdiction to determine when he shall write off the partial bad debt.

If he had two debts, both partially bad, could he take one and not the other?

Yes, he could.

Let me change to another subject: What suggestion do you have regarding the timing of charitable contributions?

They lend themselves very readily to advantageous timing. Individuals in high rate brackets may, of course, make their charitable contributions within the confines of the determination of their high-bracket incomes. Perhaps the most important area of timing is with respect to charitable contributions of corporations. The board of directors of a corporation which finds itself with high income can, before the end of the year, pledge a charitable contribution which does not necessarily have to be paid during the current year. It may be paid any time within two months and fifteen days after the close of the fiscal period. The corporation then files a certified copy of the board's resolution with its return and gets the deduction in the year of the resolution even though it pays later.

I will ask you one final question which may be of interest to the corporation executives here. What factors should be considered in the year-end dividend policy from the viewpoint of timing for the stockholders?

There is a big difference between the closely held corporation and the publicly owned corporation in respect to this problem. A publicly held corporation, of course, does not have the same pliability with respect to the amount and timing of dividends as does a smaller corporation. The

closely held corporation can time its dividend payments in relation to the rate brackets of the stockholders. If they need income, dividends can be paid. Otherwise, the dividend can be put off until the next year.

The following questions were submitted by registrants.
Mr. J. S. Seidman was moderator.

Under accrued vacation pay please explain what you mean by "vested" and its application.

Vesting applies to the fact that an employee is fully qualified, at the end of the fiscal year, without further ado to get his vacation. Where there is non-vesting, there is a qualification, perhaps that the employee be in service of the company until July 1 of the following year, for example. Where that provision would come into play as of December 31 of the previous year, that particular employee would be non-vested.

Am I correct in assuming that even though the vacation period is in the months of June and July, if the employee who quits at any time outside of those months is entitled to a pro rata part of his vacation at the time of quitting, the vacation pay would be "vested"?

Yes, that would be an illustration. For purposes of accrual, if the qualification period for vacations were from July to July, then on December 31, the accrual would be on a one-half year basis.

Is it your opinion that a taxpayer who deducted vacation pay in the calendar year 1955 on the basis of accrual on December 31, 1955, which vacation pay was not vested, will have no deduction for vacation pay for calendar 1956 as matters now stand?

That is correct. Through December 31, 1955, by reason of a recent revenue ruling, companies can continue to accrue vacation pay which is not vested. Beginning with January 1, 1956, only vested employees can be the subjects of accrual. In that case there would be no deduction available to the company for 1956.

How about the vacation that accrues between January 1, 1956 and July 1, 1956, as distinguished from the accrual. This would be vacation pay actually incurred from the period January 1, 1956 to July 1, 1956.

In that case there would be a split, as indicated.

If a company has had receivables for several years and has not taken a bad debt deduction, either on the write-off method or the reserve method, may the reserve method be elected in the current year? In other words has an election automatically been made for the direct write-off method in the first year a company has a receivable if no reserve for bad debts is set up?

Some practitioners feel that by reason of the rule that a company must elect in its first return the method of bad debt, failure to elect in its first return the reserve method would automatically put the company on the write-off method. I think that is the theoretically correct answer.

However, as a matter of practicality, if the company during the first three years had no bad debts whatsoever, there may be an opportunity to go on the reserve method beginning with the fourth year, and the revenue agent would be likely to pass it at that time. There have been some private rulings to this effect.

A corporation owns property not necessary for its business operations. The property is presently leased to a third party for a specified annual rent. The fair market value of the property is much greater than the book value. Can the corporation donate the property to a charitable foundation, the members of which are the holders of the majority of stock in the corporation, assuming the contribution is within the 5% limitation?

It is possible for the individuals themselves to make contributions from time to time to charitable foundations, and it is also possible for a corporation in such a position.

In timing dividends of a closely held company, how far into the next year may the declaration of a dividend be deferred?

The rule is that dividend payments may be made two months and fifteen days after the close of the fiscal year. This question apparently addresses itself to the declaration of a dividend. Such declaration could occur within one minute of payment.

Suppose a manufacturer has a model which has been manufactured but proves to be defective. Can the company claim a deduction for the cost of correcting the fault in such goods or inventory if the cost can be accurately determined?

The question does not state whether the cost was incurred or paid during the year. If so, I would certainly say yes. If not paid, and the company is an accrual taxpayer, I think you would meet the problem of the repeal of section 462 regarding product guarantees. I do not think it could be set up in a reserve at the end of the year. This is in the warranty field and I think that would be the answer in the light of section 462 having been repealed.

Will the hybrid method of accounting used by a taxpayer in years prior to 1954 be acceptable to the Internal Revenue Service should examination be made for 1954 and prior years' returns?

In view of the fact that the hybrid method is now given the benediction of the 1954 Code, it would be my opinion that the use of the hybrid

method for years prior to the effective date of the 1954 Code would pass muster with the Internal Revenue Service.

Is there any way by which a reserve may now be set up for liability under self-insured workmen's compensation for accidents already incurred?

I think that in view of one or two recent cases, damage claim liability is one of the items which was deductible under section 462 and which remains as an accruable deduction of the taxpayer even without that section. I would say yes.

Acquiring New Facilities; Research on New Products or Processes

PANELIST—GEORGE W. DAVERIO
MODERATOR—LESLIE MILLS

We are going to start off with a discussion of acquiring new facilities, which of course leads us right into the problem of depreciation policies. Just to set a frame of reference, I should tell you that when the Congress produced the revised law last year, the feature discussed perhaps the most and given the most publicity as being beneficial to business was the new concept of depreciation. Supposedly there were to be two results of the new depreciation provisions: the removal of shackles on business from the restrictive depreciation policies which had been enforced before and the encouragement and promotion of capital investment, which was expected to have a far-reaching economic effect on the economy.

Actually, it is very interesting to read the minority report when these provisions were being considered, because they too dramatized the effect and the importance of these sections. The majority report said that there were over 10,000,000 taxpayers affected, with a revenue loss of $375,000,000 in 1955. The minority report carried the revenue loss on beyond the year 1955, through the year 1968, and reached the staggering revenue loss estimate of $19,000,000,000. This is from the depreciation changes alone, so you see we are not dealing with petty cash items.

Now what did the Congress do? Bear in mind that they wanted to correct some administrative misinterpretations, but the statutory pro-

visions were not in fault. So they repeated the existing depreciation rule that there should be allowed a reasonable allowance for wear and tear, including obsolescense and they put in a second section. I think that it is significant that they did it that way. The second section, in effect, says that certain methods shall be deemed, without argument, to be reasonable. Therefore it is important to understand that if you had a reasonable method you are still entitled to it whether or not the second section mentions it specifically. And if you do have a method which comes under the second section, which will occupy most of our discussion here, it is applicable whether or not you are willing to admit that it isn't reasonable.

The methods automatically accepted are the straight line method, the declining balance method, the sum of the digits method (which I suspect you hadn't heard of until last year), and any other consistent method which doesn't give a larger write off than the declining balance method.

Now the Congress specifically had in mind promotion of new investments, so they made the new methods available only to new assets (by new assets meaning those acquired after 1953). The effective date is also outside the usual pattern. Most tax law provisions are effective for a fiscal year beginning or ending after a certain date. These depreciation methods are available for a qualified acquisition on January 1, 1954 or later, so we have a common starting point regardless of fiscal year. Furthermore, the government has already indicated that the election of the new methods can still be made, or can still be abandoned for that matter, for the first year affected up to the end of 1955, so that we have a chance to make up our minds as of the beginning.

Despite the time and thought devoted to these provisions, I suppose it is significant to realize that even today — well over a year later — the government hasn't been able to make up its mind on what the rules should be for applying the sections.

Now let us turn to our first question. I'm still staggered by that $19 billion, so, with all the ballyhoo of the new methods as a great attraction, to what extent do you find the new ways of arriving at depreciation allowances have actually been used by companies?

We find that in companies where depreciation is a material factor, the new methods are being used substantially and more or less selectively. We find generally that with respect to short-lived assets, like automobiles and trucks, and particularly long-lived assets, like buildings, they are being used practically without exception. For example, I took a quick look at what I thought were twelve representative industrial companies for 1954. Out of them, I found that ten had used new methods.

The choice of new methods was as follows: seven used the declining balance method; two used the digits method; and one went so far as to use both on a selective basis. So, generally speaking, I would say the new methods are being used to a substantial extent.

The use or the non-use of the new methods is the basis of a lot of study by businessmen and accountants. Tell me, what are the general factors that are being considered in this study?

Well, in looking at that particular problem, I think you have to realize that you can never deduct more than 100% of your cost as depreciation. Therefore, the important thing is timing the deductions. Now, so far as timing is concerned, you must consider the factors that are important with respect to each particular company. Among the factors that businessmen consider are such items as current earnings and future earnings prospects. There is no point in most cases to increasing a loss by additional depreciation deductions. But on the other hand, if you have a substantial profit, the new methods will be of more importance.

Another question to consider is: What are your cash requirements? The effect, naturally, of accelerating your depreciation is to increase your income tax deductions, reduce your federal taxes, and by that means — at least early in the guessing game — to reduce your cash requirements for federal taxes. Thus there will be an additional amount of cash available currently for some of the things you might have in mind, like financing equipment purchases or building additions.

And last but not least, you have to decide as to whether you want to gamble on future tax rates. Many companies using maximum depreciation rates during the 30's found that by taking too much depreciation during that period they were penalized by having smaller depreciation deductions when we had excess profits taxes. So you must also mix in with the many other factors the guess as to whether you think tax rates are going up or down.

Would you say, then, that depreciation should always be taken as fast as possible?

No, I don't think so. For example, take a new company just starting out. Early in its life, the earnings may be on the low side. I don't see any particular advantage in taking accelerated depreciation deductions to reduce the low earnings further. As I mentioned before, if you are faced with a period of possibly reduced earnings, I don't see any particular point taking rapid depreciation.

Do you think these new methods have any significance in the common business problem of buying versus renting equipment?

Yes, I think so. Particularly in the case of short-life assets, like automobiles and trucks. A number of companies that for years have rented are now very seriously reconsidering. In some cases they are actually cancelling their lease or rental agreements and are buying the equipment instead. They find that their depreciation deductions plus other deductions during the early years may run even more than the rental they currently have to pay. Of course, it's a matter of figuring with a sharp pencil.

Getting down to some detail — can a taxpayer use the declining balance method on 1954 purchases, the digits method on 1955 acquisitions, and the straight line on 1956 additions?

The answer is "yes." The nice thing about these new methods is that Congress gave us this tremendous latitude. Each year you can make a separate election with respect to each specific item that you separately account for in your records. For example, take a machine shop owner who buys four drill presses. He can take those four presses and if he keeps individual records of each in his accounting system, he can use the straight line method for one, the declining balance method for another, the machine hour method for another, and possibly the digits method for the other.

Well, here's another practical problem, especially for some large companies. Some companies find it better to keep their accounts by group rather than individual items. Are you saying then that to get this advantage, they have to consider the disadvantage of the record keeping?

Yes, that's right. If you keep item-by-item accounts, you have a tremendous amount of latitude in electing to use various methods. Furthermore, if you keep your records item by item, you have all these different elections each particular year with respect to the newly acquired assets in that particular year.

The new law specifically permits depreciation methods other than the three I named — straight line, declining balance, and digits. Would you tell us what some of the others are?

There are several others. I read an article the other day which commented upon the *"combination"* straight line method, and suggested that it be considered. Take for example an asset that has a ten-year life. Normally on a straight line basis you would use 10% a year for ten successive years. Under the combination straight line method you might use 15% per year for the first three-and-a-third years, then 10% for the next three-and-a-third, and then end up with 5% the last three-and-a-third years. Then in addition to that, we have the old unit of production method and in some cases machine hours method.

Well, suppose a taxpayer is using a unit of production method or a machine hour method, and he finds it gives a higher write-off than the declining balance or the digits methods. Can he keep on using it?

Yes, the general rule under the new law is the same as it was under the old. As long as you can satisfy the government that the amount is reasonable, you are entitled to use any consistent method under any circumstances.

And that taxpayer could adopt one of the new methods on the new

additions and continue to use the production unit method, for example, on the old?

Yes, that's right.

Now here are some questions on declining balance that might be of interest. We can all agree that declining balance was an accepted method of determining depreciation long before it was put in the law, and accountants are able to figure the scientific write-off under the method. But suppose actually for accounting purposes the declining balance write-off was less than 200%, can the taxpayer nevertheless take 200% of straight line?

Yes, because the law specifically provides that you can use the declining balance method so long as the rate does not exceed 200% of the straight line rate.

That means, however, that for good business reasons if you wanted to take less than 200% you could?

Yes. You must be careful, of course, that you don't take an amount less than normally allowable and get trapped in later years.

But if the law states that you can take less than 200%, does that mean that we could take 145% in 1955, for instance, and 135% in 1956, and so on, without getting the permission of the government?

I don't think so. I think the latitude allowed you only applies to electing a rate initially. Under the generally accepted principles of accounting, if you elect the declining balance method, you must be consistent and continue using the same percentage.

In other words, you think you would have to start off at 145% and stick with that?

Yes, I would say so.

Under the digits method, I understand that salvage value must be taken into consideration right at the start, so that the amount on which depreciation is figured is reduced by that salvage value. Does that also apply to the declining balance method?

No. You need not, in my opinion, consider salvage value, in any respect, when using the declining balance method because regardless of how long you use the asset you will never get down to a zero book value. Congress recognized that the use of the declining balance method would automatically provide a residue and hence indicated that no computation with respect to salvage value was necessary initially.

Well, then, on that basis if declining balance is figured on the gross cost, and the salvage isn't taken into account at the outset, can deprecia-

tion be continued once the remaining cost of an asset is below the salvage? That is, can you under this declining balance method depreciate for tax purposes below salvage value?

My own personal thinking is—yes. I think the law, its historical background and the committee reports give you the general impression that you need never consider any salvage value, although we understand some of the people in government service are at odds among themselves as to whether or not that is true or contemplated by the law.

If we are using the digits method and the equipment becomes obsolete before the end of its estimated useful life, can we recognize that obsolescence? We don't dispose of the equipment, but keep using it until it is obsolete.

That's a debatable question, but here is the way I view it. In arriving at your write-off on the digits method, you take two factors into consideration. One is salvage value, the other useful life. Now, at best, both of those items are estimates, so if due to changing circumstances there is a substantial error in either the salvage value or normal useful life, you may take the position that you are entitled to an additional deduction for the obsolescence factor that has occurred. So if there was a substantial change in circumstances involving the use of the asset you should have an additional deduction for the obsolescence factor.

You've mentioned useful life. What do you mean by that? As a specific example, suppose an auto rental company buys a fleet of cars. The cars have an economic life of, let us say, six years, but the company replaces its cars after 30,000 miles or eighteen months whichever is shorter. What would be the useful life of the rental cars?

I would say a taxpayer's actual experience will determine the useful life to be used for depreciation purposes. In your example, the useful life of the rental cars for the rental company would probably be less than eighteen months.

Then you think that that company could not use declining balance or digits?

It is my personal feeling that you would have a hard time convincing the government you were eligible to use the new methods. For example, let us say that the taxpayer's experience shows that he had, over a period of years, retired those cars from service after twelve, thirteen or fourteen months. That experience determines their useful life for depreciation purposes. Now there are some compensating factors, but I think sticking right to the point we can say that their useful life is twelve, thirteen or fourteen months. Since that period is less than three years, the new methods could probably not be used.

Suppose a company is negotiating to buy a business, and it has the option of working out a deal either to buy the assets or to buy the stock. How do these new depreciation methods become a factor in this business problem?

Well, in that particular instance, it may be a very important factor for this reason. You can only use the new methods with respect to *newly* acquired *new* assets. Let us assume you are buying a business that has newly acquired new assets itself, and it is using the new methods. If you want to continue the use of those methods, then you must buy the stock and continue the identity and existence of that corporation. If instead of buying the stock you actually buy the assets, you are then buying assets that have been previously used and, under the law, you, as a purchaser of used assets, may not use the new methods.

Now suppose a taxpayer is operating with leased property and makes a leasehold improvement. Can it use one of the new depreciation methods for its investment in the leasehold improvement? First, can it use a new method if the useful life of the improvements is eight years and the lease term is ten years? Can it use the declining balance or digits methods where the asset's useful life will be over before the lease runs out?

I would say in that particular case you could use one of the new methods. The new methods are applicable to depreciation and if your write-off is determined on the basis of a fixed asset with a depreciable life, you can then consider it for all intents and purposes as a depreciable asset. In your example, you are getting the full use of the asset for its full eight-year life, and, in that case, your write-off is classifiable as depreciation. You could therefore use the accelerated rates if you wished.

Let me reverse the pattern. Suppose in this case the useful economic life of the improvement is ten years but the lease is for eight years, so that normally the taxpayer would use amortization in lieu of depreciation. Can he use a new method then?

If you use the eight-year period of the lease, you are then taking a deduction on the basis of amortization, and an amortization deduction is a deduction *not* under the depreciation provisions of the law but is a deduction as ordinary and necessary business expenses under another section of the law. That being true, I am just afraid that you could not use the accelerated rates.

Now, in that specific example which is a lease of eight years and improvement with a useful life of ten years, do you think the taxpayer could elect to take a depreciation deduction based on the ten years? In other words, could he abandon the eight-year life and take a depreciation deduction on the ten years which, as you can see, will give an

earlier write-off in greater amounts than under eight-year amortization?

That is a most intriguing question. As much as I would like to recommend using the ten-year life to get the accelerated rate during the early part of that leasehold period I would say it was very questionable whether or not a write-off based on a term longer than your right to use the property under the lease would be permitted by the government.

Suppose a taxpayer buys an old building—say an old warehouse—and spends quite a lot of money converting it to an office building. He wants advice on how he can depreciate his office building. What do you tell him?

In that case you must recognize that there are two different types of expenditures taxwise. First you buy the old office building. Under the law, any previously used asset does not qualify for the new methods. So, as far as the original cost of the old structure is concerned, it must be depreciated in the same manner as it would have been under the old law. But the improvements that you make to the old building can be treated as a new building and therefore can be written off on the basis of the new methods, if you so elect.

Some taxpayers are going to have difficulty drawing the line there. I think I can see your point where an old building has been converted. But if you build a new building using old brick, I think we would have a debatable point.

Suppose a company builds a new building in 1954 and in 1955, after using it, sells it to an affiliated company. What is the affiliate's position?

The affiliate takes the same position as a stranger. The fact that companies may be affiliated is not recognized in the law. They are separate and distinct taxpayers. Therefore, if the affiliate buys a building that has previously been used by its parent or subsidiary, it cannot use the new methods.

Suppose the first company built the building and, before it used it, turned it over to its subsidiary. Do you think the answer would be different?

Yes, it would. In that particular case, the subsidiary would be the first user of a new asset. Under those conditions it would qualify for the election and be able to use the new methods.

Suppose a taxpayer elects one of the new methods for 1955, and two or three years later, a revenue agent examining the return says: "You made your election properly, but in your return you have expensed some items which should have been capitalized with this property on which you've made an election." Now if he does that and you agree to it, do you think you'll be able to use the new method on the portion which you wrote off on your return?

I would think so. When you make an election in a return you make it with respect to a specific item. Now, if you have made a mistake as to the dollar amount, I don't think that should in any way invalidate your election as to the item. Having made an election with respect to that particular machine, I think whatever the ultimate cost eventually turns out to be, that particular amount will then be subject in its entirety to the full allowance for depreciation under one of the new methods.

Let me take you one step further and go beyond an addition to an item you elected on. Suppose the taxpayer put a new roof on a building and decided that was expense. Later an agent came along and, with our agreement, capitalized the cost of the roof. What about electing a new method then?

There you unknowingly and unintentionally have not made a formal election on a specific item. Your question then is whether you can later make a valid election. I don't think you can, and I believe you would have a hard time convincing the agent that he should allow you the accelerated rate on the capitalized cost of the new roof. The safe thing to do, of course, is to include in your return a blanket election indicating that you are electing accelerated depreciation on all capital expenditures for the year. Some general statement to that effect, I think, should constitute a valid election.

I shall ask one final question on depreciation. Are there any special considerations which a company in government work should have in mind when considering these new depreciation methods?

Yes, I think so. As I understand it, for renegotiation purposes you are permitted to include in allowable costs the depreciation actually taken in your tax return. So, if you are using the accelerated rates, you should have no difficulty allocating an appropriate part of your accelerated depreciation to renegotiable business. If, therefore, your profits on renegotiable business are on the high side, it might be advisable to use accelerated rates to the greatest possible extent to reduce those profits. I understand the same depreciation rules apply to repricing in government contracts.

Now let us move on to the important problem of research and experimental expense. In this area Congress was trying to do two things: to eliminate uncertainties which had developed in this difficult problem, and at the same time, through the research and experimental provisions, to stimulate research and development and thus help the national economy. Just like depreciation, they were trying to make the rules definite, and promote economic development.

You will recall that before Congress took up this problem we had no specific rule on research and experimental expense. Some companies found themselves in most difficult situations because the general rule

was that any expenditure which was ordinary and necessary could be deducted and any expenditure which was capital in nature had to be capitalized. The result was that some companies got into extraordinary situations in research and experimental development of having to capitalize some expenses. But since there was no way of computing useful life, they didn't have any basis for a write-off until they abandoned the project. This was most unbusinesslike and unreasonable. So Congress tried to cure it on an elective basis. However, I want to make it clear, I'm talking about expenditures for research, development, or experimentation, and not the costs of physical equipment. I can get started on a very practical note.

I noticed in the Wall Street Journal the other day that one of our large industrial companies has spent 3 million over a period of six years to develop a new combination household clothes washer and dryer. Do you suppose all that expenditure could be considered research and development?

As I recall, it stated in that particular article that the first combination washer-dryer which this company produced cost them $10,000 and was a monstrosity. Actually, research and development in many large companies is often a matter of trial and error. It just goes on and on and on. So I would say in the particular case you mentioned that substantially all of those expenditures were probably research, development, and experimental in character. The one exception of course is an expenditure for a fixed asset, like a piece of machinery or equipment, that is to be used in connection with the research and development. Such items must be classed as depreciable assets and cannot be included directly in research and development expenditures. In the particular case you referred to, I would say the bulk of those expenditures could now, under the new law, be properly classified as research and development expenditures.

Well, give me very quickly the ground rules on this problem.

Under the new rules the taxpayer is given an election to either deduct all of those expenditures when and as they are incurred or to capitalize them and later amortize them over a specified period.

Suppose a company is perfectly satisfied with what they've been doing in the past. Is there any reason why it shouldn't just continue and not make either election?

No, I don't think a taxpayer should change his method if he is satisfied with it. Remember that these new methods are purely elective. They were written in the law for those taxpayers who want a better and possibly more certain basis of write-off. Therefore, if you're perfectly satisfied, I'm sure the government will be satisfied to permit you to continue without change.

Then why would a taxpayer elect to expense?

Well, because you can secure your deductions earlier than you did under the old law. You may expense absolutely everything except the cost of depreciable assets that are used in connection with research. For example, any item or cost that becomes a part of the product under development is, I think, fully deductible at once if you elect the expense method.

Then why would a taxpayer elect to capitalize and defer the expenses?

I can think of one or two cases when it might be advisable. First let's take a new company that is just starting out and has a big research and development program. The earnings during the first year or so are usually not too great and it may want, for profit and loss purposes, to defer research costs until some benefits are realized. And, secondly, even an established company may have a program of spending a considerable sum of money in relation to its earnings. It too would like to defer research deductions until it starts into production. This would enable it to allocate some of this original research expense to a later period of production and sales.

Suppose a company made one election in 1954, can it make the other election in 1955?

No. Once having elected one method or the other, the law specifically provides that you must stay on that method until you request and receive permission to change.

Suppose last year a company made an election to write off currently, and this year runs into a really big major project which it would like to elect to capitalize. Where does it stand?

In that particular case you must obtain the permission of the Commissioner to capitalize the cost of the special project. The committee reports covering the new law indicate that they expect this part of the law to be administered liberally. The whole intent of the law is to encourage research and development, and thus to help us continue our expanding economy. Hence you should have no difficulty at any time securing permission to defer deductions on a specific project and still maintain your right of expensing everything else.

We have been talking about capitalizing and deferment. If a taxpayer decides to capitalize or defer, does it capitalize direct out-of-pocket expenses for research and development expense or does it capitalize factory overhead as well?

Your general accounting policy should prevail in a case like that. For example, if you have a policy of allocating factory overhead to research projects, I think that overhead can properly be allocated to and become a part of the research expenditures that are being deferred.

What about capitalizing such an item as general and administrative expense?

That would be a dangerous thing, I believe. Under our general accounting rules and in our tax returns, we have never capitalized any of our general administrative and selling expenses, and it seems to me that any attempt to "stretch the string" in this particular area might develop into a backlash that could really hurt you in other areas.

Suppose a taxpayer has decided to defer the expenses under its election. When does the deduction start?

The law specifically provides that you start taking the deduction in the month after you first receive or realize any benefits from the expenditures.

How do you tell when you have begun to realize benefits from expenditures?

That is a part of the law which has given us considerable difficulty. Recommendations have recently been made to Congress that the law be made more definite and certain. It is a real question *when* you actually get a benefit out of an expenditure. Take, for example, the case we mentioned of the combination washer-dryer. After having spent six years on that particular project, when are they going to start to realize any benefit from their expenditures? I would say that they will start receiving benefits only when and as they start making sales of their new product. In other cases the solution may not be so easy, with the result that a substantial and uncertain period of deferment may occur.

Then the implication is that the period of amortization or recovery will begin when the benefit, which you suggest might be the first sale, comes in. What is the period of the amortization?

The period of amortization is that period which the taxpayer selects, except that the law specifically provides that in no case may that period be less than five years.

Suppose the taxpayer selected six years. Can it decide next year that it would like to go on to five years instead?

No. Once having made your election you must stick to it. Thus, if you have selected a six-year write-off period, you are bound by that selection.

What do you do with the unamortized balance if you finally abandon the project?

You just write it off and deduct it as an ordinary loss in the year of abandonment.

These new rules for experimentation do not cover depreciable prop-

erty. But I gather that depreciation on property used in research becomes a part of the research expense. In other words, a motor in the prototype or experimental model gets written off right away, but a motor which was used to develop the model is depreciable property and has to be depreciated to become a part of research and experimental expense. How does this affect the time of getting the write-off for depreciation?

Depreciation loses its identity when it becomes a part of deferred research and experimental expenses, the same as labor, material and overhead. It becomes a part of the total amortizable figure, and as such will be written off over the elective period of five years or longer.

Suppose the taxpayer has a depreciable asset and is using it for research work. It has a five-year life and cost $25,000, so that the write-off each year is 20% or $5,000. In 1955 we had depreciation of $5,000 under the straight line method. Is this 1955 depreciation spread over the years 1955-1959 at $1,000 a year because it is being used in a research project which the taxpayer capitalized?

That is right. In fact, even though you mentioned 1955 to 1959, it may extend beyond that. Let us assume that the benefits do not start until 1958. In that particular case, you actually start getting the benefit of that $5,000 beginning in 1958 and running through 1962.

Does that seem proper to you?

Yes, I think so, particularly since deferment is elective and not mandatory.

Supposing a company is expensing its research and experimental expenditures for general financial purposes. Do you think it can still elect to defer these expenses for tax purposes? In other words, do you feel there is any obligation to follow your tax election on the books?

No, I don't think so. But you should be careful to have a complete and detailed reconciliation between your books and your tax return. It is important also to retain substantial documentation on any amount deferred so that you can prove conclusively to the government perhaps five or six years after the expenditure that you are entitled to the deduction you claim on a deferred basis.

The following questions were submitted by registrants.
Mr. J. S. Seidman was moderator.

A taxpayer elects the declining balance method and he does not have to consider salvage value. But, under the law, he can switch to straight line depreciation at any time. If he does switch at a later date, must he consider scrap value?

Yes, definitely. Three determinations must be made at the time he

decides to switch over from the declining balance method to the straight line method. He will have to make a determination of the remaining cost on that specific asset; he will have to re-estimate realistically the remaining useful life; and, finally, he will then have to make a realistic estimation of what the salvage value will be. A statement showing these figures must be attached to the return for the year in which the change is made.

Would the purchase of a demonstrator automobile be considered as a new automobile or a used automobile for depreciation purposes?

Many of you may know that there are several court decisions which hold, so far as automobile dealers are concerned, that the demonstrators salesmen use and permit customers to use are considered inventory and, as such, are not depreciable assets. Since the government has taken the position that a demonstrator is inventory, the question is whether that type of an asset can be depreciated under the declining balance or one of the other methods when later purchased by a customer. The answer to that question is found right in the Code itself. The law provides that you must be the first user, and your use must start after December 31, 1953. So, a demonstrator purchased from a dealer, even though it had not been depreciated, had been used, and is therefore disqualified as an asset which could be depreciated on one of the accelerated methods by a subsequent purchaser.

Of the companies using declining balance or other new methods for tax purposes, what proportion are also using the same method for cost or book purposes?

In my experience, most of the companies that elect to use these new depreciation methods also use the same for bookkeeping and financial statement purposes. However, I can think of one exception: companies which are regulated by government agencies. I have in mind particularly the trucking companies, which must still, according to I.C.C. regulations, use the old methods of depreciation in compiling their annual reports, even though the new methods may be used in tax returns.

Do you think that the use of straight line on the books and one of the new methods in the tax return would seriously endanger the retention of the new methods in the law?

The emphasis in that question, of course, is on the word "serious." I do not think it would seriously endanger our continued right to use the new methods. Personally, however, I feel that if you are going to use accelerated rates for tax purposes, you should use the same also for financial statement purposes.

My understanding is that the election may be made with respect to

a particular asset or group of assets and, once made, should be followed consistently year after year. Is this correct?

That is correct. For example, assume that you elect the declining balance method with respect to an automobile in 1955. That same automobile must continue to be depreciated under the same method in ensuing years.

But that would not apply necessarily to another automobile acquired in 1956?

That is right. You have a new election each year with respect to each individual item that is separately accounted for in your books.

Do the costs of obtaining patents, such as legal fees, registration fees, and so forth, qualify as research costs?

I do not think so. If, as a result of your research and experimentation, you find a patentable idea and then pursue that idea to the extent of filing patent papers, at that particular point you cease having deductible research expenditures and get into the area of patent costs. The rules regarding the amortization of patents were not changed by the new law.

In developing a new machine for an entirely new process, could the original experimental machine be expensed as experimental expense?

Let us assume you are working on a new process or a new method and your efforts result in a machine which can be used in production thereafter. If you have elected the expense method for research and development expenditures you are permitted to expense all of the costs incident to its development. If, on the other hand, you have elected to defer such expenditures, the Congressional committee reports seem to indicate that you can not use a five-year write-off period if the normal useful life of that newly developed machine is more than five years. If, for example, the machine will be useful for ten years, the write-off period would be ten years.

The following questions were directed to Mr. Leslie Mills

Recent instructions issued by the Air Force audit people provide for the acceptance of depreciation as accepted by the Bureau of Internal Revenue. Recent negotiations with the Air Force indicate that the same philosophy exists in contract pricing. What is your view on that?

The Department of Defense recently decided to accept for procurement purposes the tax amount of depreciation with one exception, and that is where sixty-month amortization is deducted for tax purposes under a certificate of necessity. Here the Department insists on a determination of what they call "true depreciation."

It was stated that equipment used in research was not included in research costs. Does this mean that the research and development provisions do not apply to expenditures for productive equipment?

When the equipment is purchased as part of the research program, its cost is not to be treated as a depreciable research expenditure. The fact that it is being used in research does not make it a part of research cost except through depreciation.

However, something like an electric motor can become a part of the prototype or experimental product. In this case it should be written off right away. But an electric motor with a five-year life which is being used in research and which does not become a part of the experimental prototype product must be depreciated. The depreciation for the year then becomes a part of the research and experimental expense for that year and is either an immediate deduction under the write-off election or a deferred item with a sixty-month or longer write-off under the other election.

Employee and Executive Compensation Arrangements

PANELIST — MATTHEW F. BLAKE

MODERATOR — LESLIE MILLS

Employee and executive compensation arrangements is the subject now. This is one of the most important problems facing American business today. As a result of high taxes, high cost of living, low interest rates on personal savings, etc., employers must recognize that it is becoming harder and harder for employees to get enough after-tax dollars to meet current living expenses and to save for the future. At the same time the companies have been forced to seek ways to provide free tax dollars which are currently deductible but which are not taxed to the employee or are at least deferrable. One way out, which seems to give the ideal of a tax deduction which is not income, is the so-called fringe benefit payment. These have become so important in the compensation of employees all the way from the executive to the factory worker that they are the subject of a special study by the Congress and are always coming up in employee relationship with unions, and so on. . . . Also it is so broad a subject that I am quite sure you could fill up the question box with specific questions on it. I will simply ask one or two leading questions to define the subject. My first question is quite general. Many companies give a substantial discount to employees on the products they sell. Do you think these discounts are taxable to the employee?

In practice, cash discounts to employees, even though they are suffi-

ciently large to form a part of the wage pattern, are not reported as taxable income. However, in theory they probably are taxable and there are, of course, many other fringe benefits that would meet the same standards. From the standpoint of company policy, to remain competitive in the labor market, you have to extend these fringe benefits. However, it may be sound and prudent to go a bit slowly because the Internal Revenue Service is definitely interested in closing up many of the loopholes, and you may find, after embarking on a lavish program, that the employees will be taxed on some of the things they accepted under the impression that they were nontaxable.

In other words, we have a way of giving compensation to employees, but if it is abused we may lose what we have now?

I think that expresses it very well.

Take another common situation. Suppose the company serves free lunches or sells lunches at below cost to employees. Do you think this represents taxable income?

I think the answer would be the same. Again, it is very difficult for the examining revenue agent to police. They don't like to get into things of that kind, but there probably exists a basis for subjecting these economic advantages given to employees to tax, and some day it may happen.

Would you give the same answer if the company officers were required to eat lunch in the company dining room to discuss company problems?

They put into the 1954 Code a provision that meals and lodging which are granted to employees for the convenience of the employer are not subject to tax. What is meant by "convenience of the employer" is subject to many interpretations, but generally I would say that if the providing of meals is for the benefit of the employer as distinguished from the employee, it is not subject to tax.

Suppose a company offers to pay for a periodic physical examination for its employees, which in many cases results in a saving of personal expense on the part of the employee. Do you think the worker has income out of that?

I think you have a clear out there on the grounds that the periodic physical examinations are for the purpose of keeping up the efficiency of the employees.

Suppose the company also offered to pay for examination of the employee's wife and children?

That would bring us closer to the taxable area. In practice it is not taxed. Possibly it could be.

On the subject of keeping employees healthy and happy, have you

any suggestions as to how an employer could help finance life insurance for him without subjecting the employee to tax?

We are all familiar with the conventional group term life insurance program. Most companies have that. However, such company-wide plans are not always adequate for certain groups. The occasion does arise, particularly with the more promising younger employees, in which they are unable to finance all of the life insurance they would like to have to protect their dependents. A relatively new practice has developed whereby the employee takes out his own regular life insurance policy, not the group term renewable type with which we are most familiar. The employee pays the cost of current insurance protection, and the company finances the cost of increases in cash surrender value. As you are aware, in the standard insurance policy there are two elements: one is the current insurance protection and the other is the building up of the investment or the cash surrender value. The employee and the insurance company agree that upon the death of the employee, the cash surrender value will be returned to the company, and the life insurance element, being the excess of the coverage over cash surrender value, goes over to the dependents of the employee.

You may ask what are the tax advantages of a plan of this kind. The covered employee obtains a great deal more insurance than he could otherwise afford and pays a relatively smaller amount of after-tax dollars for the coverage. As far as the company is concerned, it loses only the interest on the money put into the cash surrender value. Those of you who like to think of these things in terms of catch phrases might like to know that this is called a split-dollar or split-premium arrangement.

I think this is something worth looking into when you have younger employees you are trying to boost along. Now I want to move to some of the side issues of fringe benefits, and consider some of the problems involved in travel and entertainment expenses. We all know that business executives must entertain customers, and I'd like you to give us some suggestions as to how we can protect these executives—and their companies, for that matter—from disallowances by internal revenue agents.

There is a slight conflict of interest here between the company and the employee. For the employee, the best arrangement is to have the company pay the bills directly or to reimburse for itemized expenses. Companies dislike this as a general rule, however, for two reasons. One is that there is much bookkeeping involved, and the second is that you tend to lose control of the total amount of money expended by the individual. Companies usually prefer that lump-sum expense advances be made to their employees. This is, however, considerably weaker from the employee's point of view because he has no excuse for eliminating this lump sum amount from his gross income on his personal tax return. He has to keep detailed records and be able to support the deductions at the

time his return is examined. Then, of course, the other method is for the individual not to request any reimbursement from the company but to claim a deduction on his tax return.

Does not a problem develop if the employee does not claim reimbursement from the company but deducts expenses on his own return? I should think that would imply that he is in business.

That plan gives the most difficulty. First, you must prove that your compensation arrangement contemplates that you will spend certain amounts out of your salary which will not be reimbursed. The law on the subject is that the company's expenses are not yours and you are not allowed to deduct them. Another difficulty would be the same as we had on the lump sum advance; that is, showing the money was spent for business purposes, the question of proof, reasonableness, and so forth.

Another fringe benefit is the accident and health plan, by which the company tries to protect its employees from loss of income due to illness or injury. One of the new provisions of the law with which we are trying to become acquainted, and one which affects almost everyone who works, is the $100-a-week exclusion from taxable income for employees who are absent from work because of sickness and injury. Will you tell us how that works?

I think everyone here will agree that this is a major administrative headache, not only for the employers but also for the Treasury Department. Briefly the provision works like this: Where an employee is absent from work due to injury or illness, up to $100 per week of the money paid him in respect of that period can be excluded from taxable income. There is a seven-day waiting period before the exclusion applies, unless he is absent because of a physical injury or unless he is hospitalized sometime during his absence, in either of which circumstances there is no waiting period.

I will ask you just two of the many questions which come to mind concerning this subject. Let us take the case of a man earning $75 a week who was absent from work last March. Now he receives a $25-a-week increase, agreed to with the union and retroactive to last March. How would you recommend that he handle that $25?

I would say the $25 is nontaxable, which would bring him up to the limit of the $100 exclusion for the weeks of absence during March, because the law states that the exclusion relates to income for the period of the illness. It does not say, income paid to him *during* his illness.

To avoid the seven-day waiting period, the employee must be hospitalized. Suppose an employee has a serious operation, but it is performed in the doctor's office because he has the facilities, or it is performed at the employee's home because he could not be moved. Do you think that is considered hospitalization?

The rulings say that will not do. He is supposed to be in a regular hospital for at least one hospital day.

If a company has an accident or health plan, does it have to be company-wide or may it be tailored to a small group?

The law is very liberal on that point and so are the regulations. Almost any type of prearrangement among a group, whether it be large or small, will fill the bill provided the plan is made known in advance to the people who are affected.

How small is small? Could you have a plan for only one person?

I believe you could.

I am going to move on to deferred compensation. There are many ways sanctioned by the law to spread taxability of compensation over future years, to and beyond retirement. Here we deal with very complicated provisions of the law and new wrinkles and developments always come up. However, the focal point usually is the pension plan. There is an almost infinite variety of pension plans, but everyone will probably be interested in this question: Having in mind the new statutory provisions, what changes in existing pension plans would you recommend to make sure that the employee receives capital gain benefit when he retires or dies?

The law as it is now drawn makes it possible for the members to obtain long-term capital gain benefits on the amounts contributed by the company in two situations. One is where an employee, upon separation from employment or when he becomes a pensioner, withdraws his entire interest in the plan in the form of cash or property (as distinguished from receiving an annuity policy) within a year. Here his share is treated as a long-term capital gain. This provision was with us before, but the next situation I will discuss is a liberalization made in the 1954 code. Where a pensioner dies before receiving the full amount of his benefits, long-term capital gain treatment can be obtained by his personal representatives if they withdraw everything he was entitled to receive within a year's time. By the way, such action also could affect the $5,000 death benefit. I think it is important to review pension plans every year as a matter of routine, and these two particular advantages should be introduced as features of every pension and profit-sharing plan.

I have a question on the investment of the fund of the pension plan trust. Suppose they invest in tax-exempt securities. Would this exemption carry over to the payments to the employees?

No, the income loses its identity in the trust, just as though it were a dividend paid by a corporation out of tax-exempt income.

If you are the trustee of a pension plan and the employer suggested

that you use plan money to erect a building which he would lease from the plan, what tax problems would you face as trustee?

That problem is coming up very often in practice today. I would recommend strongly that an advance ruling be obtained on any transactions between the trust and the company. The case you mentioned of the trust putting up a building to be leased to the employer company, for instance, presents these difficulties. If the rent is set too low, the examining revenue agent may say that it is a "prohibited transaction" because you are taking advantage of your close relationship with the fund, and the trust or fund could well lose its exemption. On the other hand, if the rent were set too high, the government may claim that you are attempting to circumvent the limits on the amount of contributions established for the employer.

Would these comments apply to almost any other business transaction between trust and employer?

Yes. There is another facet of that problem. The income from the rent of real estate would not be taxable, but if you changed the facts a little and rented a piece of machinery or a steamship, the income *could* be taxable to the trust if such rental constituted engaging in a business. Even with respect to the real estate, the trust could lose its tax-exempt status to some extent if it borrowed money in order to finance the purchase. Again it is suggested that you obtain an advance ruling if you meet these situations.

One of the objections often raised to pension plans as a method of compensating executives and others is that they commit the company to a fixed charge in the future which may be very difficult to meet in years of poor earnings. I am told that a profit-sharing plan is recommended to meet this objection because it gives more flexibility in that the contributions for the benefit of employees would be geared to profits. If a company embarks on this kind of program, must it have a permanent iron-clad formula for determining the contribution of the employer to the plan?

I am going to take the liberty of commenting first on the question of flexibility of pension plans. Actually, a great deal of flexibility can be built into pension plans. People are inclined to reject them too quickly without knowing what can be accomplished along those lines.

In answer to your specific question, those of you who have been operating with profit-sharing plans for a number of years are well aware that the government has insisted that there be a pre-determined formula. The Commissioner lost just about every court case in trying to enforce this requirement, and the proposed regulations indicated that in the future the government will approve plans that do not meet the old predetermined formula requirement. You may ask what advantage does this

give. Flexibility is a very important element of deferred-compensation planning to management. You may want to give management the discretion of contributing between certain levels of income, such as anywhere from 5% to 25% instead of say, 15% of income. My belief is that this new rule will permit such discretionary contributions. The ground rules have not yet been issued, but I do not see how you can be prevented from amending your plan, if you want to introduce this element of flexibility on a reasonable, nondiscriminatory basis. Of course, the 15% of compensation ceiling on contributions still applies.

There is another subject in the news now, and that is the subject of the guaranteed annual wage. I suspect many companies do not like to face up to it. It has been suggested that a profit-sharing plan may be used to offset some of the growing pressure in this direction. Have you any comment on that?

I believe there is a great deal of sense to your thought. A profit-sharing plan, which can be used for the purpose of providing separation or unemployment pay, also builds savings for the employees who stay with the company, so that it gives advantages both to those who may be separated and those who stay. Additionally, under the guaranteed wage, the formulas, as I understand them, are rigid and contributions must be made whether the employer prospers or not. Hence they constitute a fixed charge. A profit-sharing plan has flexibility built in; you contribute to it only to the extent that you make money.

Another problem with regard to profit-sharing plans is often met by companies which are operating with a series of corporations. If such a company had a group of profitable units, but one growth company which at the moment was operating at a loss, is it permitted to have the profitable companies receive a deduction for contributions to a profit-sharing plan which are credited to the employees of the loss company?

The 1954 Code specifically allows this, and it can be very helpful both in attracting new personnel and in transferring personnel from the profitable companies to the loss company.

There is a relatively new wrinkle developing in the profit-sharing field which is called thrift or stock-saving plans. I wish you would tell us briefly how these plans operate.

The advantages of profit-sharing and pension plans stem basically from the fact that they can be made tax exempt. Here is a form of savings plan for employees which is catching on because it also may be made tax exempt. The usual arrangement in brief is to set certain limits within which employees may save in a fund; the employer agrees to match or pay a certain percentage of the employee's saving into the fund; an

individual account is kept for each employee. Neither the income of the fund nor the contribution of the employer constitutes taxable income to the employee until withdrawn.

If he is not taxed until he makes withdrawals, what kind of income does he have when he does draw it out?

He will have ordinary income unless the withdrawal relates to his departure from the company. In that event he would have the same capital gain privilege available under a profit-sharing or pension plan.

However, suppose the fund follows the practice of buying stock of the employer. By the time the employee draws that out, it has appreciated in value. When is the appreciation taxed?

Let us assume that at the employee's direction the fund bought for him a share of his employer's stock at $10. At the time that he takes it out in kind, it is worth $25. The $15 is not taxable to him at that time. However, the $10 a share remains as his cost when and if he sells the stock.

However, he has an investment under company management which has appreciated and now he has it under his control.

We cannot leave the subject of compensating executives without mentioning stock options. This has such a long history of legislation and litigation that we cannot begin to cover it adequately. I will ask a basic question: If an employee receives an option to buy company stock at $60 which has a market value of $100, is that taxable income?

It may or may not be. If the intent of allowing him this spread of $40 per share is to give him compensation, the spread is taxable. If, on the other hand (and now we are dealing with an issue which is before the Supreme Court), the purpose of giving him the spread in price is to permit him to invest in the company, then it is not taxable. If you changed the facts and made the purchase price $85 or higher, then you probably would have a restricted stock option, which would not result in any tax to him at the time of granting.

"Restricted stock options" being a statutory term which is covered by very specific rules, we will not try to cover them here, unless you want to submit questions on it. I'm interested in your point as to whether or not compensation is intended. If a corporation wants to give stock to an employee, it can either give him an option or a stock warrant. When would a stock warrant be advantageous?

Stock warrants are not used very often but have some advantage in that the legal background is a little clearer than on taxable stock options. If you use warrants, you will want to make it very clear that in granting the stock warrant, the spread which you are giving the employee represents taxable income to him at that time.

If you do that, does the employer get a deduction for the spread?

The employer gets a deduction only to the extent that the granting of any one of these rights results in taxable income to the employee.

Does that mean that the employer must find out the final answer on the employee's tax return?

Yes. This is one situation in which the employer's tax situation depends on the treatment accorded the employee. There are occasions where the employer should make clear that the stock option granted is taxable at the time it is granted so that there is no worry about what may result from an increase in value between that date and the date when the option or warrant is exercised.

We have been discussing specific methods of deferring compensation or reducing tax. Let us look at the over-all deferred compensation problem, aside from these formalized ideas. I think many executives would prefer to stretch out their income over a long period by a simple deferred arrangement to reduce the high surtax. Will you outline for us the essential elements of such an arrangement?

It appears that these high surtax brackets of ours are affecting everything in the United States today, even the old adage about a bird in the hand being worth two in the bush! Today, substantial tax savings can be achieved by deferring compensation until the time of retirement. However, you must protect the employee who is to be the recipient of the deferred compensation. The only way to do that is to set up contingencies. For instance, require that he must stay in the employ of the company until retirement. Or require that he render consulting services after he leaves the company. There is a variety of other contingencies which can be inserted. This too is important: Do not tie the plan to any trust fund or endowment policy. The company can take out an endowment policy to finance the future payment, but be sure to make the policy payable to the company and not to the employee.

You mean that the company and the executive could work out an arrangement by which he would take a lower salary now in return for an agreement to pay him X dollars when he retires and until he dies. Would it be prudent to require that the executive must be available for consultation and must not work for any other company?

The one thing you mentioned that I would avoid would be to reduce his salary coincident with giving him a deferred compensation plan. That may well bring about immediate taxation under the constructive receipt doctrine. You may, however, set up a deferred compensation agreement in lieu of a potential increase in compensation.

But you do think it prudent to have some strings on it?

That is right.

What about using the "stretch-out method" for "one-shot" compensation? Suppose the employee earns a large bonus or commission. What can be done to spread the payment over two years, assuming, as we must, that the employer is on the accrual basis and the worker is on a cash basis?

That is being done. The arrangement should be made before the income is earned; that is essential. You may want to introduce a contingency, as we have with the long-range deferred compensation contract, such as to require that the employee must remain with the company during the period that he is receiving the extra compensation or forfeit his interest in the agreement.

In both these problems, the one being a long-term arrangement with an executive and the other being a one-shot affair, what about the deduction to the actual-basis company?

On the long-range plan the law is clear that no deduction may be taken until the year of payment. On the short-range plan the government probably will apply the same rule. It is certain that if there is a contingency in the short-range type of deferral, you may not take the deduction until you pay the compensation.

The following questions were submitted by registrants.
Mr. J. S. Seidman was moderator.

How far must you go in keeping records for entertainment and travel expenses, and boats, airplanes, and summer cabins used for entertainment of business contacts? Suppose a cabin is turned over to various contacts for their own personal use. Are these deductions approved and what records are required?

We do not know who owns the boats, airplanes, and cabins. Let us assume that a corporation owns them, and that it is a closely-held company. Under those circumstances, you would want to keep a log or other record so as to determine the business element as distinguished from the personal element in the use of these facilities.

What benefit does the split-dollar life insurance, in which cash surrender value goes to the employer, give over the usual group term life insurance in which no tax is incurred and all the proceeds go to the employee's dependents?

Group policies usually are extended on a company-wide basis, whereas a split-dollar plan can be limited to a relatively small group. A split-dollar plan is less costly than group coverage because the employer gets its money back, and the only loss is interest on the money advanced to

finance cash surrender value. Further, this is a standard type of insurance policy which can be taken over by the employee at such time as he can afford it, or when he leaves the company, whereas group insurance represents merely renewable term coverage with no cash or loan value. When the employee takes over the policy he probably will be able to borrow sufficient money against the cash value to effect the purchase from his company.

Would you say that this is a fair summary of split-dollar insurance? Essentially, insurance involves two things: one is investment and the other is mortality. The split-dollar plan has the company looking after the investment portion and the employee getting all the benefit of the mortality part.

That is correct.

Can an approved profit-sharing plan be set up to cover only supervisory personnel?

That would be discriminatory; it is not possible to do so.

A corporation adopts a pension plan which qualifies under the Treasury Department rules. May the corporation, in periods of high earnings, make additional deposits into the pension fund and receive an immediate tax deduction?

No, that would not be possible. You have to adhere to the plan.

If an employee incurs an illness which results in an indefinite, or possibly permanent, absence from work, how would the $100 exemption be treated in connection with any voluntary payments made by the company?

The regulations make it quite clear that the sick pay exclusion relates only to temporary absences on account of illness.

While on vacation, an employee is hospitalized for an operation. His vacation pay is $100 a week. Would his vacation pay be exempt income as sick pay?

No. During his vacation period, he is away from work because he is on vacation and not because he is sick.

Assuming that a company has both a thrift plan and a profit-sharing plan, does the 15% limit on company contributions apply?

Yes. The law states that for profit-sharing plan purposes, the limit on contributions is 15% of the compensation of the people covered. Since a thrift plan is another form of profit-sharing plan, it qualifies under the same subsection of the law, and the 15% would cover both contributions.

The Quest for "Capital Gains" and Other Low-Tax Income

PANELIST—HARRY JANIN

MODERATOR—LESLIE MILLS

What are the capital gains provisions for corporations for 1955?

The capital gains tax for corporations is 25% on the net gain from sale of property which has been held for six months or more. If a corporation has had numbers of sales, it is first necessary in determining such net gain to segregate the sales transactions into two different groups. In the first group will be put the gains and losses from sales of property held for more than six months, commonly known as long-term capital assets. In the other group will be put gains and losses from sales of property held for six months or less, these are known as short-term capital assets. If after applying the losses against the gains in each group, the result is a net gain in each group, then the net long-term capital gain is subject to the 25% maximum tax rate, and the net short-term capital gain must be added to regular income and is subject to tax at regular rates. Gains and losses are then correlated. If there is a loss in one group and a gain in the other, the loss must be offset against the gain. The net gain as it thereafter appears in either group is taxed in the manner I have indicated. After gains and losses are segregated, if there is a loss in each group, it is not deductible for tax purposes. It may be carried forward to the five succeeding taxable years and applied against capital gains which may be realized in those five years.

As I understand you, a taxpayer must, before the end of the year, see

where it is on capital gains and losses, because the effect is so different depending on what the final result is going to be.

Yes, I think it is desirable to avoid winding up the year with a short-term capital gain, because that gain is taxed as ordinary income.

The objective always seems to be capital gains rather than ordinary income, but we have a lot of corporate representatives here and a great many stocks are owned by corporations, so is it always better to receive capital gains rather than dividends?

No. If a corporation has a choice between a capital gain and a dividend, it is preferable in the usual case to receive a dividend. This is for the reason that corporations are permitted a deduction for dividends received equal to 85% of the amount of dividends so received. Since the corporate tax rate is 52% and 85% of dividends may be excluded and only 15% reported, we sometimes refer to the effective tax rate on dividends for tax purposes as 7.8% (meaning 15% of 52%).

In effect, then, there is a conflict of interest when a corporation has an opportunity to pay either a dividend or give the stockholders capital gain in that the corporate stockholders will be paying 7.8% and the individual stockholders the normal rates if it is a dividend and 25% if it is not.

Now you mentioned that a corporation receiving a dividend is permitted an 85% deduction—85% of what and with what limitations?

The general rule is that it is 85% of dividends received. However, if the corporation's net income, that is after taking into account all of its income and all of its deductions, including dividends, is less than the gross amount of dividends it has received, then the 85% dividends-received deduction is limited to 85% of the net income. For example, if a corporation receives dividend income of $100,000, and its net income is $90,000, it will be entitled to a dividends-received deduction of 85% of $90,000, which is $76,500, instead of 85% of $100,000, or $85,000.

In that example it appears that the corporation has lost the benefit of a deduction of $8,500. Is there anything you can suggest they do to take advantage of this deduction?

In such circumstances, it would be advisable for the corporation to attempt to increase its net income to a sum at least equal to $100,000. If it could increase its income by $10,000, raising its net income from $90,000 to $100,000, it would then receive the full dividends-received credit, and the effect of increasing income by $10,000 is to pay a tax on only 15% thereof, or about $1,500.

In other words, here is the situation where timing planning can pay off by getting income at an exceedingly low tax rate.

Now, on dividends, what are the problems that corporations will have if they receive the dividend in property rather than in cash?

If a corporation receives a dividend in property, it is required to take the dividend into account for tax purposes at the cost of the property to the distributing corporation, or the market value of the property, whichever happens to be the lower. Its dividends-received deduction of 85% is measured by the amount which it takes into income.

I want to go back to the pattern which you gave us initially of realization of gains and losses, how you can plan to avoid a short-term gain, and so on. Suppose we have a corporation with potential gains and losses from securities, some held for more than six months and some for six months or less. I would like you to comment on how it should plan its gains and losses on these potentials.

It would seem to me that the first thing the corporation should do is to determine whether it will have a net gain or a net loss after sale of all the property which it proposes to sell. If the result is a net loss, it really does not make too much difference in what order the gains and losses are taken, provided they are all taken within one taxable year and are not spread over more than one year. If the result of the transaction is going to be a net gain, it is advisable to arrange the gains and losses in such a manner as to wind up in any one taxable year with a net long-term capital gain, that is, a net gain from sales of property held for more than six months. If that result is achieved, then the maximum tax of 25% is paid with respect to such net long-term capital gain. On the other hand, if, as a result of poor planning, the corporation finishes its taxable year with a net short-term capital gain, that short-term capital gain has to be taken into income in the same manner as regular income, and the 52% tax rate paid upon it. The fact that in the subsequent year there is a capital loss will be of no benefit to the corporation except by way of carryover.

If a corporation finds in surveying its security position that it has the same security bought at different times and has potential gains and/or losses on it, would it have an opportunity for planning that?

Yes, a corporation can control the amount of gain or loss it reports with respect to a particular sale by identifying the security by certificate number. Although the general rule is that the first purchases are deemed to have been the first items sold, that rule is overridden by the showing of the cost of a particular certificate which was delivered against a particular sale. So, if a corporation purchases securities at $50 a share, and two months later at $60 a share, and desires to sell part of the securities and minimize its gain or set up a loss, it could pick the security purchased at $60 a share and, by means of certificate numbers, identify the security and deliver the particular certificate. If that is done, the

amount of its gain or loss would be based upon the $60 purchase price, rather than the $50 purchase price.

You said that a corporation can do its planning on the basis of identification by certificate numbers. Can it use other means of identifying what it is selling?

Yes. Sometimes it can identify by keeping separate ledger accounts. In other words, it may keep a separate page on each purchase, either in its general ledger or some subsidiary record, and identify it by the date of purchase and the amount. This type of identification has proved sufficient in the past.

Now I have a question which suggests that under some circumstances it is advantageous for a corporation to buy a stock before it goes ex-dividend and then sell it after it has gone ex-dividend. I would like you to tell us under what circumstances that method can be used in tax planning.

I think that can best be explained by an example. Let us assume a corporation has a net long-term capital gain already realized of $50,000 and if it does nothing, it must pay a tax of $12,500. It learns that a stock is going ex-dividend and will pay, let us say, $50 a share. Our corporation buys a thousand shares of the stock before the dividend date, receives the dividend, and then sells the stock. If the stock market does not fluctuate, our corporation will receive a dividend of $50,000 and will have a capital loss of $50,000. The market price of the stock will usually drop by the amount of the dividend. If the $50,000 dividend and the $50,000 capital loss are superimposed on our corporation's income, the $50,000 capital loss can offset the $50,000 capital gain, and what is left is only the $50,000 dividend. You will recall that a corporation receives an 85% dividend-received deduction. As a result, only 15% of the dividends, or $7,500, is subject to tax and, if our company had no other income, its maximum tax would be $2,250. Thus by buying the stock, receiving the dividend, and selling the stock thereafter, our corporation can convert the capital gains tax into a tax on dividends. In the particular example there is a saving of approximately $10,250.

What about the similar situation in which the corporation might get a tax advantage by selling the stock before it goes ex-dividend and buying it back, instead of buying and then selling?

Again by reference to an example, let us assume that our corporation had a capital loss of $50,000 before it embarked upon this new transaction, and that capital loss serves no benefit for tax purposes except as a carry-over. If our corporation were to sell the stock short before it goes ex-dividend, carry the short sale past the dividend date and then buy it in, it will have a capital gain on the sale and repurchase transaction because the stock will drop the amount of the dividend. However, our corpora-

tion will be required to pay out a sum equal to the dividend to the lender of the stock. This payment is a regular deduction for tax purposes—not a capital loss. As a result of the transaction, our corporation has realized a capital gain but need pay no tax thereon because it already has a capital loss. It has an ordinary deduction for the dividend payment. The final result is that our corporation is able by this method to convert a nondeductible capital loss into a regular deduction.

But just a word of caution, if I may, on these types of transactions. You will find that the market does not fluctuate exactly the way you would like. Too often a stock will drop considerably more than the dividend involved. Therefore, a corporation seeking to indulge in such a transaction should examine carefully the market risk involved.

I think that is a fair caution. You see what is happening in transactions like these which are just examples. You are embarking on a group of transactions which will produce no gain or loss, but you are nevertheless converting income into a lower tax bracket or doing the reverse with a deduction.

One of the problems that a corporation faces in tax planning is when to pay taxes on capital gains. How may short sales be used to control the time of payment of taxes on capital gains?

Let us assume that a corporation has a profit in a security which it desires to sell, but for some reason is unwilling to include the tax it would have to pay on the profit in its tax liability for the particular year. The corporation can sell the stock short. Its broker will borrow to deliver against the short sale, and the corporation will keep its own security in its box. After the taxable year has passed, the corporation then delivers its own security to cover the short sale. For tax purposes, the short sale is not completed until the corporation delivers its own security. As a result, therefore, although the corporation has insured its profit by a short sale, it need not pay the tax and need not report the profit until the succeeding year.

Some time ago there were quite a few public statements and discussions to the effect that tax evasion was being practiced in the purchase of callable bonds. I'd like you to explain how that works.

There are bonds, or have been bonds (I do not know to what extent they are available today) which sold at a premium and contained a provision whereby the issuing company could call the bonds on thirty days notice. Let us assume that such a bond was selling at 110 and could, on thirty days notice, be called at 102. The law permits the deduction of the 8-point difference within the thirty-day period, and the deduction is a regular deduction for tax purposes. If such a bond is purchased on April 1, the deduction is available by May 1. The corporation's basis for the bond, for tax purposes, is not 110 which it paid but 102; that

is 110 less the 8 points which are written off. If it carries the bond for more than six months and if the market price remains constant (a big "if"), it can then sell the bond and have a long-term capital gain. The result of the transaction therefore is a regular deduction of 8 points, against which up to 52% of tax may be saved, offset by a long-term capital gain of 8 points, on which the maximum tax is 25%.

I understood that this problem was considered in the law last year and that the tax advantage was supposed to have been eliminated or reduced.

No, it was not eliminated; it was only limited. In the 1954 Code it was provided that if the bond was issued after January 22, 1951, then the thirty-day call provision could be used for tax purposes provided that the initial call date was at least three years after the date of issuance. For example, if the bond was issued on, let us say, May 1, 1955, and provided for a call date beginning May 1, 1956, that call date could not be used for purposes of amortization. But if the bond provided that on and after June 1, 1958 it could be called on thirty days notice, the thirty-day call date could be used. If the earlier call date is not available because of the limitation I have just indicated, then the amortization of the premium, to which I referred before, must be taken not over the thirty-day period, but over a period which ends with the maturity of the bond.

So if the market situation is right, there still is an opportunity for moving around in this field?

To a limited extent, yes.

Now what about the situation with respect to bonds convertible into stock?

To the extent that the premium on a bond is attributable to the conversion features of the bond, the benefits I have indicated do not apply. The premium attributable to the conversion feature must first be eliminated before determining the amount which may be written off over the thirty-day or extended period.

We have been discussing opportunities for tax planning on securities owned by corporations. I wish you would take up the matter of the corporation's transactions in its depreciable assets.

There is a special rule dealing with depreciable assets, or assets used in a trade or business. It operates in somewhat this manner. If depreciable assets are sold at a loss, the loss is fully deductible no matter how long the depreciable assets have been held. If the depreciable asset is held for more than six months and is sold at a gain, the gain is subject to tax only as a long-term capital gain. If the asset has been held for less than six months, the gain must be added to the regular income. If there is more than one sale of depreciable assets during the year, then the

gains must be offset against the losses and only if there is a net gain on sale of assets held more than six months is that net gain subject to tax at the 25% rate. Losses always must be offset against gains.

Now what does this mean if you have both gains and losses? And I am going to assume for the moment that the assets are held in all cases for more than six months. If you take the gain and loss in one year, the tax benefit from the loss is only the amount of tax saved on the gain. Since the maximum tax on the gain is 25%, it is to a corporation's advantage to place, if it can, the gains and losses in different years. If it has a loss in a year in which it has no gains, the loss can be offset against regular income and a 52% tax saving effected. But if the loss is taken in the same year in which a gain is taken, the effect is to save only 25% of the loss, rather than 52%.

Then this is another situation in which year-end tax planning is most important.

Yes, very important.

Have we not the problem on depreciable property of deciding whether or not to take the gain or loss at all?

Sometimes that problem may arise in connection with trade-ins. If property is traded in in connection with another purchase, it may be advisable to consider first selling the property and then making the purchase separately. For example, if the sale of the property would result in a loss, it is certainly advisable to sell the property and make a separate purchase of new property because the loss is not deductible if the loss property is traded in for the new. For tax purposes the trade-in of like property results in no gain or loss. In that type of situation, sell the property instead of trading it in, obtain the loss which can be offset against regular income, and then go out and buy the other property. If, however, the property which you are ready to trade would be sold at a gain, then you can save the capital gains tax by trading the property rather than selling it.

Considering this problem of depreciable properties, I suppose it is fair to say the opportunities for planning, such as were just outlined, are going to be more and more present as we use these new depreciation methods because they will be reducing the tax basis of property rather more rapidly than in the past so that there will be more potential gains. I would like to ask this, however. In tax planning on capital gains versus other income, suppose our corporation has a problem in stocks and bonds and other securities, and it also has a problem in its physical equipment. Does it have to consider any correlation, or are they separate problems?

They are separate problems, I believe. If a corporation has gains in securities and losses in depreciable property, the losses need not be offset

against the gains. The losses may be deducted as regular income. If it has gains in securities and gains in depreciable property, it also will not matter because in both cases they incur the 25% tax. However, there is one time when they overlap and that is when you have gains in depreciable property and losses in securities. Since the gains on depreciable property are treated as capital gains, the losses on securities (which are capital losses) may be offset against the gains.

I have one or two questions on the leasehold problem. If, pursuant to a lease, the lessee erected a building on the lessor's property, does the lessor have a tax incidence from that?

No, he does not.

If a lease goes into default, and the lessor takes possession of the premises which have been improved, what then is his taxable situation?

There is no tax when the lessor takes possession. The only time the lessor has a tax is when he disposes of the property with the improvement on it.

Now to take up the problem for the tenant. If a tenant receives consideration for cancelling the lease, does he have income on it? In other words, the landlord buys out the tenant. What is the income situation?

Under the new law a tenant receiving consideration for cancellation of a lease has capital gain. Prior to the new law, it was regular income. I should add a word of caution. The new law did not affect the landlord or lessor's position. If for some reason the tenant pays the lessor consideration for cancellation of a lease, the lessor continues to have regular income, not a capital gain.

The following questions were submitted by registrants.
Mr. J. S. Seidman was moderator.

Will a corporation realize any tax saving by selling rather than trading equipment, reporting the gain, and obtaining a higher basis for the new assets?

I think a corporation can, if it is willing to gamble, invest in a capital gains tax on the sale of equipment, and recoup the tax or more by getting a higher basis for the new equipment which it purchases. It thereby obtains a depreciation deduction on such higher basis, probably at a tax rate higher than the 25% rate it will have to pay on the gain.

A company generally realized losses on the sale of fixed assets and therefore adopted the policy of selling replaced assets rather than trading them in. Now by utilizing the accelerated depreciation methods,

gains on sales will be realized. Thus, it is advisable now to go to a policy of trading rather than selling. How does the government look upon such a shift in policy?

I do not think the government is concerned about the policy of the company, whether it chooses to trade its assets or to sell its assets. I think the company has the right to shift at any time, to shift within the year, or to decide to make more than one shift within the year. Whether it decides to trade to avoid payment of the tax, or to sell and pay the tax, are considerations which it can determine on its own account without restriction by the government.

Here is an example. Assume a corporation received a $100,000 dividend, and, including it, has a net income of $60,000. Therefore, with a net income of $60,000 and a dividend deduction of $85,000, there would be a net loss of $25,000. Would not that result, then, in a complete allowability of the dividend deduction, and an operating loss carryback?

Generally, the answer to that question is yes. However, consideration should be given to the alternative of increasing the year's income which, I believe, could give greater advantage to the company than seeking the operating loss deduction. A company is entitled to a dividend-received deduction equal to 85% of the dividends received. There is another provision which says that the deduction is limited to 85% of the net income. There is a further provision which says that if, as the result of a full deduction, there is a net loss, then the limitation does not apply. In this example, the company, by picking up $40,000 additional income, could get the full benefit of the dividends-received deduction in the particular year in which it received the dividend. It might find the ability to get this $40,000 almost tax free more desirable than the carry-back loss deduction.

Stockholder Relations – Dividends and Stock Reacquisitions

PANELIST — MARK E. RICHARDSON

MODERATOR—WALLACE M. JENSEN

Our subject at this point is the corporate form of business. We will touch on the tax problems of organizing and forming a corporation, acquiring another company, transferring assets to another company, and rearranging stock and securities in a recapitalization. It may be desired to divide a business into two or more corporations, and, of course, it will be desired to distribute cash or property to stockholders, either as dividends or in some other form, each having different consequences. And finally we must consider winding up a corporation. Each of these transactions has tax consequences.

Our first subject is entitled "Stockholder Relations, Dividends, and Stock Reacquisitions." Let us assume we have a very profitable, closely held corporation. It has large accumulated earnings, a lot of cash, and the stockholders would like to get their hands on the cash. How can they do this without paying a large penalty in high personal income taxes?

I must say your question is a fair one; fair in that that is the way a question is generally presented to a practitioner. You have given me about 20% of the facts. I must ask questions before I give any answers. Am I to presume that this corporation is in an active business and it does not want to get rid of any part of it — that it does not want to split up or get rid of any segments of the business? You're not going to give me any help in that area, are you?

No, they do not want to dispose of any of it.

How about the stockholders? Are they willing to change their percentage of ownership or let someone else come in or perhaps one of them get out?

No, they would like to keep their same pro rata share and they certainly do not want any outsiders in it.

How about salaries? Can we increase the salaries a little bit and give them some more money that way?

I think they're pushing to the limit already.

Then the money in the corporation cannot be gotten out without paying dividends and having the stockholders pay taxes thereon. You have covered the whole negative side of our subject. At least, you have given all the things that will preclude any answers.

I am afraid we get some questions like that. It is obvious that under certain circumstances a dividend has to be a dividend, and nothing can be done about it. Let us consider some of the problems when an admittedly taxable dividend is distributed. Frequent questions in this circumstance relate to whether or not the amount charged to earnings and profits by the distributing corporation must necessarily be the same as the amount reported as income by the stockholder.

As to the general subject matter of the question, the two things are normally entirely different. The stockholder under normal circumstances reports the fair value of any property he receives other than cash. On the other hand, the corporation under normal circumstances charges against its accumulated earnings and profits the adjusted basis of any property it distributes.

There is a limit as to the portion of a dividend which is taxable, based upon the available accumulated earnings and profits. Further, there is a question as to whether unrealized appreciation is included in the earnings and profits. It would take too long to go into the details, but I think it only fair to point out that last year many people thought this problem was settled. In fact, judging from the report of the Senate Committee on Finance, it apparently thought the problem settled. Presumably, Congress did not intend to include unrealized appreciation on property distributed in the corporation's earnings and profits. But the language is not clear. The Treasury Department is flatly standing on the cases under the pre-1954 Code, and I am not sure that the Code was fixed. There may be some basis for the Treasury Department's position. When you are involved in such a situation, it is best not to assume blandly that earnings and profits are not increased by unrealized appreciation. *[Ed. Note: Final regulations clear this doubt.]*

If the dividend is to be paid in property which is worth much more than it cost the company, they had better stop, look, and examine it very carefully.

Obviously, the difference in treatment of distributions of property gives rise to some unusual situations. Let us suppose the company owns a patent that cost it nothing but is presumed to have a present value of about $30,000. The patent has ten more years to go before expiration and is producing royalty income of about $5,000 a year. Let us further assume that the company owning the patent has paid out all previous earnings and has no accumulated earnings. If the company distributes this patent to its stockholders, how will the stockholders treat the patent, and would the income which the stockholders report each year differ from that which they would have reported had the company retained the patent?

I think we can answer in such a way that the figures will be lost but the principle remain; that is probably the best we can hope for. The problem is simplified by assuming that the corporation has distributed all its earnings up to this time, because it permits us to point out the material differences from the situation we discussed earlier. As it has no accumulated earnings and profits, the distribution of the patent by the corporation does not give rise to ordinary income to the stockholder. He applies the value of the property he receives (the patent) against his basis. If the $30,000 exceeds his basis, he may have capital gain but he does not have ordinary income. He now has an asset worth $30,000, to be amortized during the next ten years, so he has something he can write off at the rate of $3,000 a year. He receives directly the $5,000 of royalty income, so each year he has, against $5,000 of royalty income, $3,000 to write off and only $2,000 to be subjected to ordinary income tax during that ten-year period. Obviously there is materially less tax, materially more after-tax net income, than there would be if the corporation received the $5,000, paid 52% tax, and then distributed the remaining profit. There is a material advantage where there are no accumulated earnings and profits in distributing an asset in kind, particularly an appreciated asset.

We started with the assumption that no part of it would be reported as a dividend. Would this be true even though a larger portion might have to be reported as a dividend in the first instance?

Yes, it would still be logical and advantageous even though some part were a taxable dividend.

In this discussion of dividends, we have been thinking, I believe, about individual stockholders. To what extent are the rules different if the stockholder is a corporation?

Fair market value, which the individual stockholder would report as

income and which becomes his cost, ceases to have as important a meaning in the intercorporate distribution. A corporate stockholder reports as income and takes as its basis the basis to the distributing corporation, unless the fair value is lower.

The timing of dividends sometimes becomes important. Many corporations maintain the practice of paying only token dividends during the year and making a large dividend distribution close to the end of the year. In some instances this payment is so late as to be unavailable to the stockholder until the next year. Does this procedure have any effect on the stockholder?

Of course, it has the obvious effect of making a change in the dividend credit to an individual. Other consequences are, however, probably more important. I would say that the major effect it can have is where the dividend is either material as related to the income of the recipient or material as related to business operations that he might have.

Let me explain in this way: Assume it is the only dividend of the individual receiving it. He has other income from his business, which he operates as a sole proprietorship. Whether he receives the dividend income at one time or another during the year can have an enormous effect on his individual tax. It can affect his computation of medical expense deductions or charitable contributions. The limitations can be affected by which year they go in. I would say that the biggest effect is probably where there is an operating loss; this would apply to both an individual and a corporate recipient of the dividend.

On the cash basis, of course, the taxpayer is taxable when he receives the dividend, or when it is available for him to receive.

Changes in the law last year included some which materially affected stockholders who receive stock dividends. Have these changes proved to be important, and do they still merit consideration?

I would say they are extremely important and represent part of the major problem of the stockholder-corporation relationships, because they affect most of the thinking in that field. Probably it would be best to restate our position now. Instead of the confusion regarding what kinds of dividends, on what kinds of stock, were taxable, we now have a definite rule that stock dividends are not income at the time of the distribution of the dividend. There are only two minor exceptions: As has been true for a long time, if the stock dividend is an optional one and the individual could have taken cash, that is income as though it were cash; and if the stock dividend is in payment of preferred dividends either for the current year or the preceding year, it is still income. Otherwise the stock dividend is not income at the time of distribution. There may be a later date when some of it will be income.

If the stock dividend clears up preferred arrearages for six years, for example, only two years are taxable?

The current year and one preceding year. For the years prior to that you would not have a taxable distribution.

In connection with this discussion of clearing up preferred stock arrearages with the stock dividend, suppose the corporation develops a recapitalization that takes care of these back dividends? Is that kind of transaction taxable?

As has been true for some time, in general you can have a recapitalization that would even take care of these arrearages, which would otherwise be ordinary income, and do it without it being considered income at that time. You can avoid even that particular tax with a recapitalization. There is, however, a possibility of later taxation.

This discussion of stock dividends naturally leads to questions of distribution of stock rights. This situation has been confused for many years, and it is important to know whether the changes in the law last year clarify the question of stock rights.

They made the one change that was feasible. I know there still is much confusion about how people *want* to handle stock rights, but from a practical point of view the only problem in the past has been the splitting of the cost of the shares on which the rights were issued and the detailed allocation of minor amounts. The statute has been changed. Now if the value of the rights is less than 15% of the value of the stock on which the rights were issued, you may ignore the allocation. If you wish to allocate, you must make a definite election in the return for the year the rights are issued.

In other words, if a taxpayer sells some stock, we used to have to adjust cost for many of the small stock rights. Now we must remember to do it for part of the time, but not since the beginning of 1954. Is that right?

Yes.

As we have discussed, sometimes the distribution must be a dividend and nothing can be done about it. However, in many instances a stockholder wishes to get money out of the business and, not wanting to pay tax on ordinary income, is willing to have the company redeem some or all of his shares of stock if this will result in capital gain. Can this be done?

The question of the redemption of shares and the tax problems involved fall into four categories. Two of those categories represent the complete or the partial liquidation of the corporation. That subject will be discussed later.

The other two segments of the problem are the retirement of all of the shares of one stockholder, or the retirement of some of the shares.

The one point to keep in mind is that any distribution which is not essentially equivalent to a dividend results either in no tax or in capital gain, depending on circumstance, rather than ordinary income. That rule was not changed, and it still is the overriding rule on the entire subject.

But the statute was materially changed last year, and now sets limits specifically on partial redemptions. It does give us precise measurements, and we can eliminate a great deal of the question as to whether something is essentially equivalent to a dividend. There are really three parts to the rule. First, after the redemption of part of the shares, the stockholder cannot be a controlling stockholder; he cannot hold 50% or more of the total outstanding shares. Secondly, the relationship of the shares he has left after redemption to the total number of voting shares must be less than 80% of the same relationship (his shares to total voting shares) before the redemption. Third, the same 80% rule applies to total shares of all classes of stock.

For example, suppose that A and B own a corporation with a hundred shares. A has sixty and B forty. A wants some money from the company and suggests that the company redeem ten of his sixty shares. That leaves him with fifty and B with forty after the redemption. He would still own more than 50%, so he cannot do it. If twenty of A's shares were redeemed he still would hold 50% of outstanding shares.

But if the corporation redeems thirty of A's shares, B, who still holds forty, is controlling stockholder, so we have met that test. A owns about 42%. He did have 60% so his 42% is less than 80% of what he had before. Thus he can have thirty of his shares redeemed and have the transaction treated as a partial redemption.

Simple as it is, this still must be qualified. He must make sure that he has no family relationship with other stockholders. Where you apply this type of redemption, indirect ownership is still a major problem and must also be watched. We will return to this subject later.

Are there any other instances of apparent partial redemptions which might still be disallowed?

You may have a case of a redemption which apparently meets the requirements perfectly but will not work. Take an example in which A, B, and C are equal stockholders. A has 20% redeemed this year, B has 20% redeemed next year, and C 20% the year after that. It may look as though each redemption meets the requirement, but in view of the fact that it is obviously an established pro rata distribution, it will not work.

Keeping in mind this family relationship provision and its effect on the redemption of shares, suppose a company is owned equally by two brothers, and one brother wants to get out of the company entirely. If

the company were to buy all of the stock of the one brother, would the capital gains treatment be available to him?

Yes. It is an interesting point, often overlooked in this sort of planning. Indirect ownership through family relationship applies to spouses, parents, children and grandchildren but does not apply to brothers and sisters. Two brothers can have a fight and separate quite safely, whereas father and son may have trouble.

You were dealing with one brother disposing of all of his shares. This leads to a general question which you touched on. Suppose that all of the stockholder's holdings are redeemed? Would this result in capital gain?

If all of a person's shares are redeemed, and he has no interest in the company afterwards, it cannot be essentially equivalent to a dividend. If the distribution were essentially equivalent to a dividend, the recipient would remain as a stockholder. Now it is clear by statute that a man who gives up all of his holdings is safe and is eligible for capital gain treatment. This is where indirect, attributed ownership becomes a serious problem, because the man may feel that he is completely out of the picture, if he has given up all shares that he held directly in the corporation. But if he is a partner in a partnership, a stockholder in another corporation, or a beneficiary of a trust, or related to some of the other stockholders in the family relationship I noted, these conditions can destroy this apparently complete divestment of all interest.

You will probably ask if there is some way for the man to save himself. If, despite these other relationships, he gets out of the corporation in such a way that he has no employee relationship, no director capacity, and nothing that gives him a direct interest in management other than possibly as a creditor, and if he maintains that status for a period of ten years, then he's safe despite the family relationship.

The ten-year rule becomes very involved because any shares that were transferred by him to somebody else during the preceding ten years also must be redeemed if he is to have the same treatment. I think it is vital to our discussion to realize that even if all of a man's shares are redeemed, he can lose all of the capital gain benefit of the distribution because of an unsuspected relationship.

The points you have just discussed sound like real long-range tax planning to me. In a family-controlled company like that, you must plan not to make any gifts for the next ten years, then you can afford to have all your stock redeemed. But then you do not dare buy back in for ten years. That takes a generation!

Just make sure that you are advised over a long period.

Now let us suppose that two individuals, A and B, are the sole stockholders of a company. A wants to get out. Can he sell one half the stock

to B and have the company redeem the remaining half? Would this still allow capital gains treatment?

Yes, so long as there is none of the family interrelationship we have been talking about.

In connection with this problem of having the stockholder retiring shares and staying out of the company for at least ten years, may the selling stockholder serve as a consultant or work for a subsidiary of the company?

He certainly could serve as a consultant if there was no employer-employee relationship, and it was a true independent contractor relationship. I see no reason why that would not be proper. Personally, I think it is just as certain that he probably could work for a subsidiary or affiliated company, but I have a feeling that there should be some reason why that wouldn't be allowed!

Speaking of redemption of shares, problems arise when a stockholder dies, and it is necessary to have a company redeem some or all of his shares in order to pay estate taxes. Some years ago the law was changed to allow such a redemption to take place without it being considered a dividend. Is this still possible?

Yes, not only is it still possible, but the law was changed further to permit an even better and more logical application. When that provision first went into the law, the shares to be redeemed had to be 50% of the net estate. That did not seem to work, so it was changed to 35% of the gross estate. Now it's either. More importantly, the relief provision formerly applied to only one stock. A man might own 100% of the shares of three different companies, but if they were of equal value, none of them represented a sufficiently large proportion of the estate to meet the requirements. Now any stock of which the deceased owned 75% or more can be covered if, in the aggregate, the stocks comply with the 35-or-50% rule. That change has been a substantial help.

Is there still some confusion regarding the amount that can be redeemed?

Under prior law, a redemption was permitted only to pay estate tax. Now estate expenses can be covered through the redemption.

In the perennial desire to extract money from a corporation and still retain voting control it is often contemplated that a company might declare a dividend in preferred stock to its stockholders, and then the stockholders could later sell their preferred or have the company redeem it. Does this system work?

This is a vital part of the subject. Now we are talking about what is presently called "Section 306 stock," and we should learn that name be-

cause it is the official statutory title given to the stock we are discussing: preferred stock issued as a dividend on common or preferred. At the time of the stock dividend, there is no recognition of gain. But at the time these shares are redeemed or sold, we have a recognition of ordinary income and not capital gain. While that solves some problems, it is a pretty serious solution.

Suppose this preferred stock were issued as a dividend on common at a time when the company had no surplus, and the preferred is later sold or redeemed when the company has a large surplus. Does this situation change the general rule?

It does, because the rule is that the "stigma" attaches to Section 306 stock only if, at the time it is distributed, a distribution of cash would have been ordinary income. If a corporation, without accumulated earnings and profits, made a distribution of cash, that would not be a taxable dividend at that time. Section 306 would not apply, and any preferred stock issued at that time would still be tax free, without the stigma.

Suppose instead of being issued as a dividend, the preferred stock is issued with the common as part of the original capital of the company. Is such preferred stock tainted stock?

No, such stock is not tainted; it doesn't have the stigma. That is another exception.

Does this taint on most of the preferred stock dividends serve to eliminate all tax advantage in the use of that kind of a stock dividend?

No, not at all. Such stock dividends are still useful in estate planning, particularly where you are planning distributions of stock holdings to presently minor children with no income or very small incomes. You can still let this taint, this stigma, carry over and get material benefits in the planning. You can't arbitrarily ignore the possibility of the use of that kind of shares.

It still has some virtues?

Oh, yes. It is not tainted beyond redemption.

Are the same answers that are related to preferred stock dividends also applicable to distributions of non-voting common on common?

No, we still have a possibility that remains over from prior law, in distributing common shares that really are common. The difference between voting and non-voting shares does not make them necessarily a preferred or throw them into a tainted category.

Now, turning to a slightly different variation, where an individual controls several companies, or controls one company which has a wholly

owned subsidiary, is it not possible for him to obtain the capital gain benefits of a partial redemption by having one of the companies purchase some of his stock in lieu of it?

That was a field with a lot of questions that are now eliminated. In the brother-sister situation, i.e., corporations controlled by the same party — if the stockholder still controls the other, he has not divested himself of his stock and is still in control, so he is not meeting the requirement that he must *not* be in control after redemption.

The parent-subsidiary situation is taken care of now by treating any such redemption as a redemption by the parent. That will normally prevent capital gain treatment, although not always. Going back to the question of estate shares being redeemed, there is sometimes the possibility of using this rule to advantage in redeeming shares in an estate which otherwise would not meet the 75% test or one of the others. You may still have a redemption by the parent and come within those provisions.

The next question relates to the redemption or transfer of shares which we have not covered so far. Suppose the owner of a business wishes to retire and would like to sell his stock to a trusted employee or a group of employees. Suppose, further, that the employee does not have enough cash to buy the stock and probably could not get enought after-tax income in the form of salary or dividends to enable him to pay for the stock if he purchased it on time. Is there any way the deal could be arranged?

Yes, fortunately now there is a rather simple way. There was a case right before the 1954 Code enactment that apparently nudged the Congress into going ahead and making it possible. After the prospective seller has sold some of his shares, or even concurrently, he can arrange to have the corporation redeem the balance of his shares and get the capital gain. He is out of the picture altogether. The corporation's cash or its assets can be used to retire most of the shares, and just a small amount that can be financed by the employee is purchased by him before the redemption.

Would it not be just as simple for the corporation to redeem some of his shares first and then have the prospective purchasing employee buy the remaining shares?

No. Let's not stumble on the timing of this one, because if the corporation redeems some shares first, he still is a 100% stockholder afterwards and he has not met the rule. He has to sell a few of his shares first, and then have all the rest redeemed. The timing is vital.

Obviously a lot of changes have taken place from the stockholder's point of view regarding the tax treatment of distributions by corporations. Some of these problems would not be so serious if the corporation were not faced with the necessity of making dividend distributions. Is a

company under the same pressure to declare dividends as it had been for very many years from the standpoint of possible penalty for not making dividend distributions?

It isn't at all under the same pressure because of the relief that was enacted. Most of us are well acquainted by now with the changes, although it is probably worthwhile going over them quickly. The first $60,000 of accumulated earnings now does not have to be distributed. Keep it in mind that this is an accumulation, it is not $60,000 a year. The basic change is twofold. One, that to the extent there is improper accumulation, only that amount which is improper is taxed — not the whole amount, so that you no longer get the old effect of one dollar being improper and all of the profits retained being subject to tax.
The other principal change is the shift of burden of proof. Where the government thinks it has an improper accumulation case, it must notify the taxpayer in writing. The taxpayer then will answer telling the reasons why. Such answer then shifts the burden of proof to the government. We haven't yet seen this in operation enough to know just how it is going to work, but presumably it should relieve some of the pressure.

The following questions were submitted by registrants.
Mr. J. S. Seidman was moderator.

Where an intercorporate dividend in kind is taxed to the recipient corporation in an amount equal to the basis of the property to the declaring corporation, that being less than fair market value of the property, how is the holding period of the property in the hands of the recipient determined?

Where you have any kind of distribution of property between corporations, the basis going over to the recipient corporation is fair market value at the time if that is less than the basis to the distributing corporation. Otherwise the basis of the distributing corporation goes over. It is necessary to make that distinction because the holding period to the recipient corporation will be controlled by whether or not the basis is the same as that in the hands of the distributing company. If the basis goes back in whole or in part, the holding period goes back. If the basis is fair market value, then its holding period begins from the date of receipt.

Three brothers are stockholders of a closed corporation. Each holds approximately the same number of shares. Can the 20% redemption rule apply so that each will, after a redemption, have different amounts in ratio to each other, and the redemption not be considered as pro rata?

Brothers are not within the family group and therefore the question relates to three individual stockholders unrelated for this purpose. As

long as the retirements meet the mathematical tests, and unless it was obvious that the planned retirements were in such a ratio that when they were all through they left the three about where they were when they started, the redemption would be treated as disproportionate.

Here is a question on the unreasonable accumulation of earnings. If there is no tax on the first $60,000 as it accumulates, is the entire exemption lost when it becomes $60,001, and is the entire $60,001 subject to the tax, if there is no showing of reasonable need for any part of it?

No. The $60,000 is an amount which can be accumulated without the imposition of the penalty surtax. If there were $60,001, it would be only the $1 that would be improperly accumulated.

The following question was directed to Mr. J. P. Goedert:

The presence of substantial debts normally will prevent the invocation of the penalty for unreasonable accumulation of surplus. Is this true in the case of notes due to officer stockholders, assuming they arose from loans made in the normal course of business?

The words "unreasonable accumulation of surplus" are a misnomer. Dividends, even though measured by surplus, are paid out of assets of the corporation. If a corporation has no free assets because all of them are needed for the reasonable need of the business, which includes the necessity to pay maturing obligations, the surtax should not apply. In the absence of special circumstances, it should make no difference whether current bona fide obligations incurred in the normal course of business are due to stockholders or outsiders.

Organizing and Reorganizing Companies

PANELIST—PAUL F. JOHNSON

MODERATOR—WALLACE M. JENSEN

In setting up the original capital of a company, are there advantages in having debt or bonds to stockholders so that they can later have a basis for drawing out money from the company without taxation as a dividend?

In answering this question let us assume that all of the capital is coming from a small group of persons, and that whether bonds or stock are issued is flexible. The issuance of a reasonable amount of bonds would have two advantages. In the first place, the interest on the bonds would be a deductible expense in the computation of taxable income. In the second place, the amount eventually paid in retirement of the bonds would be received by the holders as payment for them. If all of the original capital had been allocated to capital stock, the receipt of any cash by the shareholders would no doubt be an ordinary dividend.

In setting up the original capital structure, is it better to start with both preferred and common stock, or to start with only common stock and issue preferred at a later date?

I assume that if preferred stock is issued at a later date, it would be issued as a stock dividend or in connection with a recapitalization. In that case it would be much better to issue preferred stock in the first instance so that the holder would be free to deal with it without the restrictions imposed on preferred stock received without payment. You will no doubt hear more about "Section 306 stock," which is a term

applied to preferred stock received as a dividend or on a recapitalization, and the transfer of which often results in ordinary income.

If a closely held profitable corporation is about to start a new business in an allied line, what factors should be considered in determining whether the new business should be operated as a branch or started as a separate corporation?

The real question is the ownership of the new business. Should it be owned by the present corporation and operated as a branch or subsidiary or should it be separately incorporated and owned individually by the same persons who own the corporation? Breaking up a business into separate corporations may involve tax risks. I believe it better to have the new business separately owned since its stock may be sold, given away or redeemed without effect upon the ownership of the primary business. As a general rule there are tax advantages in operating through a number of individually owned corporations.

Occasionally there are situations where subsidiaries have loaned substantial amounts to their parent company. Is there any particular danger in this type of situation?

I do not believe there is any particular cause for concern in this type of situation. We have all seen cases where the Internal Revenue Service has contended that advances constituted dividends but I believe in most cases where there was a clear record of intent the taxpayer prevailed. I do not think there should be a different result here.

Upon the transfer of property to a controlled corporation, bonds may be issued as part of the consideration. Is this a tax-free transaction?

Yes, it can be a tax-free transaction. You can issued bonds as part of the consideration in a transaction where property is transferred to a controlled corporation without having any tax on the exchange.

How far can one go on issuing bonds in this type of exchange? Is there any question but that when the bonds are redeemed, the redemption would constitute a capital gains transaction?

Well, that question gets us into the area of thin corporations. By a thin corporation I mean one that has an abnormally small amount of equity capital and an unreasonably large amount of debt. There have been cases that have approved situations where the debt was three to three and one-half times equity capital. Basically, I believe the answer to the question is that you can issue bonds in such a transaction but they must be in an amount that is reasonable in relation to the total capital of the corporation. The other part of the question was, is there any doubt that this would be a capital gain transaction on the redemption of bonds. Assuming that we are outside the area of the thin corporation, I don't

think there is any question. However, if you stray over into this thin ice area, and you do have a redemption, you may have the question of whether or not the bond interest accrued and paid by the corporation is deductible and you may also get into the question of whether the redemption or some part thereof might be treated as an ordinary dividend.

If these bonds were to be treated as capital instead of debt for tax purposes, would the interest still be deductible?

Assuming that you have a reasonable amount of bonds, I do not think there is any question about the deductibility. However, if the corporation gets too thin, there may be trouble.

In organizing a corporation, would it make any difference if the property to be transferred to the corporation was subject to a mortgage? What if the amount of the mortgage exceeded the cost of the property to the individual?

The transaction is complicated a little by the debt element because there is a general rule that if liabilities are assumed in a transaction of this character there is a business purpose test. That is usually not difficult to meet and I think that if you can defend the assumption of these liabilities by a business purpose, you are perfectly all right, and the assumption of debt will not affect the tax-free character of the transfer.

Now, getting to the second part of the question which was—assume that the mortgage that is taken over by the new corporation is greater than the cost basis of the property in the hands of the individual, or individuals, transferring it, what then? So we can clearly see the situation, we will use an illustration. Suppose that you have a piece of property that has a depreciated cost basis in the hands of the people who are organizing the corporation of $100,000. They've held it a long time and it has appreciated in value to the point that they were able to get a $150,000 mortgage on it a few years ago. So, we have a situation where the mortgage is $50,000 more than the basis of the property. The law provides that in such a situation gain will be recognized to the extent of the excess of the mortgage over the basis of the property.

We have covered the field of organizing a company, and now that we have it organized, let us consider the problems of recapitalizing. We have a company that has been operating and is dissatisfied with its capital set-up and wants to change it. How much freedom does it have in making such changes without tax to itself or to its stockholders?

That is one of those questions you could make a speech about. However, I will try to limit it. I think you should make further assumptions as to what you are thinking of doing in this recapitalization, and for that purpose let us consider three possibilities. You might merely increase the number of outstanding common shares or the stated or par value of com-

mon shares; you might create some preferred stock; or you might go all the way and try to create some bonds or debentures.

As to the first one, which is merely an increase in the amount of the stated value of the common stock, it would involve essentially the capitalization of a part of the earned surplus by a transfer to common stock. I don't think there is any question but that this is tax free. I can not see anybody getting taxed in that type of a transaction.

Then the next one. Let us assume that the corporation has only common stock and that you have been quite successful, you have a good-sized earned surplus, and you think it would be desirable to have some preferred stock. You issue some preferred stock either as a dividend or in a recapitalization transaction.

Up to that point you are all right, and there isn't any tax. But the preferred stock that is issued would bear the taint of Section 306 stock, and you would no doubt receive ordinary income when you sold the stock to a third party.

Now, the third possibility that I mentioned was the issuance of a debt security, such as a bond or debenture. That is the one that you really must be careful of because it will no doubt be considered as a taxable dividend to the extent of the market value of the securities received.

Many of our moderate-sized businesses started from humble beginnings with limited capital and have expanded through retaining their earnings. To what extent should such a corporation endeavor to keep its capital structure "up to date" by capitalizing earned surplus so that it will not have a lopsided capital structure?

Perhaps we should define a "lopsided" structure. Suppose you started a corporation with $50,000 cash ten years ago. The corporation has been quite successful and at the present time you still have the $50,000 capital stock and, let us say, about $800,000 or $900,000 of earned surplus. You have a plant worth $300,000 or $400,000, and a substantial inventory, etc. etc. Quite obviously, the $50,000 capital stock is inadequate for the size of the business being conducted. I believe there is good reason for reflecting an amount in the capital stock that is more in keeping with the actual capital needs of the company.

There are several reasons why I feel that way. One is that some stockholders in reading a report do not understand the difference between cash and surplus, and they might feel that the $800,000 or $900,000 surplus is available for dividend distribution, which obviously is not true. You may not be in a position to pay *any* dividends. Also, if you deal with employee organizations, they may point the finger at you in negotiations when you have such a large surplus.

In addition, you may get into the area of the surtax on the improper accumulation of surplus, and with regard to this problem, many people raise the question as to whether or not there is any advantage in capi-

talizing a part of the surplus into the stated amount of capital stock. I see no particular disadvantage, and any effect appears to me to be on the plus side. Technically, the capitalization of part of your surplus has no effect upon the improper accumulation tax. However, it does indicate a recognition that earnings have been dedicated to permanent use in the business, and I feel that it is a wise step.

Several corporations recently have refunded their outstanding preferred stock by offering debentures in exchange. Is this a taxable transaction? What are the motives behind that type of exchange?

That is unquestionably a taxable transaction. The new law is specific regarding the issuance of debt where previous debt was not in existence. In this transaction, the exchange of preferred stock for debentures constitutes a taxable exchange. The primary motive was probably to get the interest paid as an income tax deduction.

Can there be a tax-free recapitalization where A and B are equal common stockholders and A exchanges his stock for new common stock but B exchanges his common stock for new preferred stock?

Yes, that could be a tax-free recapitalization. The law does not require that every one get a pro rata distribution of the stock. It is possible for one shareholder to take one type of stock, and another shareholder to take another type of stock. A question may arise, however, if the two stockholders do not receive the same value in the transaction. If not, there is the implication of a gift from one to the other, or the possibility of compensation to one of the parties. Therefore, it is important to give consideration to equal treatment on a value basis.

If a father tried to give his son most of a company, he would be in a gift tax jam?

There would not be much question about it.

Instead of reorganizing the company, let us talk about working through new or other companies. Suppose this sort of problem comes up. Company A has been offered all the assets of company X. Company A wants to make the acquisition through a new subsidiary to be organized, called company B. The stockholders of company X are willing to take company A's stock but they do not want any part of the stock of this new subsidiary. Can this be done without tax?

Yes, that is a new provision in the 1954 code. The newly organized subsidiary is permitted to acquire substantially all the assets of the other company in exchange for stock of its parent.

Instead of the assets of company X, suppose the deal involved the stock of company X. Can this be done tax free by having the new

subsidiary acquire the stock of company X and then giving parent company stock in exchange?

No, the new provision covers only the acquisition of assets. It would not permit such a transaction in which the stock of another company is acquired.

Suppose corporation A acquires 80% of the stock of corporation B in exchange for the stock of corporation A. Stockholders who held out on the original deal later on, in a separate transaction, make the exchange. Is this tax free?

Yes. The present requirement of the law is only that after the transaction the acquiring company have at least 80% of the stock of the other corporation. They could go from nothing to 81%, or 81 to 99, or 81 to 85, and it is tax free so long as they come out with more than 80%.

Here is one dealing with cost. Corporation A acquires all the stock of corporation B in exchange solely for voting stock of A. Corporation B continues as a subsidiary. Should A decide to sell its investment in B, what is the basis for gain or loss?

That may be a $64,000 question in some cases—not necessarily the technical requirement but the practicalities of getting the information. The basis in the hands of the corporation receiving the stock in exchange for its own stock is the transferors' basis, namely, the basis in the hands of the individual shareholders of the acquired company. This could result in an almost impossible situation. Suppose you acquire all the stock in a company which may be listed and have several hundred stockholders. It would be extremely difficult to determine the cost basis of the stock exchanged in the transaction.

As an alternative which might result in less tax on the transaction, you could liquidate the subsidiary company, bring its assets into the parent company, and sell the assets involved. Thus you would know the cost of what you are selling. When you sell stock, you may well *not* know.

Suppose that in an exchange, the stockholders receive some cash as well as some stock. Under the old law, if corporation A transferred all its assets to corporation B for voting stock of corporation B, there was no tax. But if corporation B gave cash in addition to the stock, the transaction was taxable. Is that still the situation?

No, there has been a little change, although I am not sure that it is particularly advantageous. If the acquiring corporation acquires at least 80% of the fair market value of the assets of the transferor company in exchange solely for its stock, it is free to pay cash for the balance. However, for the purpose of determining whether the acquiring company has paid 80% of the fair market value of the assets in stock, the liabilities assumed in the transaction are treated the same as cash. The net result

is that if the liabilities assumed in the transaction exceed 20% of the fair market value of the assets, you cannot distribute any cash. This raises complicated problems concerning the assets being acquired. How about goodwill; should that be reflected? Also, you reach a point at which a few dollars can throw you over to a taxable transaction, so it is a provision that can cause substantial difficulties. Because of the fact that liabilities assumed are treated as cash paid out, I do not believe this provision adds much.

Do you mean that if liabilities plus cash were exactly 20%, and an income tax deficiency showed up, you would really be in trouble – both ways?

That is right.

On the treatment of liabilities as cash, does this still apply where the assets are transferred subject to liabilities to corporation B, if B issues only stock and no cash?

No. If you give nothing but capital stock in the transaction, the amount of liabilities assumed is not significant.

This 20% rule becomes important only when cash is given in addition to the voting stock?

Yes, only when the cash is distributed as a part of the consideration for the assets.

Is 20% cash all right where instead of company A transferring its assets to company B, company A's stock is acquired by company B?

There is no change in that rule. You cannot have cash in that transaction. You must obtain all the stock solely in exchange for voting stock of the acquiring company.

In other words, you can give cash only when acquiring assets and not when acquiring stock?

That is right. And in that case, watch the amount of the liabilities.

In corporate reorganizations you sometimes have problems as to just what rights and obligations the successor takes over from the predecessor. In the past, a big stumbling block in taking over a company with prior operating losses has been that the right to carry forward these losses died with the old company. The successor did not succeed to these losses. Has this situation been changed by the new law?

Yes, the new law specifically provides that if the corporation acquired has an operating loss, it can be used by the successor provided that the assets of the loss corporation are acquired in a specified type of transaction, such as a merger, liquidation of a wholly owned subsidiary, etc.

That question actually referred to the liquidation of a wholly owned subsidiary with losses over a period of many years. Once we extend it beyond that area, we meet problems which will be discussed later.

In the case of a tax-free merger or acquisition of another company, where does the successor stand with respect to other tax features of the predecessor, such as depreciation methods, inventories, contributions to pension plans, charitable contributions, and so forth?

All of those are specifically covered by statute. The acquiring corporation stands in the shoes of the predecessor. Any benefit accruing from any of those specific items accrues to the acquiring corporation.

In respect to the surplus one company inherits from another, suppose company A takes over the assets of company B for company A's stock. Company B goes out of existence. Suppose company A has a surplus of $100,000 and company B had a deficit of $100,000. Does this deficit cancel out the surplus? If company A thereafter pays out a dividend of $10,000 to its stockholders, is the payment considered capital and not a dividend?

No, it would be too simple if that was the case. The deficit of the acquired company offsets future earnings of the acquiring company. The $100,000 deficit is merely available as an offset to future earnings of the successor company. If that was not the case, companies with large operating deficits would bring high prices. If you took one over and its deficit wiped out your earned surplus, any dividends in excess of current earnings would be a return of capital and this could lead to abuse. I believe there is equity and logic in the rule that a deficit inherited from another company offsets only future earnings.

Does this discussion mean that there is now a greater tax advantage for a person to start separate companies and then bring them together as against doing business all through one company in the first instance?

Under the old law (whereby the operating losses of a company died with it), you would never get the operating loss as a tax deduction. You no longer have that risk. If you organize a new corporation and it has an operating loss, you can throw it in with another corporation and carry the loss to the successor. There is now less risk in organizing a separate corporation.

If a person or family is starting several corporations, can they plan to put them together later on if they do not work out separately?

That's right.

If a company obtained permission to write off defense facilities on a five-year basis, and the company is taken over by another, does the successor inherit the right to write off the assets in the five-year pattern?

No, it does not. I believe that when they drafted the statute, they intended the successor company to stand in the shoes of the predecessor

for practically all purposes. But when they wrote it, they forgot to mention these facilities, and that situation is not covered. Other things are not covered, such as foreign dividends, foreign tax credits and so forth. Amortization of defense facilities is one aspect the successor does not inherit.

Let us turn to separating a business — breaking it up into two or more companies. If a corporation has a subsidiary that has actively carried on a separate business for a five-year period, what is the tax effect of distributing the stock of the subsidiary to the shareholders of the parent company?

Essentially, there is no tax effect. I will not say there might not be, but the transaction as described (the mere distribution of stock of the subsidiary pro rata to the shareholders) should not result in income tax.

Do we have a problem of finding a corporate business purpose as distinguished from the stockholders' desire?

The business-purpose test rears its head in the requirement that the separation device must not be used to siphon off earnings and profits. You are not allowed in the position of being able to spin-off part of a corporation and sell it at capital gains rates rather than having the corporation itself sell the part and pay ordinary dividends. The significant point is what the shareholder does or intends to do with the stock after it is received.

You used a phrase which I think helps to define the area we are talking of when you said "spin-off" the corporation. When you have a spin-off, how soon can the stockholders then sell the stock of the former subsidiary?

I think it is possible to have a spin-off with stockholders acquiring stock which they did not have previously and which they could sell relatively soon. I think you would need an almost ideal set of circumstances to have that result. If you were unable to show that the sale happened more or less on the spur of the moment, you might be in trouble. I could conceive of a situation involving a spin-off of stock and a few months later a company you never heard of a thousand miles away made such a fine offer for the company you could not turn it down. If you had prior relations with the purchaser, you might be in a different situation. The heart of the matter is the intention of the shareholders at the time the stock is distributed.

Proving an intent is sometimes harder to prove than black or white, isn't it?

Absolutely right.

What if they liquidated the company soon after the stock was distributed to them and then sold its assets?

I would say they were asking for it. I think the only way to defend

yourself on the other transaction we talked about would be if a complete stranger came along and made a very attractive offer for the stock. But if you yourself liquidate a company, and sell the assets to obtain cash, it seems to me you would have difficulty saying that you had no intention to liquidate at the time the distribution was made. To be really safe, you should wait until the statute of limitations tolls, which can go to a six-year period in certain circumstances.

So far in spin-offs, we have been talking about a subsidiary which had been actively carrying on a business for five years. Suppose that the company is in the manufacturing business and has owned its plant for more than five years. Can it now incorporate the plant as a wholly-owned subsidiary and distribute the stock of the real estate company to its shareholders in a tax-free transaction?

The question there is what constitutes the conduct of a separate trade or business. My understanding of the present position of the Internal Revenue Service is that ownership of real estate by a corporation that uses the real estate is not the active conduct of the trade or business. A few years ago, we were able to obtain rulings allowing the spin-off of a corporation that owned the real estate used in the business. It is not possible now. It is the current view of the Service that ownership of real estate does not constitute the operation of a business.

In other words, it is not necessary that it be the kind of normal business that might be conducted by others; the corporation itself must be actively in the trade or business?

That is right.

Suppose A and B are equal stockholders in a company and want to split up their interests. Half the assets of the company are put into company A and the other half into company B. All of the stock of one company is given to one stockholder, and all of the stock of the other company to the other stockholder. The original company goes out of existence. Is this transaction subject to tax?

I do not see how you could do it unless you were operating two businesses in the presently existing corporation. Assuming only one business, in organizing a new corporation, you would have to put in either the business you are now operating, or extraneous assets not necessary to the present company. If you distribute to one of the shareholders the stock of the company with miscellaneous assets, it seems to me the equivalent of a buy-out of his shares. I do not see how a spin-off can be used to facilitate the tax-free retirement of one of the shareholders. I do not believe you can split up unless you have at least two businesses.

Then you cannot simply divide the assets 50-50 into two companies and qualify.

Is this possible: Company A owns all stock of company B. Company A has a lot of free cash. If it paid it out, stockholders would have a dividend. Instead it transfers the cash as additional paid-in capital to company B, the subsidiary. It then distributes company B's stock to its stockholders. They turn around and sell company B's stock. It has, of course, been enhanced in value by the cash the parent company put in. Do the stockholders have capital gain on the sale?

I do not believe the sin is putting the cash into the subsidiary, but I think you will have trouble sustaining the spin-off. Apparently you are making the spin-off to facilitate withdrawal of cash and to sell stock of corporation B. You have some latitude regarding the amount of cash you put in corporation B, but the real question is whether the spin-off can be sustained.

If you put in too much cash, you will also beg the question.

This is the problem of a company owned by one stockholder who wanted to sell his company to the employees, who do not have enough cash. Now, suppose XYZ company is worth $1 million. It has $500,000 in cash and government bonds not immediately needed in the business. A group of individuals wants to buy it, so they organize a new company and put $100,000 into capital stock. These same persons lend the company $250,000. The new corporation then borrows $650,000 from a bank, and now with total available funds of $1 million it buys all the stock of XYZ corporation. The new corporation then liquidates XYZ corporation into itself, sells the government bonds, reduces the bank loan by using the $500,000 from XYZ company, and then eventually pays off the rest of the money owed the bank and its stockholders from its earnings. Is this transaction vulnerable from a tax standpoint?

It appears that these people are buying a million-dollar corporation for $100,000 capital. It is the so-called boot-strap operation, and I do not see any particular point of attack other than the possible question of a thin corporation. If that can be defended, I do not believe there is any other concern.

The following questions were submitted by registrants.
Mr. J. S. Seidman was moderator.

In a merger, can a successor corporation take accelerated depreciation on assets of a subsidiary it has merged?

Yes, it can. That is one of the attributes of the predecessor which is specifically covered by statute and which is carried over to the successor to the assets.

Assume company A acquires company B by an exchange of stock. Both are manufacturing companies. Company B continues to operate. Company A is on Lifo; company B is on cost or market. If B is liquidated,

may company A's Lifo base be continued with respect to B's inventory?

The statute specifically states that the predecessor's inventory basis can carry over into the successor. The statute further states that where one company is on one basis, and the other on another, they are to be valued in accordance with regulations promulgated by the Commissioner. These have not yet been promulgated.

In this kind of situation, with the surviving company on Lifo, you probably would have to continue on Lifo. The question presupposes that the inventories are somewhat alike, so that the categories of the liquidated company fit in with the categories of the parent. In that situation, probably all would be on Lifo. Otherwise the inventory might be on Lifo in one location but on another basis if it were moved to another location.

If company A has owned 60% of company B for thirty years, and acquires 40% more in 1955, can company A dissolve company B and take company B's assets at the cost to A of B's stock?

In order to attribute the cost of stock to the assets acquired in liquidation, you must acquire 80% of the stock in a twelve-month period by purchase. Since that is not the case here, you cannot attribute the cost of the stock to the assets received in liquidation.

A, B, and C own all of the stock in two corporations, one profitable and the other with losses. The corporations are in different lines of business. May the profitable corporation acquire the stock or the assets of the loss corporation in a manner which will allow it to use both the current year's losses and the previous years' net operating loss carryover? The corporations report on different fiscal years.

Yes, I think that transaction can be worked out. It does not seem to me that you would run into any difficulty, since I assume the corporations have been owned by the same people for a period of time.

Do you think one criterion might be how the stock was acquired; that is, by purchase or by a tax-free transaction?

Yes, there would be a difference in treatment depending upon whether you acquire stock by purchase or by a tax-free exchange. But the limitation on loss carryovers does not apply if the corporations are owned by the same interests, so I believe the transaction just discussed could be accomplished.

Two corporations, in exactly the same type of business and with the same customers, merge. The acquiring company is on the charge-off basis for bad debts, while the merged company is on the reserve for bad debts basis. What does the acquiring corporation do with the bad debt reserve of the merged corporation?

This is related to the Lifo question. The statute says that this problem

also will be handled in accordance with the regulations to be promulgated. We do not yet know the ground rules. It would seem that if the successor company does not go over to the reserve basis and does not use the acquired reserve against accounts taken over, there might be some realization of income.

A and B each own 50% of all of the outstanding stock of A company. They sell all their stock to C corporation for 50% cash and 50% stock of C, restricted as to sale for two years. What is the taxable feature as to the 50% payment in C stock?

Of course this will be a taxable transaction because they get 50% cash. The next question is what is the fair market value of the C stock. This fair market value must be established to determine the gain on the transaction.

A reissues some of its treasury stock to B, and A receives all of the outstanding capital stock of B. What is the basis of the capital stock of B to A?

When stock is issued for stock in a tax-free transaction, the corporation issuing the stock inherits the basis of the individual shareholders who make the exchange. The basis of the corporation issuing the stock is the combined basis of the several shareholders making the exchange.

Could a split-up of one corporation into two separate corporations, each new corporation performing the same business activity as the former corporation, ever qualify as a tax-free split-up?

Assuming that the business had operated in one location, I think you are precluded from ever having a tax-free split-up. If the business was in numerous locations, for example, a chain of retail stores, it might be possible to identify "separate" businesses. But if it is all in one place, doing the same thing, I do not see how it could be done.

When a spin-off or a split-up is considered taxable, specifically how is the tax levied, and on whom?

The tax will be levied on the individual shareholders, just as in the case of an ordinary dividend. You cannot use a spin-off or split-up as a method of withdrawing earnings. If it is held that a transaction does not qualify, it will be regarded as a method of withdrawing earnings, and therefore will be taxable as a dividend.

Where a parent corporation, at the end of its year, merges its wholly owned subsidiary into itself in a tax-free liquidation, can the parent carry over the subsidiary's net operating loss against future earnings?

Yes, it can.

If the parent, at the beginning of the next taxable year, changes its name to the subsidiary's name, does this negate a tax-free liquidation?

I do not believe it would.

The following questions were directed to Mr. Wallace M. Jensen.

If assets such as the supply inventory have been expensed by the seller, does capitalization by the purchaser have any adverse affect on the seller's tax treatment?

In theory the answer is no; in practice, yes. The question deals with the sale of assets that have been charged to expense. For example, many corporations have a policy of charging to expense all items under $50 or $100. Then if the corporation were to sell all its plant and equipment, the buyer inventories those items and sets up a cost. If the returns of the buyer and the seller were examined at the same time, the revenue agent might insist on going back and capitalizing in the seller's returns all the items of that sort. This problem may also arise in the area of research and development costs which have been expensed, and where the buyer puts a value on the development work up to the point that it takes over.

Since it is relatively unusual for buyers' and sellers' returns to be examined at the same time, as a practical matter, the accounting treatment on one end of the transaction is rarely matched up with the other.

That is correct.

What is the current picture with regard to the taxability of profit on the sale of a corporation's treasury stock?

Under the 1954 Code, profit on the sale of treasury stock is not taxable, although one Congressman has described this as a loophole and has introduced a bill to go back to the old rule under which it was more important to follow a correct form, even though the substance was the same.

In 1954 a parent company filed a consolidated return with its 80% owned subsidiary. In 1955 the parent acquired the remaining 20% of the subsidiary's stock. Should the parent continue to file consolidated returns, merge with the subsidiary, or liquidate the subsidiary if it is expected that within two years the business activities of the subsidiary may result in substantial losses?

In 1954, owning 80% of the subsidiary, the parent company had the right to file a consolidated return, and did so. When it acquired the other 20% in 1955, it is still required to go ahead on a consolidated return basis. It could break that consolidated return if this were its only subsidiary and it liquidated it. If it liquidated it during the year, there would be a consolidated return up to that date, and perhaps for the full year.

If the subsidiary is going to have losses two years from now, it would be cheaper to liquidate it so that the 2% penalty tax on a consolidated return would not have to be paid. As long as the losses are incurred after the subsidiary is acquired those losses still can be used in a consolidated return, but at an extra 2% cost.

Winding Up Companies

PANELIST—DON J. SUMMA

MODERATOR—WALLACE M. JENSEN

The subject now before us has to do with winding up companies. Does it matter to the individual stockholders of a company whether its assets are sold before or after liquidation?

While it formerly mattered, under the new 1954 Code it no longer need make a difference whether the assets are sold by a company in process of liquidation or whether the assets are sold by the stockholders after liquidation. In both cases, generally, the double tax on that sale is eliminated. The tax is paid only by the stockholders; the corporation pays no tax whatsoever.

In other words, when we wind up within a limited period of time, the corporation has no gain or loss on the sale of assets.

Yes. There are certain limitations, of course, to prevent corporations from staying in liquidation forever and never paying any tax. The limitation in the Code is that the corporation in process of liquidation must sell the assets and completely dispose of substantially all its assets by way of liquidation to stockholders within a period of twelve months from the date the plan of liquidation is adopted.

In this kind of case, does a different rule apply with respect to assets sold at a gain as distinguished from assets sold at a loss?

No, and as a matter of fact, this rule applies whether or not companies want it to apply. It applies to any corporation in liquidation and applies

during the period from the date of adoption of the plan until the date the corporation is finally and completely liquidated. Obviously, this means that when assets are sold at a gain, you will be very happy to have the provision apply, whereas, in the case of assets sold at a loss, you would prefer not to have the provision apply.

There are two ways to try to keep the provision from applying in the case of loss assets. One, which I feel quite sure would always work, is to extend the liquidation period beyond twelve months. For example, it can happen where you plan a liquidation, but between the time of adoption of the plan and final liquidation, some event occurs which makes the market value of your assets go down appreciably. In such a situation there is normally some advantage which can be obtained by the corporation's realizing a loss, for example, by use of a net operating loss carryback. You can, therefore, stretch out the liquidation and make those losses of some tax consequence to the corporation.

The other way to make loss assets of some tax value to the corporation is to sell them before adoption of the plan of liqudation. But that, I think, can give rise to some serious problems as to when the plan of liquidation is in fact adopted. It would be a question of fact which would have to be proved in each particular case.

Suppose the assets sold include inventory. What is the tax effect of liquidating inventory in this type of liquidation?

Because of the nature of inventory, and because it is the kind of asset that is regularly sold by a corporation, special rules had to be put in to prevent sales of inventory in the normal course of business from being treated like sales by a corporation in the process of liquidation. I think, however, that in taking care of this, Congress has gone a little farther than was required. The provision is that inventories can be sold and gain or loss not recognized, but only if the inventory is sold in one transaction, sold to only one purchaser, and is not replaced at any time after that until the date of liquidation. It seems to me that it can be shown equally appropriately that several sales of inventory, or one sale to several purchasers, constitute in fact a sale of inventory as part of the liquidation of a corporation. But you will fail to meet the test in the Code unless it is one sale to one purchaser and no replacements take place.

Suppose our company has inventory on a Lifo base, and the Lifo base cost is very low. The market value, though, is high. In other words, if we are careful to sell this to one person in one transaction, we do not have to pay tax on that Lifo increment.

That is exactly right. In the converse situation, you can very well have inventory on which you have a potential loss, and there it is completely within your power as a liquidating corporation to make the sale be more than one sale to more than one purchaser, clearly having the loss allowed as a tax deduction to the liquidating corporation.

When such a corporation is to be liquidated, does the date of formal adoption of the plan of liquidation have any significant effect on these tax consequences?

The adoption of a plan of liquidation is important. It is important from this point of view, that if you're selling assets at a gain, you must be sure that the assets sold by the corporation are sold during the twelve-month period following the adoption of the plan of liquidation. You must be careful that the twelve-month period during which the corporation is completely liquidated is not missed somehow so that you find yourself taking twelve months and two days to complete liquidation. On the other hand, touching again on the situation where you may have loss assets, it would seem altogether too simple to sell the loss assets on Monday and adopt a plan of liquidation on Tuesday, and say that this came before the twelve-month period and therefore the losses are recognized by the corporation. In a situation like that, I think the government can say that despite the fact that the formal plan of liquidation was not adopted until Tuesday, you really had formed a plan of liquidation before then, at the time when you started disposing of any assets of any substantial amount as part of the over-all plan of winding up the company.

As I remember, the proposed regulations took a step in that direction by saying that the first step in the execution of the plan was the date of adoption.

That is right. The proposed regulations have been out so long that I understand we may have additional proposed regulations. We cannot, of course, be certain just what the final regulations will say.

This area of the tax law was intended to eliminate double taxation on the sale of a corporation's assets. Does this result in complete elimination of tax at the corporate level for the year ending with the liquidation?

No. I think we should keep clearly in mind that this relates only to assets sold by the corporation in process of liquidation. It relates only to sales made in the twelve-month period, and does not relate in any case to income collected in the normal course of business by the corporation during that period—for example, inventory sold as regular sales, rental income collected, and similar items.

Let us look at this problem of selling a business from the buyer's side. We want to buy a business and primarily we want to obtain its assets. Suppose a corporation wants to purchase the assets of this other corporation. If it does so by acquiring that corporation's stock, what are the relative advantages and disadvantages compared to acquiring the assets directly?

Speaking very broadly and generally at first, the choice between buying

assets and buying stock now is one that can be made almost entirely on the basis of non-tax considerations. In other words, if you can work the deal by buying stock or if you must work the deal by buying stock, that is what you do. If, on the other hand, you do not want to buy stock and you can arrange to buy assets, certainly that is what you should do. The tax difference which formerly existed between these two methods of approach is now almost completely eliminated.

However, if you buy stock for the purpose of buying assets, and for the purpose of having the cost of that stock become your tax cost of the assets, then you do have to comply with certain formal rules, which do not apply in a pure purchase of assets. In general those formal rules have to do with the period of time during which you acquire the stock of the new company. That must be done within twelve months. You must acquire 80% or more of the stock of the company within that period. In addition, you must adopt a resolution to liquidate the company within two years after the time that 80% control is acquired.

These are formal, technical rules which must be observed. If they are observed, you automatically come within the coverage of these provisions. I might add an interesting point in connection with the fact that the law requires only that the liquidation plan be adopted within two years of acquiring 80% control. If for some good business reason, or some non-good business reason, you do not feel like liquidating the company promptly, it may well be possible to acquire control over a period of a year, wait two more years, adopt a plan of liquidation, and then carry out the liquidation at the end of a longer period of time, which in my opinion cannot be more than three years from the close of the taxable year in which the plan of liquidation is adopted.

In this kind of case, where we buy a company's stock for the purpose of liquidating the company, what adjustments are required for transactions from the date of purchase of the stock to the date of liquidation?

In order to prevent what would be a clear case of double deduction or double income, the law provides that what we would consider normal accounting adjustments must be made from the date the corporation's stock is acquired until the date the assets are received in liquidation. Those normal and proper adjustments include adjustment for any dividends or other distributions made by the acquired company, to prevent your getting assets in the distribution and also having basis attributed to the remaining assets. An adjustment is also made for additional capital contributions to the newly acquired company, should you make any. Most important of all, you are required to make a further adjustment for any gains or losses of the acquired company from the date of acquisition of control to the date of liquidation. In other words, there is a broad rule which tries to apply the purchase cost to the assets received in liquidation, adjusting for new assets that appear by way of income of

the new subsidiary, and adjusting for assets that disappear by way of losses or distributions by the newly acquired company.

Then even though the purchasing company drew out the dividend during this period between purchase and liquidation and paid tax on it, it still has to reduce its cost by that dividend as one of these adjustments you just referred to.

That is right, which emphasizes that if this corporation is likely to be liquidated, then part of good tax planning would require that no dividends be paid during the period up to the date of liquidation.

When we liquidate the company, how is the cost of the stock allocated among the assets received, as for example where a building is received but is subject to a mortgage?

The proposed regulations you referred to set forth a rule which I think will probably be retained: namely, that the tax cost to you of the stock will be spread out over all the assets received in liquidation. The rules require that the spread be made in relation to the fair market value of the assets, but—here is the important point—not at the date they are acquired (the date you buy the stock) but rather at the date the assets are received in liquidation. Again that is intended to give effect to the fact that the composition of the assets necessarily will have changed from the date you bought the stock until the date you liquidated the company. You make this apportionment based on the fair market value of those assets, but you must also apply a further special rule. If any asset is subject to a specific liability, then you first reduce the fair value of that asset by that specific liability. After that, you use that net value and the fair value of all other assets in apportioning the total cost of stock.

I might add, without trying to give an example or illustration, that you can get some interesting results, depending upon whether assets are, or are not, subject to a specific liability. You get quite unusual results in some cases.

This problem of allocation is easier if we distribute all the assets at one time, but you said you could stretch out this liquidation over a period of two, three, four, or five years. If you did that and distributed some assets one year, some the next year, and so on, would that create a problem?

That would obviously make a great deal of work for accountants. I do not suggest that it should be done. I suggest, however, that it can be done if for other good, valid reasons you have to stretch out the liquidation period.

Are the assets to which the allocation of cost is to be made limited to the assets that appear on the books of the company?

No, and this can be both an advantage and a disadvantage. The advantage can apply in a situation where the acquired company, following what was for it a proper accounting and income tax procedure, charged off certain assets as acquired, like supplies and various and sundry other assets. Even though those assets have no income tax basis to the acquired company, they clearly are assets of the acquired company. They are assets that the new company purchased—they just happened to have a zero income tax basis—and, for that reason, you can apportion some of the cost of the stock to those assets based on a fair market value determination. That is the possible plus feature in assets not on the books.

The disadvantage can be that you may be required also to apportion part of the tax basis or cost of the stock to an item like goodwill which normally will not appear on the books even though a company can have it in substantial amount. If so, you will be required to apportion part of your tax cost to an asset which is nondepreciable and where the ultimate tax recovery may be so far in the future that, as a practical matter, it will do you no good.

Suppose the assets of this company we are liquidating after a purchase include the stock of a subsidiary. In what manner is the cost of the subsidiary's assets affected?

It is clear that if you do not liquidate the sub-subsidiary, and if you simply liquidate the acquired company, then the cost of that acquired company's stock is going to be attributed to the assets it owns, which in this case will include stock of a sub-subsidiary. There will be no effect, however, on the assets of that sub-subsidiary. Therefore, to that extent, you will have lost part of the tax advantage of the purchase of stock followed by liquidation.

Now, in my opinion, that can be eliminated by the simple means of liquidating the sub-subsidiary first. In other words, you liquidate the sub-subsidiary on Monday and on Wednesday of the same week you liquidate the acquired company. Then in apportioning the basis of the stock of the acquired company to the assets you receive, you will receive not the stock of the sub-subsidiary, but all its individual assets. You will be able, therefore, to apportion the tax cost of the acquired company's stock to those assets.

Now, you also may have a situation where you will not want to do that. The tax cost of those assets may be greater than what you paid for them and, in that case, you may prefer to leave the sub-subsidiary in existence.

If you can arrange to have the selling parties liquidate that sub-subsidiary before you acquire the company, I think that is even better. This will eliminate any question whatsoever about the composition of the assets which you purchased.

These problems of acquiring a corporation and then liquidating it raise some general parent and subsidiary problems. For instance, what

effect will the payment of dividends by a subsidiary to a parent company have on the liquidation of the subsidiary if such a liquidation took place six months later, or many years later?

If a subsidiary is liquidated under a plan adopted within two years after acquisition, any dividend paid by it during that period will serve to reduce the tax basis of the stock in the hands of the parent company, and therefore reduce the tax basis of the assets received by the parent company. On the other hand, if no plan of liquidation is adopted during the two-year period following acquisition by the parent company, then the general rule will apply: namely, that the assets, when they do get over into the parent company's hands, do not change their tax basis. They go over at the same tax cost that they had in the hands of the subsidiary. In that case dividends paid by the subsidiary during the time it was held by the parent company will have no effect whatsoever on the tax results.

Suppose a corporation wishes to acquire assets but have a new subsidiary conduct the acquired business. May this be done by acquiring the stock of a company followed by immediate liquidation and then reincorporation?

I think in this area you get into the old problem of practitioners in taxation everywhere: that is, of form vs. substance. I think the government might very well contend that a liquidation followed by immediate reincorporation of the identical assets really did not take place at all for tax purposes, or alternatively, that what took place was in reality a tax-free reorganization. And, if that is the case, they can just say that you have not properly come within the provisions of the Code that would give you a stepped-up basis. On the other hand, my opinion is that if you reincorporate substantially less than all the assets of the newly acquired company, or if the reincorporation takes place after a substantial period of time so that, in fact, a liquidation took place and business was conducted after the liquidation took place – if these conditions are met, you can liquidate and reincorporate and still get the benefit of a stepped-up basis.

Let us take the reverse of the stepped-up basis. What should be done if the stock of a corporation is purchased by another corporation at a bargain price which is lower than the tax cost of the acquired corporation's assets?

That is very easy. Don't liquidate for two years. That is not always a practical answer; sometimes you must liquidate for one reason or another. Before doing so, you should give very serious consideration to the various factors involved. We are talking of only one here, that of the basis of assets. There are related questions dealing with loss carryovers and other items, all of which should be considered at the same time.

This problem of buying the stock of a corporation in order to obtain its assets sometimes raises problems of allocation of cost beyond what we have discussed. In that sort of situation, what should be done in the purchase of a group of assets at a price which is less than the fair market value of the assets separately?

This is a practical problem which can arise where the sellers can afford to sell assets for a group price lower than their individual values because they themselves obtain a tax advantage by means of a net operating loss or a net operating loss carryback. In such a case the purchaser will not do himself any good taxwise if he realizes the gain on these assets in the near future, which would happen if the lower cost in relation to value is attributed to inventory or other short-lived assets. To the extent that it must be attributed to inventory, a practical solution, or a least one that should be given serious consideration, is the immediate adoption by the purchasing company of Lifo so that it can freeze for itself this extremely low cost of inventory. To the extent possible, it would seem to me it would be advisable for the purchasing company to attribute as much as possible of the remaining cost to short-lived assets, such as accounts receivable, and to other assets, as to depreciable assets which will give rise to tax deductions. The remainder, the lower cost in relation to value, will then be attributable to goodwill, if any, to land, and to other assets which will not give an immediate or a quick tax deduction. Obviously, everything we do in this area of apportioning basis in relation to fair value has to be done with some reasonable relationship to fair value. We cannot stretch it too far one way or the other, but certainly we can do the utmost in presenting the strongest case for what we would like to accomplish.

When we do buy assets at a bargain price, it appears to me that sometimes we must pay a little more tax than if we had paid more for the assets. We can postpone that until we sell the inventory by electing Lifo.

Yes, I think the Lifo election is the one that can be most useful in that situation.

Then by allocating more to short-lived assets, we have a lower cost in our plant and we get less depreciation, so it is just a question of when we pay the tax.

Now for several parent and subsidiary problems. Suppose a corporation owns a subsidiary which was acquired many years ago. The parent company's investment in the subsidiary is substantially greater than today's fair market value or the tax cost basis of the subsidiary's assets. Is there any way for the parent company to take advantage of this unrealized loss?

This question, I think, points out one of the areas where real tax planning can be of great advantage to the corporation. The normal rule is that on liquidation of a subsidiary there is no taxable gain or loss, and

no change in basis. Even though this parent company has a large unrealized loss, if it simply liquidates the subsidiary, it will get no benefit whatsoever from that loss except for available loss carryover.

On the other hand, there are possible ways in which the corporation can make the liquidation a taxable liquidation. Or alternatively, the corporation can sell sufficient of the subsidiary's stock or perhaps all the subsidiary's stock, and in that way also give rise to a taxable transaction. In both cases, the loss on the taxable liquidation or on sale will be a capital loss. It will still, however, be better than no loss at all, and it will have the further advantage of giving you a capital loss with which you may then be able to get other tax benefits, perhaps by realizing capital gains, for example, on certain sales of fixed assets, and paying no tax on those gains.

You have still another and more interesting possibility, however, in a situation of this sort, where the parent company has an investment substantially greater than the value of a subsidiary. It may well be worthwhile to consider letting the subsidiary continue to lose money so that, instead of being worth a small amount, it will be completely worthless.

In the case of a domestic subsidiary which meets certain special tests, the law provides not a capital loss but an ordinary loss deduction for the entire tax cost of the subsidiary's stock and other advances and investments in it by the parent company.

It seems to me that if the subsidiary is pretty sick, it might be better tax-wise to let it die and salvage what you can.

That is right.

In connection with this type of situation, does it matter whether the company's investment is represented by capital stock or by some form of debt, like bonds?

On the surface, it does not. If you had a wholly worthless subsidiary, you would get a full deduction both for the bad debt part represented by advances and for the worthless stock represented by capital stock investment. However, this is another area where the problem of thin corporations may arise, so that you may have a problem if your debt-capital ratio is not strong enough to show a capital, as differentiated from a debt, investment. The way that could happen would be that, assuming you had a small amount of assets remaining in the subsidiary, you might then find that all you do is take those assets and pay off the debt to the parent company. The balance of that debt will therefore be a bad debt and the stock investment will be a worthless security. That should be the result. But if some part of this debt is held to be capital stock, then you will be deemed to have received something on the stock, even if only one dollar, and that will change it from an ordinary worthless stock deduction to a tax-free liquidation of a subsidiary. In that connec-

tion, I mentioned the possibility of just one dollar making the difference. There is also the possibility of this happening not only because of one dollar of cash, but of having even a very small value attributed to goodwill, particularly if you continue to carry on the business formerly carried on by the subsidiary. If you do that, you again face the serious problem of losing the worthless stock and bad debt deductions.

Suppose the parent company owns bonds of the subsidiary which the parent company had purchased at a cost of less than face amount. If the subsidiary liquidates into the parent in a tax-free transaction, does the parent have taxable income from realization of the bonds?

As the subsidiary must pay off debt before it can pay off its stock investment, the answer is yes. Presumably the parent gets the face amount of the debt represented by property worth that amount. However, in certain circumstances it seems to me that it may be possible, prior to liquidation, to convert that debt into a stock investment. While there are certain dangers involved, if you can do it successfully you may then be in a position to eliminate the tax on such income.

For instance, could you contribute the bonds as paid-in surplus?

You might, although there is a theory that that might give rise to taxable income. You might be safer to have a recapitalization, converting the bonds into some form of stock investment in a tax-free recapitalization.

If a parent company is about to liquidate a subsidiary, will the fact that consolidated returns may have been filed in prior years have any effect on the liquidation?

Yes. If consolidated returns ever have been filed, you would have to think very carefully about what you did before liquidating because of the possibility of having a reduced tax basis due to losses used in consolidated returns in prior years, or because of other inter-company transfers and transactions. It is something to consider carefully before making any moves.

Suppose we want to wind up part of a company. It wants to stay in business but liquidate part of its business. Are there any restrictions on the portion of business which may be so liquidated and still result in capital gains to the stockholders, rather than ordinary dividend income?

Speaking generally, you can liquidate a separate business conducted by a corporation or distribute the assets attributable to sale of a separate business conducted by a corporation, and have the gain on such a distribution in redemption of stockholders' stock treated as a capital gain to them.

If a corporation is to be partially liquidated, may it distribute a separate business conducted by it which was acquired in a tax-free transaction, or which was acquired in a cash purchase?

The separate business requirement specifies that the separate business must have been conducted for five years prior to date of distribution, or if not, it must have been acquired only in a tax-free transaction during that period. If you have a taxable or partially taxable acquisition during the five years preceding liquidation, you cannot distribute that business in a partial liquidation and have the result be capital gain to the stockholders under this rule.

In determining whether this distribution may be made in a partial liquidation, what is a separate business?

Whatever will constitute a separate business for the purpose of a spin-off or split-off will also constitute a separate business for this purpose.

In order to have a partial liquidation, is it necessary to have a distribution that meets the test of a separate business, or will any distribution that results in contracting the corporation so qualify?

Yes, any contraction of the business may qualify as a partial liquidation provided it is pursuant to a plan in redemption and is not held to be the equivalent of a dividend. I think it is important to keep in mind the distinction between partial liquidations and spin-offs in this regard. In spin-offs, you must distribute a separate business; it is an absolute requirement. In partial liquidations, a distribution of a separate business is merely one kind of distribution which may result in capital gain treatment. Any distribution, however, which results in a genuine contraction of the business may also get capital gain treatment.

In other words, we are not limited to the separate business case.

Is there any situation in which a corporation entering into complete or partial liquidation may nevertheless be taxed with respect to the assets distributed by it in liquidation?

The general rule is that a corporation cannot be taxed on such a distribution in partial or complete liquidation. The law, however, provides one exception for taxable liquidations, which may be a minor one, with regard to distribution of installment obligations. Over and above that, however, I think there is a more serious qualification, particularly in the case of a cash-basis taxpayer. This is fairly rare in a corporation, but nevertheless if one exists, I think that the corporation may be taxed on income earned by it but not collected by it. In other words, if it distributes to its stockholders a receivable which has never been taxed to it, I think the distribution of that receivable can give rise to taxable income to the corporation.

The following questions were submitted by registrants.
Mr. J. S. Seidman was moderator.

A corporation liquidates within twelve months. In filing Form 966 relating to liquidation, should any mention be made of liquidating under section 337?

No special mention need be made in filing that form. However, you should keep in mind that when the regular income tax return form for the year itself is filed, there is special information required to be included in that return, which is so far set forth only in proposed regulations under section 337.

If stockholders negotiate before adopting a plan to dissolve under section 337, is there any danger?

No, normally it would not make any difference at all (except possibly for certain assets sold with respect to which the corporation plans to claim a deductible loss). It should, however, be noted that section 337 applies only in the case of a complete liquidation. In the case of a partial liquidation it would still matter whether the corporation or the stockholders made the sale of assets distributed.

Assume a depreciable asset is sold by the corporation in a twelve-month liquidation and that mortgage notes are received. The transaction would normally be an installment sale. When the mortgage notes are distributed to the stockholders, would the stockholders report the mortgage notes on an installment basis?

A careful distinction must be drawn. The stockholders in this situation would not be able to report on the installment basis, which they would be in a position to do if they received the notes directly on making the sale themselves.

A subsidiary company owes $10,000 to its parent company on a note. The parent company acquired the note by purchase for $5,000 several years ago from an outsider. Will the parent company realize a taxable profit of $5,000 if the note is paid and a consolidated return is filed, or will the $5,000 be eliminated from income as an intercompany transaction?

The basic rule is that payment of such a debt held by the parent at less than face amount of the debt will give rise to taxable income, on the theory that the parent is realizing income from settlement of the debt. The fact that you file a consolidated return will probably not, of itself, eliminate that potential income possibility.

If the parent company turns the note over to its subsidiary, either as paid-in surplus or in payment for additional stock, what is the tax effect?

You may possibly be able to eliminate any tax on this kind of income by having the debt become part of the capital of the subsidiary, either by contributing it to capital or by having the debt converted into capital by way of a tax-free recapitalization. If you do that and if that transaction itself is not held to be taxable, then of course this merely represents an investment in the stock of the subsidiary, and it will be treated tax-free if, as, and when you eventually realize it by liquidation of the corporation.

However, there is still a serious question. I think you may be attacked on the contribution of capital itself or on the attempted tax-free reorganization of this debt into stock in the subsidiary. While that is a possible means of avoiding such income, there is no certainty about it.

An aircraft subcontractor is performing most of its work under one major purchase order from a prime contractor. Deliveries under this purchase order will be completed in October 1956. The corporation desires to liquidate and desires to adopt a resolution to do so in December 1955, making a liquidating distribution at that time. Will completion of the major purchase order affect the nature of the distribution? The corporation may be required to accept various small orders in 1956. Will performance on these new orders affect the nature of the distribution?

The question essentially is whether or not the corporation really is in the process of liquidation. The regulations dealing with a corporate liquidation of a subsidiary into its parent company contain specific language stating that a status of liquidation must exist at the time the first distribution in liquidation is made. That specific language does not appear elsewhere, and the situation where a corporation is liquidated to individual stockholders is not specifically covered. However, it seems that the same rules basically should follow. The corporation must be in a status of liquidation; otherwise the payment may very well be considered an ordinary dividend.

Depending on all the facts of each problem, I would say that you can justifiably complete a contract and still be in the process of liquidation. As to whether you can take additional orders, it would seem that if they are orders unrelated to business in being prior to the adoption of the plan of liquidation, the answer should be no, since that would be a pretty clear indication that you were still in business.

Making the Most of Losses

PANELIST — FRANK T. REA

MODERATOR — J. P. GOEDERT

We are now going to discuss the problem of losses and how they are treated for tax purposes, business entities—the various forms of doing business and some of their significant tax aspects, administrative procedures, and finally planning the businessman's estate.

Our first session is titled in your program, "Making the Most of Losses." The average businessman finds it very difficult to contemplate a loss, and yet it does happen even to the best of them. It is somewhat comforting to realize that the tax law does give some consideration to this loss question and does provide a substantial amount of tax relief. In connection with the losses themselves, we have the paramount question of the right of carryover and carryback. In addition we have the effect of acquiring a business which has a loss. What are the tax effects? In that connection, I think you might be interested in an advertisement I saw this morning:

> "WANTED TO BUY: all the capital stock of a corporation with deficit or loss position engaged in manufacturing, processing, or distributing oleomargarine."

In other words, there is still very definitely an interest in the utilization of a loss company. We will discuss this subject now. First we should

make some generalizations regarding the tax aspects of losses. Suppose a company has a loss for 1955 of $100,000. What use can it make of this loss for income tax purposes?

This loss can be used as an offset against the income of certain other of its taxable years, thereby bringing about a sort of averaging. This is the area of the net operating loss deduction which is provided for in the tax law. The purpose of this part of the law is to offer tax relief. It is intended to avoid the otherwise inequitable taxing of the good years without granting any relief when and if a bad year comes along. The net operating loss is allowed to be deducted from the income of the two years preceding the year of loss, and is allowed to be offset against the income of five years following the years of loss.

I understood you to say that you carry the loss back two years. That means a 1955 loss would be carried back to 1953. Suppose the company found it more advantageous to carry the loss back to 1954. Does it have a choice?

No, it does not. The law prescribes a definite procedure to be followed in carrying the operating loss to the other years. The loss first must be carried to the second year which precedes the loss year. In your 1955 example, it would go first to 1953. To the extent that the income of the year 1953 did not fully offset the amount of the loss, the company is permitted to carry over the unabsorbed portion to the next year, which is the first year preceding the loss year. In your example that would be 1954. If there is still some portion of the loss unabsorbed, it is available to be carried forward and offset against the income of the next five years in their chronological order.

In other words, there is no choice in the matter. Is the loss which is carried back to 1953 exactly the same as that which is shown on the tax return for 1955?

No, it is not. Before the loss is allowed as a deduction against the income of another year, certain adjustments must be made in carrying the 1955 loss back to the year 1953. These are the adjustments most likely to be encountered: If there was, in the 1953 return, a deduction for percentage depletion, there is a requirement that this deduction be substituted with a depletion deduction based on cost. Furthermore, if, during 1953, the corporation received any tax-exempt income (for example, interest on municipal bonds), this exempt income must be taken into account in determining the amount of loss that is eventually going to be deducted in 1953. Furthermore, if during 1953 the corporation received dividends from another corporation, it was entitled to exclude 85% of the dividends in arriving at its net income, subject to a limitation that the amount excluded did not exceed 85% of the corporation's income

before deducting the dividend credit. If after carrying the 1955 loss back to 1953, the net income is so reduced as to bring it below the point of the maximum dividend credit, the dividend credit must be recomputed on the basis of 85% of the net income as changed by the net operating loss.

In other words, the effect is to compute an economic loss rather than a tax loss before you bring it back. Do these same adjustments apply with regard to a loss in 1956, which is to be carried back to 1954?

No, they do not. As you know, we have a new tax law which applies to years 1954 and later. Under the new law these adjustments are substantially liberalized over those in the prior law. As a matter of fact, the adjustments which I mentioned regarding percentage depletion and exempt income need not be made under the new law. Furthermore, under the new law the maximum dividends-received deduction is not affected by the fact that you have a net operating loss.

In other words a loss in 1956 will give more tax relief than a loss in 1955.

Yes, it certainly should, because of the liberal provisions of the new law. Due to these same conditions, the year 1955 is quite a crucial year. In view of the two-year carryback, a loss in 1955 will be the last to encounter the less liberal requirements under the provisions of the old tax law.

In connection with these net operating loss calculations, I have heard it said that it is possible for just two dollars of income to make a difference of thousands of dollars of tax. Is that correct?

Oddly enough, it is. This arises from the deduction for dividends received. The maximum deduction for dividends received is 85% of the corporation's net income before the dividend deduction. This limitation does not apply in a loss situation; therefore it is possible for $1 of loss or $1 of income to make a vast difference in the final tax result.

You mentioned operating loss. Can the loss from winding up a business be figured also? Suppose, for example, that a manufacturing business wants to sell out but will continue in operation as an investment company. Can the loss on the sale of the manufacturing assets be considered a net loss which can be carried back?

Yes, it can. I was careful to refer to the deduction as a net operating loss deduction because it is the basic intention of the law to allow this tax relief only in the event of losses arising from the conduct of a trade or a business, as distinguished from losses arising from a nonbusiness transaction. However, as one of the exceptions, losses incurred in the sale

of property used in a trade or business are accorded the same treatment as a regular business transaction.

What about the mechanics? How does a company go about getting a refund for 1953, for example, on account of a carryback loss in 1955?

A special refund claim is filed on a special form provided for that purpose. In accordance with the basic principles of tax relief, the government makes a refund of the amount claimed within ninety days after the filing of that refund claim.

Regarding traffic in loss companies, does the law try to prevent or control this traffic in any way? Suppose, for example, a company is just a shell but has a large net loss from prior years. Can its stock be bought for a relatively small amount and the losses used by the buyer?

I do not believe it can. The law definitely does have provisions for dealing with traffic in loss companies. Generally speaking, the effect of these provisions is to disallow any tax benefit which otherwise might be obtained through the ownership of such loss companies. The law attacks these transactions in several ways. In one approach, sometimes referred to as the subjective test, the law seeks to determine the real intent of a person who acquires a corporation that has accumulated losses. If it can be shown that the intent was principally to avoid paying federal income tax, then the government can and will disallow the carryover deduction of the loss.

Intent is, of course, a very difficult thing to ascertain; however, the law also contains a presumption dealing with the intent. If it is shown that, in purchasing the company, the price paid was substantially different from the aggregate of the depreciated tax cost of the company's property plus the value of the tax benefits derived from its operating loss status, then it will be presumed that the requisite intent was there. The presumption will aid the government in invoking this regulatory section.

There is another way of dealing with the problem and this time the test is mechanical. In the case of a substantial change in the ownership of a company simultaneously with a change in the type of business it conducts, the operating loss carryovers of the company will be disallowed. More particularly, the requirements are that if within any two-year period it is shown that there has been a change in the ownership of 50% or more of the stock of a company through purchase or even through a combination of purchase and liquidation of part of the stock, and if during this period there has been a change in the kind of business the company conducts, then the operating loss carryover of the company will not be allowed as a deduction. This is also the provision that is intended to deal with those transactions where the assets of a loss company are acquired through one of several types of tax-free reorganizations.

Generally speaking, if the substance of the transaction is to absorb the assets of the company without at the same time giving the stockholders of the old loss company a rather substantial interest in the new venture, stated to be at least 20%, then there will be a partial or perhaps a complete disallowance of the loss carryovers.

In other words, in an effort to control this traffic in loss companies, we have certain specific tests, one of which is subjective, namely the intent, and the other which is mechanical, and involves the change of ownership or change of business and also the reorganizations. That is the general rule. There must be some exceptions that do permit the utilization of loss. Let us assume that a company acquires all of the stock of a loss company in exchange for common stock of the buying company, and the buying company then liquidates the loss company. This might well be the intention behind the advertisement I read. Can the past losses in this instance be used by the buying company?

I think it might well be the purpose behind the advertisement, because it appears that the transaction you have just outlined presents a possibility which was not fully comprehended at the time the law was enacted. The reorganization limitations which affect the carryover of net operating loss deductions are intended in those situations where the assets of a company are acquired in a reorganization, and the loss company passes out of existence. However in the situation that you have mentioned here, there is simply an exchange of stock for stock, and thereafter there is a parent-subsidiary arrangement. If it is a tax-free reorganization, it seems to me from as close a study of the law as I can make, it would be permissible for the acquiring corporation to use the full benefit of the operating loss carryover without the limitations that otherwise would apply in what is apparently a very similar transaction.

Let us change the facts a little. In the first example we were acquiring stock for stock, and you say that there appears to be a situation where the loss will be available. Would your answer be different if the acquiring company received assets instead of stock?

Yes, it would. If in a tax-free reorganization, one corporation acquires assets of another loss corporation, and thereafter the loss corporation takes the stock it has received and distributes it down to its own stockholders in its own liquidation, then the loss carryover would be available as a deduction to the acquiring corporation.

However, there is a limitation involving the 20% ownership that I referred to briefly a minute ago. If the stockholders of the old loss company receive as much as 20% of the stock of the acquiring company in this transaction, the full amount of the loss carryover will be allowed as a deduction. If, however, the stockholders of the old loss company receive

some portion *less* than 20%, the loss carryover allowed as a deduction is proportionately reduced. For example, assume that the stockholders of the old loss company receive only a 10% interest in the acquiring company — one-half the stated minimum. In such event, the acquiring company would be entitled to carry over and deduct one-half the loss company's loss carryover.

In one situation, we have stock for stock (which you say is permissible) and the loss is available. In the other situation, we have assets for stock, and the loss is still available but on a somewhat more restricted basis.

Another aspect of availability of losses concerns subsidiaries. Suppose a company has a loss subsidiary and wants to utilize its losses. Can the parent do this by liquidating the subsidiary into itself?

Yes, generally speaking, the liquidation of a subsidiary will allow the parent to inherit the subsidiary's operating loss carryover. However, to keep a corporation from purposely purchasing another corporation in order to acquire the subsidiary's loss status and then liquidating the subsidiary, there is a prohibition that denies the carryover deduction if the subsidiary is purchased and then liquidated at any time within two years after the date of purchase.

Let us assume that there is no liquidation involved, but that a loss company is continued in the same business and a new, profitable business is added to it. Are those losses available?

Yes, they are. So long as the status and the entity of the loss company are not affected, and so long as the kind of business it conducts is not changed, the right to deduct its own loss carryovers is unaffected. It can enter new avenues of business to produce profit that can be used as an offset against these losses.

In other words, the losses of one business can be offset against the profits of another within the same framework.

Suppose a profitable company purchased all the stock of a loss company without merger, liquidation or anything similar. The old business was continued by the loss company and the profitable company set up profitable transactions in the loss company. In other words, the old business was continued but something new was added. Can the benefits of past losses of the loss company be obtained in this way? Keep in mind that we have added a variation to the previous example in that the loss company is acquired by another company.

I think it is all right because it is the only thing you have done. You have not changed the nature of the business. As long as you do not, it is all right to add more profitable lines to produce income which can be utilized as an offset against this operating loss deduction. As a matter

of fact, it seems like a good way to obtain tax benefit from operating loss carryovers.

While discussing the various control tests or restrictions, you mentioned one involving what you called the subjective test. Let us demonstrate that by an example. Suppose a company has assets with a depreciated tax cost of $100,000. The company has large operating losses. A new group buys the stock of the company for $100,000. Are the losses available to the buying group?

With respect to the subjective test, I feel that the losses would not be available because of this acquisition, inasmuch as the example you put states that the price paid for the company merely equalled the depreciated tax cost of the assets. There was no payment made because of the tax benefits of this loss carryover. The presumption requires that the price paid be substantially the same as the aggregate of the depreciated tax cost and the tax benefits to be derived. I believe your purchase price falls short of the mark.

I will not ask you how you evaluate the tax benefit. I assume that it is in the area of the unknown right now. Another test you mentioned involved reorganizations. You made the point that the old stockholders of the loss company had to have 20% of the stock in the resulting company, the acquiring company. If not, some of the loss carryovers would be forfeited. Is there any purpose in intentionally violating this rule and in effect forfeiting part of your carryover?

Yes. While the transaction might be free from attack on the mechanical rule, if there is a reorganization wherein the stockholders of the old loss company do receive as much as or more than 20% of the stock of the new organization, it does not follow that the transaction is also free on the subjective test involving the intent behind the transaction. On the other hand, if the transaction is one that does come within the coverage of the 20% rule, then that rule applies to the exclusion of the intent rule. Under the subjective test involving intent, the government has the authority to disallow the entire amount of loss carryover. But under the mechanical rule involving the 20%, it is stated that the carryover will simply be reduced in proportion to the amount of stock owned by the stockholders of the old loss corporation and the rule of the subjective test will not apply. Putting that to our advantage, if the stockholders in the old loss corporation obtained 19% of the stock, then the acquiring corporation will be entitled to 95% of the loss carryover instead of the full 100%. Nonetheless, the forfeiture of 5% of potential tax benefits might be a far better compromise than running the risk of the subjective test with a full disallowance.

It is rather interesting to realize that you can purposely violate a rule

with the intention of obtaining a specific tax advantage, but that is the way the law is.

Let us assume that a loss company is acquired by another company, but it fails to fit within some of the exceptions we have mentioned, and it conflicts with the specific tests. Therefore the loss carryovers definitely are not available. Would it also prohibit using the losses of the current year in which the transaction takes place?

No, these prohibiting provisions deal only with operating loss carryovers. They do not deal with the loss status of the current year of the acquisition or reorganization.

Are there any restrictions on the use of the selling company's capital losses or losses not yet taken by it, but reflected in assets which have depreciated in value?

No, there are no such restrictions. Once again, these sections apply only to operating loss carryovers, and capital loss carryovers are not involved. They also deal only with losses that have in fact been realized, and have no effect at all on potential losses that may be foreseeable.

Is there any restriction on our buying into a company which has a deficit as a means of absorbing future profits before there is any net surplus, with the hope of being able to make dividend payments to stockholders tax free? Is that feasible or practical?

It might well be. There are no strings attached to the surplus-deficit angle. Deficits are not involved in the provisions dealing with limitation of a loss carryover. Under the proper circumstances, it might well develop that in view of a surplus-deficit, dividends in excess of the current year's earnings can be paid by a corporation, which will be a tax-free distribution to the stockholders.

We have a five-year carryforward after the two-year carryback. Therefore 1956 would be the last year to take advantage of 1951 losses. In planning, due to the fact that our 1951 losses will expire next year, should we wind up a subsidiary which has such a carryover and has been losing money for the past four years? Or should we try to make the company profitable in 1956 and make use of 1951 losses?

It is time for something to be done. After the five-year carryover period has elapsed, the unused portion of the loss is gone forever. Under the generally accepted definition of a subsidiary, taking into account the matters already mentioned, involving the subsidiary-parent relationship, the subsidiary can be liquidated this year and its loss carryover used as a deduction by the parent in its 1955 return. Or, as an alternative, if the

subsidiary can be made profitable, of course its own loss carryover could be used advantageously against its profits this year and next year.

Keep in mind that in trying to plan for full use of a carryover that will expire soon, watch the date of the merger or liquidation. If it is not handled right, you may have a short-period year which will accelerate the absorption of the carryover.

The following questions were submitted by registrants. Mr. J. S. Seidman was moderator.

A parent corporation has available a net operating loss carryover for 1955, but has no income for this year. However, it can realize a capital gain from the sale of stock of some of its subsidiaries greater than the carryover loss. The loss is $500,000 and the capital gain would be $1 million. To what extent can the corporation use up its carryover loss? Would it be advantageous to postpone some sales of subsidiary stock until later years, or effect an installment sale in 1955?

If the corporation sells the stock of its subsidiaries and realizes a capital gain of $1 million, it will thereby have income against which it can offset the operating loss. The net effect also will be a complete loss of the tax benefit of the loss carryover, inasmuch as the corporation will pay either the alternative tax on a million dollar gain, which is at a 25% rate, or the regular corporate tax on the corporate net income of $500,000, which is roughly $260,000, or a little more than the maximum alternative tax. This, of course, assumes that the capital gain was the only item of income that the corporation had during the year.

There was also a question as to whether an installment sale would help. If the corporation sold all the subsidiaries, realizing a million dollar capital gain, and put the transaction on an installment basis, there would not be a full tax offset, since the maximum gain that could be included in this year (by virtue of the 30% limitation that applies to installment transactions) would be only $300,000. And there is a $500,000 loss carryover. It is not stated whether the loss carryover is still available for a year subsequent to 1955. Perhaps something could be worked out there.

As an alternative, the loss corporation could sell one of its subsidiaries this year for a profit of approximately $500,000 and thereby utilize the operating loss. In the next year, the corporation could sell the other subsidiary and take advantage of the alternative tax of 25%.

This goes a little beyond the question, but apparently the subsidiaries are quite valuable, and presumably they are money-makers. Perhaps the subsidiaries could be liquidated into the parent and their profits offset against the operating loss carryover of the parent. This would be better than offsetting the carryover against capital gains.

A corporation sells all of its fixed assets at a large loss which qualifies as a net operating loss. It is then practically a shell. It enters into a wholly new business requiring practically no fixed assets. Can it utilize such net operating loss to absorb profits in the new business?

The loss from the sale of its fixed assets would generally be accorded net operating loss treatment. The fact that the corporation changes its type of business is not critical unless there has been a change in the ownership. It would be perfectly all right for the corporation to take a loss on the sale of its fixed assets and enter a new avenue of business, and if it is profitable, offset the prior losses against the income of the new business.

In the same circumstance, will dividends be tax free until the deficit created by the sale of the property is wiped out by later income?

Not entirely. Dividends are taxable to the recipients to the extent that there are earnings and profits either during the year of the distribution or accumulated during prior years. By virtue of the loss from the sale of the fixed assets, it appears that the surplus account has a deficit in it. However, if there are profits during the year in which the distribution is made, the dividends will be considered to have been made first from the profits of the current year; so to the extent that there are profits in the current year, there will be taxable dividends to the stockholders.

If a loss company was acquired in December 1953, is it free of the presumptive and subjective tests required under the 1954 Code?

The subjective test in the new law is a continuation of a very similar provision in the old law. As a matter of fact, the subjective test applies to acquisitions on and after October 8, 1940. So the 1953 acquisition would be subject to the test of intent. However, the presumption that the law provides is new and applies only to acquisitions after March 1, 1954.

The following questions were directed to Mr. Wallace M. Jensen:

A partnership has recently acquired the stock in a corporation in partial satisfaction of indebtedness by the corporation to the partnership. The corporation has large loss carryover credits. To what extent are these credits available as offsets against future earnings of the corporation?

The partnership acquires the stock in payment of an account receivable. That has the same effect as a cash purchase. Even though 50% or more of the stock of a corporation which has loss carryovers is purchased, those loss carryovers can be used as long as the corporation does not change its business.

What would be the situation if the corporation now leases its plant to another, and engages in a different business?

It is implied that the corporation has a plant, and presumably has been using it in a manufacturing business. If it stops manufacturing and leases the plant to someone else, it is changing the character of its business. It may therefore lose the loss carryover.

Doing Business as a Corporation, Partnership, Joint Venture, Etc.

PANELIST—MARY LANIGAR

MODERATOR—J. P. GOEDERT

The businessman has one picture of a partnership while the tax law may look upon it differently. Let us examine that a bit. For example, suppose A and B pool their money to buy stock on a joint speculation. Would that be considered a partnership?

Yes. This pooling arrangement is a partnership for tax purposes. The definition goes this way. If we have two or more people engaged in a business venture which is not a corporation, an estate, or a trust, then it is a partnership. In this pooling for investment area, which we are talking about, there is one interesting election in the new law. These investment ventures, which are technically partnerships, are given the right to elect not to be treated as partnerships providing each of the participants is able to determine his own taxable income without the necessity of filing partnership returns.

Now let us suppose that several people work out a business arrangement that they call a partnership or a syndicate, but they actually run it along the same lines as a corporation. How would that be taxed?

If these organizations operate like corporations, they will be taxed as corporations. The principal points to watch are agreements that the venture will be managed by a central committee without all of the investors having a say in management, or, sometimes, it is agreed that an interest may be transferred without the consent of the other participants.

In this area, we are reaching the danger point of being taxed as a corporation.

Can a corporation be a member of a joint venture and be treated as a partner for tax purposes?

Yes. Corporations quite frequently are members of a joint venture to engage in a specific project. As far as being treated as a partner for tax purposes, this follows too. The joint venture files a partnership return, showing the income distributable to each of the partners, including the corporation, and the corporation picks up its share of the income in its corporate tax return.

Is a partnership, as such, subject to taxation?

It is not really subject to taxation because there is no partnership tax, but a partnership is a taxpayer. A partnership is required to file a return which is technically an information return. In that return it reports the income for the year and shows the distribution of that income to the various partners who, in turn, pick it up on their individual returns.

Saying that a partnership is a taxpayer does have some real significance. It is a taxpayer for purposes of selecting methods of accounting, and also for purposes of selecting a taxable year. In talking of taxable years, perhaps I should explain another point. When the partnership has a different taxable year from the partners, we have to follow a special rule. The rule is that the partners pick up the income from the partnership in their taxable year in which the partnership year ends. For example, if we have a January 31st partnership, the income for the year ended January 31, 1955 would be picked up by each individual partner in 1955 if he is on a calendar year.

To summarize, a partnership is a reporting entity not itself subject to tax, whereas a corporation is actually a taxpaying entity.

So much for definitions. Let us talk a little about mechanics. What about operating losses? A stockholder certainly cannot pick up in his own tax return his share of any corporate losses. Does that also apply to a partner's share of partnership losses?

No. The rule is different here. A partner picks up his share of the partnership losses just as he picks up his share of the income. In a new business where losses may be anticipated, this is an important consideration in choosing the form of organization because a partner having income from other sources is thus able to make immediate use of the new business's operating losses. A corporation makes use of these losses by way of carryforward against future income, but a partnership gets the tax benefit from those losses right away.

In other words, a partner in a high income bracket could make substantial investments in a company and if there are losses it may not

cost him very much. Now let us see if there are any limitations on that. Assume that A invests $5,000 in a partnership and in its first year the partnership has a loss and A's share of that loss is $8,000. He invested $5,000, and his share of the loss is $8,000. Can A deduct this $8,000 in the first year?

Well, he could certainly deduct a part of it. There is a very special rule as to these partnership losses. The rule is that a partner may deduct partnership losses up to the amount of his investment in the partnership. In this example, we have a loss of $8,000 on an investment of $5,000. In the first year the partner could deduct $5,000, but he could not deduct the remaining $3,000 until a later year, at which time he invested $3,000 more.

There is one special consideration here which we should point out. You have very nicely told me that the investment was $5,000, but this investment is not figured as a businessman ordinarily computes his investment. For purposes of the partnership tax law, the amount of the partner's investment in the partnership includes not only the money which he puts in but also his share of the partnership's liabilities. This is a tricky point that must be watched.

So our high-bracket taxpayer couldn't get his loss unless he either invested or incurred liabilities in the partnership to the full amount of it.

Let us talk about fiscal years for a few minutes. Can a corporation, newly organized, adopt any accounting year or taxable year it wishes?

Yes, it certainly can, with the usual provision that the year should end with the end of a month. There is a considerable business advantage to selecting a natural business year. The corporation has complete freedom in this area.

Can a partnership likewise select any taxable year it wishes?

No. Since April, 1954 there are some very strict limitations on a partnership's choice of fiscal years. The rule is that in selecting a fiscal year, a partnership must not use a year that is different from the year used by any partner having an interest of 5% or more. As you can see, this is very restrictive, and since most partners would use a calendar year, that would mean that many partnerships would not be free to select a natural business year.

So we cannot have a partnership fiscal year different from the taxable year of a principal partner, and a principal partner is anyone with a 5% interest. Now, what happens if we have two principal partners with different taxable years?

Well, there are several possibilities. Let us assume that one of them has a June 30th year and the other has a December 31st year. Now, if the partnership wants a natural business year which ends at a different date, they are not able to select that year. There is a provision for getting

permission from the government for the adoption of such a year, but we understand that even if a good business reason is shown, permission usually will not be given unless all of the partners will adopt the same year as the partnership.

There is another possibility in this June 30th-December 31st situation. If the December partner would change his year to June, then the partnership could use June and would be all right.

There is a third possibility, and that is that when the partners have different years, the partnership could use a calendar year.

Well, one last question on fiscal years. This question involves changes from one year to another. What is the difference between a corporation and a partnership insofar as changing its fiscal year is concerned?

Again, there is quite a difference. A corporation may change under some circumstances without getting advance permission, and is usually given permission to change if a good business reason is shown. A partnership runs into this same rule as to partners with a 5% interest, and it is not permitted to adopt a year or change to a year which is different from the year of any partner having a 5% or greater interest. Again we have freedom of choice for the corporations and severe restrictions for partnerships.

It is quite obvious that insofar as the fiscal year is concerned, a partnership is under very definite restrictions.

Now about the formation of entities. The formation of a corporation can be handled in a tax-free manner. Is that also true in the case of a partnership?

Yes, it is quite easy if it is handled properly.

Is it possible to incorporate an existing partnership tax free?

Normally this isn't difficult either.

Can a corporation be converted into a partnership tax free?

Generally, it cannot. When we are talking about the conversion of a corporation into a partnership, we would have to do that by liquidating the corporation. When a corporation is liquidated, the stockholder must pick up the assets of the corporation at their present value, and the difference between present value and the cost basis of his stock represents gain or loss in the stockholder's hands. Usually the corporation will have accumulated earnings which have not been distributed, or will have appreciated property, so that when we talk about liquidation, we are talking about a substantial tax in order to get into a partnership status.

We can incorporate tax free, we can form a partnership tax free, we can incorporate a partnership tax free, but we will have trouble in converting a corporation into a partnership.

In connection with the formation of a partnership and the contribution of property to it by a partner, suppose a partnership is formed between A and B. A invests $10,000 cash. B invests a building worth $10,000, but which cost him $3,000. Does B realize any gain by contributing his building to the partnership?

No, he does not. While in dealing with his other partner this gain is recognized, the tax law is that no gain or loss is recognized when property is contributed to a partnership.

Let us look at it from the standpoint of the partnership now. Assume that the building has a ten-year life. How does the partnership compute depreciation? Is it on the $10,000 value at which it was accepted, or the $3,000 cost?

For tax purposes the partnership must use the same cost as that of the contributing partner. In other words, the partnership must use B's $3,000 cost. With a ten year life this would give us annual depreciation of $300. As far as the partners are concerned, assuming again an equal partnership, they would ordinarily divide this $300 equally. However, the partner who contributed the cash and thought he was getting a $10,000 building is not going to be happy with this, because he thought there would be $1,000 depreciation and that his share would be $500. For tax purposes we cannot give him $500, because we only have $300, but A and B may, by agreement, provide that A, who contributed the cash, is to get all of the depreciation.

Let us assume that this building which is valued at $10,000, but cost the partner who contributed it $3,000, is sold by the partnership in the first year for $9,000. Now, what is the tax effect of that?

First of all, just so that we do not get involved in too many figures, let us assume that no depreciation had been taken yet. For accounting purposes we have a $10,000 building sold for $9,000, and we have a $1,000 loss. For tax purposes, however, we are still using the cost to the contributing partner which you will recall is $3,000. So, on a sale for $9,000 we have a gain of $6,000. Now this gain in an equal partnership may be reported one-half by each partner. However, again, the gain all occurred before B put the building into the partnership and the law permits A and B to agree that the contributing partner is to pay tax on all that type of gain. Accordingly, it would be perfectly possible for these partners to agree that B is to pay all the tax on the $6,000 gain.

So we have a book loss of $1,000 ($10,000 less $9,000) and we have a tax profit of $6,000. Let us assume that the partner with the building, instead of contributing it, sold it to the partnership for $10,000. It still cost him $3,000. Now what is the tax effect of that?

Under some circumstances this might be a very good idea. Assuming

that the partner owning the building had held it over six months and that it was depreciable property in his hands, he would have a gain when he sold it to the partnership for $10,000. He would have a $7,000 gain, but it would be a capital gain. When the partnership bought the building, it would then be entitled to use the $10,000 cost and to compute its depreciation on the basis of this $10,000. Here you see we are converting capital gain into ordinary depreciation deductions.

However, there are some limits on this. If the selling partner himself owns an 80% or greater interest in the partnership, or if he and his close family members own such an interest, then the law says that we must recognize the gain, but it is going to be ordinary income and not capital gain. While we are talking about selling property to the partnership, it might be well to point out that losses are not recognized if the selling partner or the selling partner and his family have a 50% or greater interest.

You indicated that a partnership was a reporting entity. Let us just talk about that a minute. Suppose a partnership makes $10,000. Of this, $9,000 is capital gain on the sale of securities. Does each partner report $5,000 partnership profits, or does he separate the capital gain from the remaining profits?

If he is well advised, he certainly doesn't just report $5,000, but will report his half of the capital gain, $4,500, and his half of the ordinary income, another $500. The tax law is quite clear that partnership income in the hands of a partner retains the same character as it had in the hands of the partnership. If it is tax free under the partnership, it is tax free to the partner, and so forth.

How is the income or loss of a partnership allocated as between the partners?

Usually the partners will have an agreement between themselves, and this agreement will be followed for tax purposes, unless it is completely unrealistic. In talking of these partnership agreements, we should point out that when there are special items such as depreciation, which we were discussing, or gains on sale of contributed property, then the agreement must be specific as to how these items are to be handled to get the maximum tax benefit.

In other words, the provisions of an agreement will control unless they are obviously directed toward what you might call tax evasion?

That is right.

Can the share of partnership gains and losses allocated to each partner be changed from year to year?

Yes, they certainly can, provided the change is for business reasons. If we had a family partnership and the change was simply to give more

income to one of the members of the family who was in a lower tax bracket, that, of course, would not work. But if we have the usual situation in which the partners want to make changes to recognize the fact that one partner contributed more effort during the year than the other, those changes are perfectly all right. In fact, the tax law is written almost as though changes are expected at the end of the year after we see what the profits are. As we mentioned, the partnership agreement controls, and the tax law provides that any changes in that agreement which are made up until the time the tax return is filed will be given retroactive effect. That is, if you want to change your agreement for 1955 any time up until April 15, 1956, before you file your return, you may change the agreement as to the distribution of 1955 profit between partners.

So the tax law says that you can change your distribution any time before the filing of the tax return. In other words, the law now recognizes what everybody has been doing for years anyway.

What about partners' salaries? How are they treated for tax purposes?

As far as the partnership is concerned, it deducts these salaries, just as it deducts salaries paid to any other employees. The partner picks up the salary and pays tax on it. The timing here is important, however, because a partner does not pick up his salary from the partnership as he receives it, as he would a salary from a corporation. With partnership salary, he waits until the end of the partnership tax year and picks up the salary at that time—in other words, at the same time as he picks up his other partnership income.

Are partners' salaries treated in all respects the same as salaries paid by a corporation to employees?

No, they are not. For example, partners' salaries are not subject to income tax withholding, nor are they subject to payroll tax. The most important difference is that a partner is not treated as an employee for purposes of pension and profit-sharing plans, and fringe benefits. This can be a very substantial tax advantage to an owner who is an employee of his own corporation, and the fact that these pension and profit-sharing plans are not available to partners is one reason why a small, closely held business often decides that it is better to incorporate.

Suppose a partner retires from a partnership under an arrangement that gives him a continuing interest in the profits for several years. Is he taxed on those profits, or are they taxed to the continuing partners as part of their cost in acquiring his interest in the partnership?

This is a big subject which I am going to try to dispose of in about two sentences. It depends upon the underlying business situation. If the partnership has property, and the attempt is to pay the retiring partner his share in that property by giving him a continuing interest in the profits, then the rule is that he is not taxed on those profits, or at

least he is not taxed until he recovers his investment. The continuing partners are required to pick up those profits, even though they are paid over to the retiring partner.

Now, if the situation is different and the retiring partner has already been paid for his interest in partnership property, or if the partnership has little or no property, then we have different rules. Under those circumstances, the retiring partner must report his share of these profits, and the profits are not taxed to the continuing partners.

If a partner dies, does that wind up the partnership for tax purposes?

No, it does not. Here we are talking merely about the closing of the tax year. If a partner dies during the middle of the year, the partnership goes on to the end of its normal taxable year. At that time, it files its return showing the deceased partner's share of the income, and the deceased partner's estate picks up this income. It picks up both the income prior to death and the income after death.

What happens if a partnership is finally liquidated?

Again, this is a big subject which I will try to dispose of briefly. If a partnership simply distributes its property to the various partners, then the partners do not realize any gain or loss until the time that they sell the property. However, if one of the partners takes cash for his interest in the partnership, then, as you would expect, gain or loss is recognized. This is the difference between his investment in the partnership and the amount of cash which he receives, and this gain or loss is ordinarily capital gain or loss.

There is one difficult area in these liquidations which I should mention. If the partnership has receivables which haven't yet been reported for tax purposes, or if it has a lot of low cost assets such as Lifo inventory, which are now worth considerably more, we have a very difficult tax situation and, under these circumstances, a liquidation should not be undertaken without some very careful consideration and some competent tax advice.

We have covered the question of formation, selection of fiscal years, allocation of income, treatment of partners' salaries, effect on retirement, death, and the liquidation of the partnership.

Can a partnership be taxed as a corporation if it wants to?

Yes. This is a new provision in the 1954 tax law. It is subject to a lot of restrictions, however, so that not all partnerships have this election. Also, there are a lot of unsettled areas in exercising this election. For this reason, I do not think that it is an election which will be very much used or very useful. But it is interesting.

Now the converse of that—can a corporation be taxed as a partnership if it wants to?

No, not under present law. There was such a proposal early in 1954,

and it was actually in one of the bills. However, it was not retained in the final law. It is a very interesting proposal and one that makes a lot of sense and many of us hope that it will be reconsidered.

Well, one final question and that is the basic one that we are concerned about—that is whether to do business as a corporation, considering the tax factors only. Does the amount of income expected from the operations of the business have any bearing on your decision to function as a partnership or a corporation? Or does the amount of money that the owners think they will have to take out of the business have any bearing on the selection?

Yes, both of these factors are very important. Getting back to the income, partnership income, which is taxed at individual rates, will be taxed on the graduated scale anywhere from 20% up to possibly 91%. Corporate rates, however, are 30% on the first $25,000 during a year and 52% on the excess. That means that if we have relatively low income partnership rates are lower. However, if we have an individual owner with high income, either from this business or from outside sources, then some immediate advantage would appear to be possible by transferring part of that income to a corporation. In doing that, we have to keep in mind the possible withdrawal of cash. We know, of course, that a corporation is permitted to pay salary to an owner who is also an employee, and that such salary is deductible by the corporation as long as the amount is reasonable. But, assuming that we have a corporation which has earnings substantially in excess of that salary, those earnings either must be left in the corporation or, if they are distributed, we have the double tax on dividends.

The government, of course, has an interest in seeing that these dividends are paid out, and it isn't possible to accumulate earnings over $60,000 unless there is a good reason for doing so.

That often is not the real problem. The real problem is with the owner who has jumped into a corporation without thinking of the personal cash requirements which he may have, and sometimes we find a situation in which a business has been incorporated and then the owner says, "Well, I need those earnings for my personal expenses and to pay personal debts." If he is going to immediately withdraw all the earnings as dividends, there just could never be any tax advantage from the incorporation.

However, if we have a situation in which excess business earnings are needed for expansion, or are needed to pay liabilities, then we have a situation in which incorporation usually pays off. It is quite possible to have increased working capital simply by incorporating some businesses, because, while the ultimate tax effect over a long period of time may not be very much different, certainly the current tax bill is a little less when a corporation is used, and this enables a new and growing business to have adequate working capital.

The following questions were submitted by registrants.
Mr. J. S. Seidman was moderator.

Assume a partnership has two partners, A and B. A annually receives $20,000 guaranteed payments, with the remaining profit and loss shared equally. If the only source of income is $100,000 of fully tax-free interest, how much income or loss must A report?

Since the $20,000 of guaranteed payments would be a deduction to the partnership, it would have $100,000 of tax-free interest and $20,000 of ordinary deduction. The distributable income would be $50,000 of tax-free interest to each partner, $10,000 of ordinary loss to each partner, and A who receives the guaranteed payments would report these guaranteed payments as ordinary income.

Assume a taxpayer on a calendar year enters an existing partnership on November 1, 1955. All other partners and the partnership are on a fiscal year ending October 31. Must the new partner change to a fiscal year ended October 31, and should he change in 1955 or 1956?

Since the question states that the taxpayer enters an existing partnership, we must first determine whether that partnership must continue its October 31 fiscal year or whether it is treated as a new partnership which is subject to the rules as to adopting fiscal years. The law provides that an existing partnership is terminated only if there is a sale of 50% or more of the total interest in partnership capital and profits within a twelve-month period. Thus if the new partner came in with less than a 50% interest, we have no problem. He continues with his taxable year and the partnership with its fiscal year. The problem only arises when he comes in with more than 50% interest. Then, in effect, we have a new partnership and we are under the rules of adopting a new partnership year. If that happens, we must do something about the difference in years. I would say, as between the partner changing in 1955 or 1956, he could change in 1955 and it might be well to look at his income and decide which year would be desirable to make the change. It is possible that he would meet the requirements in 1955 so that he could change without permission. If he does not, surely he could get permission to change with these facts being set forth. However, I think he would be perfectly all right in waiting until 1956 to make the change. The problem really becomes acute when the partnership first has to file its return. In the first return of one of these new partnerships, the proposed regulations state that there must be a statement of the years used by all of the partners. This is when the difference of years becomes acute. If it has been taken care of by that time, there is no problem.

Here is one that has to do with a family partnership of a husband and wife. The question ultimately leads to who is going to be taxed on the property. A taxpayer owns half of the capital stock in a closely held

corporation. The remaining half of the capital stock was formerly held by someone not related to him. The taxpayer's wife bought it with her own money, and the corporation was dissolved.

The husband and wife then took over the business under a partnership in which the husband receives $18,000 a year for his services as manager before an equal distribution profit to the wife. Four years later, the wife gives her interest to her three minor children in an irrevocable trust. The business has since been operated by the taxpayer under a partnership agreement providing for the husband to get $18,000 a year before splitting profits equally between the husband and the trust.

Can the husband be assumed to have earned the entire profits? Can the Treasury Department succeed in attempting to tax the husband on the entire unit?

There are quite a lot of problems brought up by this question. I think first of all we are a little short on facts. The family partnership problem revolves around whether the earnings are primarily attributable to services. This does say that we had a corporation at one time and we had an outsider interested in it so it sounds as though we have a business in which capital is a material income-producing factor. Let us assume that. If such is the case, the law now and for some time has specifically said that the profits must be taxed to the owners of the capital in spite of the fact that the capital was acquired by gift. In this situation, it is obvious that at one point the husband and the wife were the two owners of the capital, so it does not seem to me that there is any basis at any time for taxing more than half of the income to the husband. He never did own more than that half.

The question is whether that other half is taxable to the wife or taxable to the trust. Assuming the trust is set up with an outside trustee, who is really active in managing this interest, I think there would be no problem in having that half taxed to the trust.

There is a good deal of reference here to salary. We are given the figure of $18,000 which seems to have gone through for quite a period of time. I do not quite remember whether that was the salary when we had this outsider in the corporation. If it was, that gives some evidence that that was a fair salary except that if the period goes on so long there might be a little question as to inflation. At any rate, we have to recognize the services of the husband when he is actively engaged in one of these partnerships, and you always have the question of what is a fair salary. That is a factual question.

There is one little technicality in the law. It provides for a fair salary, but it only provides for a fair salary to the donor. Under these facts, technically, the husband never was the donor. His wife was the donor, and she did not acquire her interest as a gift from the husband in the first place, so I think the government would have a bad time questioning the salary.

Behind the Administrative Scenes

PANELIST—ABNER E. HUGHES

MODERATOR—J. P. GOEDERT

Now we will cover the problems in the administrative area after the returns are filed and other administrative procedures such as the declaration of estimated tax, penalties, filing of returns, refund claims, extensions, etc. All of these present problems which must be fully understood by taxpayers. Quite often the tax effect of a particular transaction appears uncertain, and, in such cases, a ruling by the government might be helpful. If the tax return is examined and additional tax is proposed, it is important that you be aware of the various procedural steps that are involved.

Let us first consider the new corporate pay-as-you-go pattern. 1955 was the first year that corporations started a pay-as-you-go basis for income taxes. Just how does it work?

Unless we have a corporation which can reasonably expect an income tax for its taxable year in excess of $100,000, we can forget about this. The necessity or requirement for a declaration comes into play only where a corporation can reasonably expect a tax in excess of $100,000.

If that is the case, the corporation is required to file a declaration and pay specified percentages of the excess over $100,000 on or before the 15th day of its ninth month, which would be September 15 in the case of a calendar year taxpayer. This starts with taxable years ending on or after December 31, 1955.

The percentages which must be paid will increase so that by 1959 we will reach a maximum position. For example in 1955, if a corporation estimates it will have a tax liability of $135,000, it is required to file a

declaration on September 15 and pay 5% of the $35,000 excess, or $1750. Another $1750 must be paid on December 15.

By 1959, corporations will be paying in advance 50% of the excess over $100,000.

Starting with 10% in the calendar year 1955, the percentage payable in advance rises in graduated brackets until 1959, when the two installments total 50%, or 25% in September and 25% in December.

What are the penalties if corporations do not comply with these requirements?

The penalty is similar to the penalty for individuals—that is 6% of the underpayment in installments. The penalty is not on the failure to file, but is on the failure to pay within certain specified limitations.

Is this penalty deductible?

Perhaps the only thing worse than incurring an expenditure unnecessarily is incurring an expenditure which cannot be deducted for tax purposes, and this 6% penalty is definitely a penalty. It is an addition to the tax and it is not deductible as interest.

How can a taxpayer avoid the possibility of the penalty?

There are four basic methods of avoiding it. First of all, the penalty itself is not invoked unless there is less than 70% of the required amount paid in. In our example, we estimated we would have $135,000 tax for the year. If in fact it developed that we had $150,000 tax, we would be all right because we had paid the two installments of $1750 each. Seventy per cent of $50,000 would be $35,000, and we would be within the limitation.

Of course, this involves much estimating and guesswork and there are mechanical tests available to obviate the necessity for that guesswork. The simplest, although sometimes a more expensive one, is paying on the basis of the prior year's tax. If you pay with this year's declaration a tax equal to that of last year, there can be no possibility of penalty. Another is to compute an estimate for this year on the basis of the facts reflected in last year's return, but using this year's rates, and for individuals, exemptions. Finally, there is a relief provision for corporations which expect to earn heavily in the latter part of the year in that they are allowed to annualize their income up to the sixth or eighth month preceding filing date and compute their declaration on the annualized income.

With all of those alternate procedures available, it seems there is not much excuse for the penalty being incurred. Let us assume that

a company would not be liable for a penalty on the basis of income actually reported on its tax return. Several years later, however, a revenue agent comes to examine the return, and the result is that taxable income is materially increased. Would this taxpayer then become liable for penalties, because actually then he did underestimate?

The 1954 Code very clearly settles an area of uncertainty in that respect. The penalty is based on the tax shown on the return, not on any increased or audited amount developing in subsequent years.

Can a company escape penalty by filing a low estimate in September and making up for it in December?

This old device will no longer work for a corporation or an individual. Each quarter must stand on its own feet and be subjected to its own test.

Let us talk about a technical point in connection with these declarations. Suppose a company had less than $100,000 tax in 1954. Does it have to file an estimate for 1955 even though it knows it will have a tax way over $100,000?

There is a technicality here. Actually, the law requires that a declaration be filed under the circumstances you outlined, because it specifies that any corporation anticipating a tax over $100,000 is required to file a declaration. However, there are no penalties for failing to file. The penalties are based on failure to pay. Under these facts, assuming the prior year was not a short taxable year, there would be no basis for a penalty, since an estimate based on the prior year's income would indicate no payment was required. While there may be technical violation of the spirit of the law, there is no effective penalty.

On the basis of its 1954 income, a company would have been taxed $500,000. Because of losses in 1952 and 1953, which were used in 1954, it paid a tax of only $150,000. How does this affect the rule of using the prior year's return as a basis for the current year's declaration?

It does not alter the rule. The rule is, very clearly, that the current year's declaration can be estimated on the basis of the prior year's return's facts. Of course, that can cut both ways. You have given an example of substantial operating loss carryovers reducing the tax in 1954. You could have extraneous income items in the 1954 return, such as large capital gains, and you still have to comply with the requirement of using the return as it appears.

Can the company still base its estimate on last year's tax return even though it knows right now that this year's tax or income will be substantially higher?

Yes. There again, we may be in technical violation of the spirit of the law, but as you have outlined it, there is clearly no penalty.

The big objection to the withholding program for corporations was that it would deplete the liquid capital of corporations, and, assumedly, many corporations found it rather difficult to meet their payments. Can extensions of time be obtained for filing declarations?

Yes, extensions up to a maximum of three months can be obtained on filing declarations, but ordinarily they are not granted for a period longer than one month. The extensions can be obtained only on the basis of written application which shows undue hardship, not merely financial inconvenience.

What about the payment of the tax?

The same financial inconvenience rule won't get you by on an extension of payment, although the law does provide that a six months' extension may be granted.

Is there any penalty or interest?

Surprisingly enough, this is one case where there is no interest charged on deferred payments. But the 6% penalty, which is far worse, is automatically invoked.

Let us talk about filing returns. When is a return considered filed—when it is placed in the mail or when it actually reaches the government?

The 1954 Code carries a very clear statement that all documents, with the exception of certain court documents and, specifically, tax returns and declarations, may be considered as filed when they are placed in the mail. Please note the specific exception which has to do with returns and declarations. It is not sufficient to place them in the mail to consider them filed. They must reach the district director's office on or before the due date. There has been a misconception among a great many people, brought on by frequent special local circumstances where a district director would advise close to filing date that he would accept returns as being on time even if they were postmarked up until midnight of the due date. That is by option only; it is not part of the law and cannot be relied on. Bear in mind that the returns are not filed until they are in the hands of the district director.

If the return is not filed until it is in the hands of the government, how can a taxpayer actually give proof of timely filing?

Perhaps the surest way would be to deliver the return personally and perhaps to have the district director's receiving stamp affixed to a copy of the return or an appropriately descriptive transmittal letter. Obviously this is not feasible in the majority of instances. The next best thing is registered mail with a return receipt requested.

What can a corporation do if it does not have time to file a return before the due date?

There is provision for an automatic six-months' extension of the due date obtainable by filing a proper form. The form can be filed not only by a duly authorized corporate official, but also any attorney, CPA, or agent who is registered to practice before the Treasury Department may file on behalf of the corporation.

As a general rule the government has three years after the filing of a tax return for the assessment of any additional tax. However, if income is omitted in an amount exceeding 25% of that stated in the return, the government's time period extends to six years. In figuring income for this six-year rule in measuring your omission, do you use sales, or gross profit on sale? What is the basis of the 25% figure?

Here again, an area of uncertainty has been cleared up in the new law. The 25% omission test is based on gross income, not gross profits. That would be gross receipts, gross sales, rental income, and so on. A word of caution: Frequently we hear the term misused. People think in terms of a 25% omission of the taxpayer's income. That is not correctly stating the rule. The rule applies where there is an omission of an amount equal to 25% of the amount reported. For example, if $80,000 gross income is reported in a return, and it is determined that $20,000 has been omitted from gross income, the 25% rule has been violated, even though the figure I used is actually only 20% of the taxpayer's income.

Suppose the company feels that a significant item is not properly includable as income but it appears that the government may take an opposite viewpoint. How could that company protect itself from the possibility of giving the government an additional three years in which to make an assessment and lengthening the statute from three years to six years because of the 25% rule?

It is sufficient to affix a statement or a schedule to the return stating the facts surrounding the omitted income. In prior years this was an area of controversy and the Commissioner successfully contended that the income had to be actually included in the gross income on the return even though you might turn around and deduct it under deductions. It was not adequate merely to attach a statement. Now it is clearly adequate to attach an explanatory statement to the return.

Once a return is filed, there is always the contingency that an examination by the government might result in an additional assessment. Is there any way to obtain a quick examination of returns for past years in order to have them closed?

Yes, there are certain specified types of returns where examinations can

be accelerated. That is true of decedents' returns filed by executors on behalf of estates, and, important to our immediate discussion, returns filed on behalf of a liquidating corporation. Under those circumstances, application can be made to the Treasury Department for early examination, and the Department is given a period of only eighteen months from the date of filing such application to determine and assess a deficiency in lieu of the usual three-year period.

It happens now and then, after a return is filed, that a taxpayer ascertains or believes that he is entitled to some of the tax back. Therefore he may want to file a refund claim. How long does a company have to file a refund claim?

Refund claims may be filed at any time within three years from the due date of the return or two years from payment of the tax. Note that it is based on due date, and that does not include extensions. Do not be trapped by having filed a return under extension and think that you have three years from the extended date. I might say also that there are one or two important relief provisions afforded concerning bad debts and worthless securities, where as long as seven years may be allowed because of difficulties in ascertaining the year in which such items became worthless. A seven-year period rather than a three-year period is available.

Are there any drawbacks which should be kept in mind in filing refund claims?

File a claim for relief on a relatively minor item and you may later wish you hadn't, because there may be some other larger and very questionable items in the return. We should be very cautious, of course, in this case. The return is going to be subjected to a much more intensive review than it might have otherwise received. In many cases it might not have been audited at all. Certainly when a claim for refund is in the offing, it is human nature to expect the examiners who work on that return to see if there are other items which might offset the refund claim.

That is quite obvious, for it is apparent that Uncle Sam will give nothing back without making very sure that something is not due the other way! In the ordinary case, the government has three years after the filing of the return in which to make additional assessments. What happens if the government finds that it needs more than three years? Can it have additional time?

Actually, there is no way it can have additional time, except by mutual agreement. The taxpayer and the government must both agree on any extension of time. If they do, any amount of time can be obtained within which to examine the returns and assess beyond the normal assessment period.

Suppose a taxpayer consents to an extension of time for the government to levy additional tax. Does this also extend the time within which the taxpayer can claim a refund?

Yes, it automatically extends the time to six months beyond the expiration date of the extended assessment period. There is an exception to this rule, however, where the return was filed under extension.

Suppose a revenue agent has some substantial ideas on additional income that he thinks belongs in our return. Could you outline briefly what a taxpayer's position is from that point on?

Your statement of the facts eliminates one large area of return examination. Simple or small returns, for the most part, are subjected to internal review in the Treasury Department. When questions arise, the taxpayer is invited to come down to explain himself, and settlements are effected in that fashion.

You have given the example of a larger and more complex return. That examination is normally conducted in the taxpayer's offices or in the offices of his tax representative. The agent reviews the return, and if settlement can be effected, the matter ends at that point, except for having to pay. Probably the best place to settle a tax case still remains in the field, in my opinion. It is usually the less expensive, less troublesome place of settlement, unless you have major issues involved.

If you cannot agree with the agent, you are now afforded the opportunity of what is known as a group supervisor conference. It is based on a ten-day letter issued by the agent wherein he sets forth his proposed findings. It is not a detailed revenue agent's report; it is a mere summary of his proposed findings. It affords the taxpayer a period of ten days within which to request an audience with the agent and his immediate superior or supervisor. That conference is held in the offices of the Treasury Department, with the agent and his supervisor both present.

Here again, if agreement cannot be reached on the issues, the taxpayer then receives a thirty-day letter, which gives him a period of thirty days within which to file a written formal protest with the Audit Division of the Treasury Department. That protest, among other things, sets forth the facts and arguments and requests a conference. The protest is referred to the Appellate Division of the Treasury Department, which is a separate unit and as such can take a more detached view of the whole matter.

There you have the opportunity of meeting with experienced conferees at informal levels to thrash out the various issues involved.

Finally, and this is the next and final step of the administrative procedures, if a settlement cannot be effected at this Appellate Division level, then a statutory notice is issued which gives the taxpayer a period of ninety days to either pay his tax and seek a refund by suit in the District Court or the Court of Claims, or not pay his tax and elect to go into the

Tax Court. This is beyond the scope of our review of administrative procedures.

At that point we get into what amounts to judicial procedures and your attorney should guide you from that point on.

Now let us assume that, as a result of all these procedures, we have an assessment of additional tax for 1953. But in 1955, our taxpayer had a loss which, if carried back, would wipe out all the 1953 tax. Must he still pay the 1953 tax, and then claim a refund?

No, provision is made for filing, with or after the filing of the loss year return, an operating loss carryback claim. That tentative carryback claim, as it is known, gives the Treasury Department ninety days within which to make a preliminary review. Unless there are obvious errors or items so complex that they cannot be reviewed properly in the ninety day period, the resulting credit is used to offset any tax liability which may be due at that point, and, if there is still an excess, it is refunded to the taxpayer.

You said that the 1955 loss would wipe out the 1953 deficiency. Would it relieve the taxpayer of the interest on that deficiency?

No, it would not. The interest on the deficiency will nonetheless be payable even though the deficiency itself is wiped out by the carryback.

Suppose a corporation early in 1955 experienced heavy losses from storm damage, and still has an unpaid balance on its 1954 tax. Must it continue to pay the 1954 tax and wait until 1956 to claim a refund?

No. There is a very useful relief provision. I believe many people lost sight of it, thinking it went out with the war years. It did not. Regrettably, it applies only to corporations and not to other taxpayers, but, as I say, it can be a very helpful device. The law permits filing a form on which a corporation can anticipate a carryback loss. Such filing will defer the unpaid installments of the preceeding year's tax. It does not permit a refund, but it does permit a deferment.

You cautioned that a return might be examined more intensively in those instances in which a refund claim was filed. Are large refunds subject to review other than this?

Yes, protective measures have been set up for a combination of reasons, including uniformity. Large refunds (those which exceed $100,000) are subjected to special review by the Joint Committee on Internal Revenue Taxation in Washington.

The tax law is so complex that there are still instances in which the effect of a particular transaction cannot be predicted exactly. Suppose the tax effects are very important in a transaction, and the taxpayer

would like to determine in advance the tax effect of a merger or similar transaction. Will the government give an advance ruling?

They will. The mechanics are set up whereby advance rulings on the tax effects of transactions can be obtained.

Suppose the transaction already has been completed. Will a ruling be given in that instance?

Ordinarily yes, unless the transaction is nothing more than a recurrence of a transaction which was already under scrutiny for a prior year or a transaction which did appear in a prior year and is already under the control of the local district director.

Are there any dangers, disadvantages, or drawbacks to requesting a ruling?

There are definite dangers as well as benefits. If the transaction under review is not too complex and the return is not too large, it is entirely possible that the transaction will be subjected to only casual review by the examining agent and may never form the basis of any controversy. Therefore, when we go to Washington to request a ruling, we are deliberately jeopardizing the transaction in subjecting it to a spotlight treatment. In a consummated transaction, if the department rules against you, you are "in the soup." You cannot back out. A copy of the ruling goes to your own collection district and you are in an unhappy condition. Therefore, prospective transactions are much more suitable for ruling requests.

If a taxpayer feels he should request a ruling despite all possible adverse effects, what are the mechanics of going about that?

I might say, as a preface, that it is my feeling that we out in the hinterlands do not avail ourselves as much as we should of the ruling request procedures. I do not mean that we should dash to Washington with everything that happens to us about which we are uncertain or unhappy. I do think that where a major transaction is involved, and where tax results can be very severe if handled wrong, or could even prevent a whole transaction, then we should avail ourselves more frequently of this procedure which is established for the obtaining of rulings.

To start a ruling request, I cannot overemphasize the desirability of setting up an informal conference with the particular unit in Washington which would handle the request, and spell out what you plan on doing, how you reason, and get the reactions of the very people who are going to handle it. It sounds a little time-consuming to go through all that before the ruling is ever filed, (and it may never be filed as a result), but it pays dividends to have a man-to-man meeting with the person who is going to consider the thing. Very possibly you can eliminate much uncertainty as to what you should put in your application request.

From the very outset you can comply with what the examiner feels should be the minimum statement of the facts surrounding the problem.

There are, of course, rules and regulations concerning what should be put in. These include a complete statement of the facts, a statement of the part of the law on which you base your conclusions, and a clear statement as to the business reason, since rulings will not be given on a mere tax device. The written ruling request is filed and again you are given the opportunity to confer, and again, the personal discussion is highly desirable.

The following questions were submitted by registrants.
Mr. J. S. Seidman was moderator.

What has been your experience as to the value of the group supervisor's conference procedure?

My personal experience has been that in our area the group supervisor's conference procedure has not worked too well. I do not believe the reason is lack of conscientiousness, or integrity, or effort on the part of the agents or the group supervisor. I believe they have made a determined effort to make the procedure work. Common sense indicates, however, that unless you have a rare case of an agent who is blind to the facts, or does not have all the facts, or distorts the facts given to him, we must assume that the agent has given the group supervisor a fair portrayal of those facts. After the group supervisor has studied the facts and arrived at a decision, I do not think there is much chance of his changing his mind. Consequently, we have not experienced too much use for the group supervisor method.

What happens if a taxpayer refuses to sign a waiver extending the three-year statute of limitations?

Common sense injects itself here. The government is armed with several proceedings, the most effective of which is the jeopardy assessment proceeding which can be levied at the last moment, and which might disallow any or all deductions. You may be faced with the necessity of proving them one by one. So you cannot very well refuse. It is also a "can't win" proposition in that if you do cooperate you are going to be subject to interest, because those returns on which there are extensions outstanding are invariably going to be laid aside to get to more pressing matters, and the first thing you know you are being asked for another extension.

I understand the procedure to be that a revenue agent is not authorized to ask for a second extension without the expressed approval of his group supervisor.

A deficiency notice is received as to a minor tax deficiency which the

taxpayer readily admits to owing. Can the taxpayer use the deficiency notice to go into the Tax Court in order to contest the Internal Revenue Service disallowance of a much larger claim for refund?

That depends upon the phrase "admits to owing." If he actually admits it in writing, there is no longer any deficiency and he can not get to the Tax Court. Assuming, as I think we should, that there is going to be a deficiency, he can very definitely get into the Tax Court not only on that issue but on all issues. As a matter of fact, he must, in allowing this to go to the Tax Court, bring up all issues. That is where the final determination is going to be had, and he could not attempt later on to process a claim for refund and hope to get the same year litigated in the District Court, for example.

Well, I think the question deals with the fact that there is a deficiency notice and the only item in the deficiency notice is something that the taxpayer is ready to acknowledge, in his petition, that the government is right on. But, the taxpayer then says, "I have a lot of items that the government is not right on. They are all reflected in my refund claim." Now, the question is, under those circumstances, is the taxpayer still properly before the Tax Court?

Definitely yes—on all issues.

A claim for refund is filed on the last day before the running of the statute of limitations. The government makes examination after that date. Are they barred from making additional assessment, or does the filing of a claim for refund keep open the three-year period?

In some cases the procedure you outline may be considered normal prudence. Where the taxpayer can stand it, filing claims for refund may be delayed. If and when a return is examined, the refund issues can be raised with the agent. If the return is not examined, a claim for refund can be filed at the very last moment. After the claim has gone through its preliminary processing, it may be too late for the Commissioner to assert an additional deficiency.

The filing of the claim for refund does not extend the statute. The only thing that is permitted then is for the Treasury Department to bring up any and all issues they want to to the extent of overcoming the claim. They cannot go beyond it and collect a net deficiency.

You spoke of getting rulings in Washington. Is it necessary that all rulings be obtained in Washington?

There are actually three classes of "rulings." The most formal is the "closing agreement." That is, by statute, absolutely binding on both taxpayers and the government and has to be obtained in Washington. In the ordinary case such an agreement is not needed because the Treasury Department has very rigorously stuck to its policy of not going

beyond its own rulings, unless there is a showing of bad faith or something of the sort. Consequently, the ruling, as it is generally defined, is usually adequate.

Under the decentralized setup that we have, local district directors are empowered to grant rulings known as "determination letters" in certain limited cases. It cannot be a prospective transaction; it must entail something which has been the subject of a ruling in a regular Revenue Bulletin, and there are other limitations on the district directors' authority to grant determination letters. A determination letter once granted, however, would be just as binding on the government as a formal ruling out of Washington. So it is not necessary for non-policy, consummated-transaction rulings to go to Washington. But a matter which is complex and serious usually must be ruled on in Washington.

You said that an extension of time for assessing an income tax deficiency extended also the time for filing a claim for refund. This is not necessarily true, is it, if the return was filed late with an extension?

That is correct—a very bad flaw in the law exists here. If, for example, a calendar year 1955 return were filed under proper extension on, say, June 15, 1956, the Treasury Department could assess a deficiency against such a return as late as June 15, 1959, or on that date could enter into an agreement with the taxpayer extending the period of assessment. However, such assessment extension period gives the taxpayer six months after its expiration within which to file a claim for refund *only if the extension agreement is executed within three years from the time the return was required to be filed, without taking into consideration any extension of time for filing.* So now we have a situation where the Treasury Department is in the position of making an assessment but the taxpayer is barred from filing a refund claim. Of course, in the event a deficiency were proposed, the taxpayer could bring into play, as an offset, any items which would have been the grounds for his claim, and in the event a deficiency were paid, claim for refund could be filed within two years from its payment, the amount recoverable being limited to the amount paid during the two years preceding the filing of the claim.

Planning the Businessman's Estate

PANELIST—LEONARD PRICE

MODERATOR—J. P. GOEDERT

Just what is the federal estate tax?

The federal estate tax is a tax levied on the property owned by an individual at his death. Each asset is inventoried and valued, and the aggregate is then subjected to tax at graduated rates which range from 3% to 77%. At the $100,000 level the rate is about 30%. The property is reduced by the debts owed by the individual; it is reduced by the funeral and administration expenses of the estate; and it is further reduced by an exemption specified by law.

How much is that?

That exemption is $60,000. It is the same as saying that anyone who dies with less than $60,000 is not subject to the estate tax. In the case of decedent who owns more, the first $60,000 is tax free.

This is an estate tax which covers only property in the estate at the time of death. Can a future decedent get away from that by giving away his property during his lifetime?

Very definitely; that is an ideal estate plan. What you give away during your lifetime, you do not have at death and therefore under general circumstances is not subject to the estate tax. The only thing you must be careful about is that what you give away is a gift, and we have a federal gift tax.

What is the federal gift tax?

It is a tax related to the estate tax, but it is figured differently. For one thing it is figured on an annual basis. It is figured on all of the gifts made each year, except that there are certain exemptions. In the case of each year's gifts to any one individual, $3,000 is exempted. Of the balance which is not exempted, each donor also has, during his lifetime, another exemption of $30,000. After these two exemptions have been utilized, the balance will be subject to tax at graduated rates which are less than the estate tax rates (in fact, they are three-fourths of those rates) and they will be subjected to tax cumulatively.

Let us assume that in a particular year an individual has made gifts which have now exceeded all his exemptions. Let us say his excess is now $10,000. He pays a tax on that $10,000. Now the next year comes along and he makes gifts of another $30,000, which are in the taxable category. The tax is figured on the total he has given, $10,000 plus $30,000, or $40,000. After the tax on $40,000 is determined, you subtract the tax originally paid on the first $10,000, and the difference is what he pays on the next $30,000.

So we pay an estate tax and a gift tax. Do gifts still have advantages tax-wise, even though we pay these taxes on them?

They most certainly do. The giving of gifts, as I indicated, is a very important element in estate planning. The reasons why gifts are advantageous are numerous. In the first place, as I indicated, the rates are less. In the second place, and this is a most important consideration, what you give away during your lifetime comes off the top of your estate, just as the cream comes off the top of a bottle of milk. If a man who would have died with an estate of a million dollars has given away $100,000 during his lifetime, so that he ends up with only $900,000, that $100,000 comes off at the top rates. But $100,000 subjected to gift tax is taxed from the bottom up, at the graduated increasing rates. Actually, given the figures, you can equate this and find out how much saving results from gifts.

There is another factor which is also a tax saving, and that is this: If an individual has given away money during his lifetime, and paid a gift tax on it, that gift tax itself is no longer part of his estate. When he dies, there is a saving of the estate tax on the amount of gift tax which has been paid.

So in effect you get a deduction for estate tax purposes of the amount of gift tax paid.

In the field of income taxes, we have the principle of combined returns for husband and wife with a resulting tax saving. Is there a similar principle in estate and gift taxes?

There is. The principle is the same, although we do not have a com-

bined return in that sense. In estate taxes, the family entity is recognized in this way: Property left to a spouse—husband to a wife or a wife to a husband—is exempt from the estate tax up to one-half the estate.

In the case of the gift tax, there is a different situation. If an individual makes a gift to his spouse, only one-half is taxed. If an individual makes gifts to other parties, his spouse may consent to have one-half those gifts treated as if they were gifts of the spouse.

What effect does the splitting of gifts between husband and wife have on combined exemptions?

This has a tremendous effect in the case of gift tax. Whereas the exemptions are $3,000 per year per person receiving the gifts and $30,000 for the donor during lifetime, if the husband and wife get together and consent to treat gifts made by both, each year the family gifts to each individual are exempt to the extent of $6,000 and there is a combined lifetime exemption of $60,000, instead of $30,000.

Can you clarify the status of gifts to a wife?

It is not possible to have a wife say that one-half of what a husband gives her, she gives herself. Nevertheless, it was intended that the effect be reached. It is a principle of our gift tax law that only one-half of gifts made to a wife are treated as being subject to tax. This means that if an individual gives his wife $6,000 in any one year, there is no tax consequence because the gift is first halved, making it $3,000, and then the $3,000 exemption comes into play.

In your initial definition of the estate tax, you used the terms "valuation" and "value of estate assets." In trying to determine the size of an estate for tax purposes, what are some of the things that do not readily meet the eye and are therefore easy to overlook, but which are in fact part of the taxable estate?

I am glad you asked that, because I left an impression that all that is done in determining estate tax is to add up the property, the cash, the securities and so on. There are items which are included and are subject to the tax even though the ordinary businessman might not expect it. This can be illustrated first by an insurance policy payable to a wife or children. We would not think of that as part of the estate because the disposition is not covered by the will; it already has been taken care of. But such a policy may be includable in the taxable estate. Second, suppose a man owns property with his wife, or in an arrangement whereby on the death of one, the other takes over. In that event, again, the property is not covered by the will but is subject to estate tax. There are situations also where an individual dies, and although he does not own particular property, he had during his lifetime a right to say where that property was to go; he had a certain control over it. In many in-

stances, such powers are subject to tax. A fourth and last illustration is the case of a man who gives away property, by making the gifts we have been talking about. He dies within three years of that time and it is later established that his reason for giving the gift was that he was anticipating death. We have a technical term for these: "gifts in contemplation of death." Where it is established that a gift was in contemplation of death, it is subject to the estate tax even though the property had been given away.

The property had been given away, but apparently it had been subject to a gift tax. Are such items subject to both gift and estate taxes?

No, we do not double up. The property is subject to estate tax, and there is a provision for allowing a credit against that estate tax for the gift tax paid during lifetime.

You will recall that in speaking of savings on lifetime gifts, I pointed out that there is no estate tax on the amount of gift tax paid. That even applies if it is subsequently determined that this was a gift in contemplation of death and subject to the estate tax. So, on certain occasions, it is worth making a gift even though that gift may later be deemed to have been in contemplation of death because tax-wise there is no loss. The item may be taxed for estate tax purposes but you get the credit for the gift tax paid, and there is the saving of the estate tax on the amount of gift tax paid.

Let us illustrate some of these points with an example. Suppose a taxpayer has a $120,000 estate and he leaves one half to his wife and one half to his children. What estate tax would he have to pay?

No tax at all, because as I indicated, there is a $60,000 exemption and I also mentioned earlier that property given to a wife is exempt up to one-half the estate. We now have developed a second principle: An individual owning $120,000 worth of property can avoid tax by leaving half to his wife.

Here is a more complicated example: Suppose a married man with four children has an estate of $240,000. He makes gifts to each of these four children of $20,000 in one year, or a total of $80,000. The next year he gives each child $10,000, or a total of $40,000. Up to this point over a period of two years, he has given away $120,000 of $240,000. In his will he provides that his wife receeives half of the remaining $120,000, and the other half goes to his children. What is the estate and gift tax in that situation?

You have given me a tough computation in the sense that it is detailed. I will try to outline it. During the first year the man gave gifts to four children of $20,000 each. He is married and I am assuming his wife consents to splitting the gifts so that of each $20,000 gift, $6,000 is exempt.

That leaves $14,000 that is tentatively taxable: a total for the four children of $56,000. I indicated earlier that each family unit has a $60,000 lifetime exemption. The $56,000 may be applied against the $60,000, and at the end of the first year there is no gift tax. There still is $4,000 of the $60,000 exemption remaining.

In the second year each child received $10,000. It is another year, so on each gift we may again eliminate $6,000, leaving $4,000 tentatively taxable. Four times $4000 is $16,000, of which $4,000 may be applied against our remaining lifetime exemption. We have left $12,000 of the $16,000 subject to tax. The tax on $12,000 is not substantial.

At this point — the end of two years — the individual has given away $120,000. We will assume that he lives long enough to avoid complications from the contemplation of death rule. When he dies, he gives $60,000 of the remaining $120,000 to his wife; that is exempt. The remaining $60,000, as I previously indicated, is exempt under the law, and there is no estate tax.

In this rather involved example you have given me, an individual has disposed of $240,000 under a plan to his wife and children with only a very nominal gift tax.

That demonstrates the importance of planning. From an income tax standpoint, what is the difference to the recipient between receiving property as a gift or through an estate? Suppose a husband owns stock which cost him $1,000. At his death it is worth $10,000. It has appreciated $9,000. His wife is the recipient, and she sells the stock after his death for $10,000. Does she have income tax? Would the situation be any different if, instead of inheriting the stock, she had received it as a gift from her husband at a time when it was worth $10,000?

I will answer the second question first by saying, yes, there is a difference. In the case of property which a wife receives by inheritance, the value at the time of her husband's death – the value which is used for estate tax purposes — becomes the cost to her for income tax purposes. If the husband dies, leaving property worth $10,000, and the wife subsequently sells it for $10,000, she has no gain and there is no income tax.

The rule is not the same in the case of a gift. The cost of a gift to the wife is the same as the cost to the husband. In your case the cost was $1,000. That is true even though the property was worth $10,000 when the gift was made and even though the gift tax was figured on that $10,000 value. In the case of a gift, the cost to the person giving the property remains the cost to the person receiving it. In this case, when the wife later sells it for $10,000 she has a tax on the $9,000 gain.

In other words the appreciated property in an estate actually avoids income tax liability on that appreciation.

That is right. As a part of estate planning, wherein it is expected

that gifts will be made, thought must be given to choosing the right property that will constitute the gift. Usually you choose property that has a high cost in relation to the value of the gift that is being made.

In discussing the imposition of the estate tax, I received the impression that such a tax would be levied on every estate. Suppose a father dies and leaves his entire estate to his son. Five years later the son dies. Must the tax be paid all over again on the son's estate since it is the same estate?

No, not entirely. The property was owned by the son when he died and would be included in his estate in figuring his tax. The law now contains a provision that where property is received by inheritance and the individual receiving it dies within ten years of the person from whom he inherited, the entire amount is not subject to tax but only a percentage based on the elapsed time between the two deaths. In other words, there is a credit in the second estate for some of the tax paid in the first estate.

What if the son did not die until fifteen years after his father?

If it exceeds the ten years, the property will be subject to full tax the second time.

Suppose that instead of leaving the property outright to the son, the father was advised to leave the estate in trust, with the income to go to the son, and on the son's death, the trust assets to be paid to the son's children. Must estate tax be paid on this when the son dies?

Generally speaking, no, since the property was not owned by the son but went directly from the grandfather to the grandchildren. There is no tax on the son's estate. In fact, this device is commonly called the "grandfather trust." The property is taxed only once when the grandfather dies. Ultimately it goes to the grandchildren without being taxed when the son dies.

You mentioned earlier that insurance may be a part of a taxable estate. Let us talk about insurance insofar as it affects estate planning. First, an income tax question: Suppose an executive takes out a policy for $10,000. He pays a premium of $1,000 and then dies. His estate collects $10,000. Is the gain of $9,000 subject to income tax?

No.

Is the $10,000 collected on the policy subject to estate tax?

Yes, it is.

Could the decedent have handled the insurance policy so that it would not have been taxed as part of the estate?

Yes. He could have given it away. An individual can give away an

insurance policy which is payable to a named beneficiary other than his estate. By giving it away, I mean that he retains none of the rights which attach to that policy. He cannot borrow on it; he cannot change the beneficiary; he no longer has any ownership rights. Upon his death that policy will not be included in his estate. As a matter of fact, under the new law that policy will not be included in his estate even though he paid premiums before he gave away the policy and even though he continues to pay premiums after he gives away the policy.

This is a very, very favorable provision in the law as it stands today. An individual can give away an insurance policy, retaining no rights whatsoever, and may continue to pay the premiums without the insurance proceeds being included in his estate. Just how long we will have that favorable provision in the law, I do not know. At present we have it.

Insurance can be paid in several ways: lump sum, installment, left on deposit, etc. Are there any income or estate tax advantages that would lead you to leave it one way or the other?

Insofar as the estate tax is concerned, I would say no. The value of the proceeds of the policy is included in the estate if this is a policy which is included in the estate. However, there are certain income tax consequences to the beneficiary depending on how the proceeds are collected. If the proceeds are collected in a lump sum, that is the end of it as far as the insurance is concerned, and we do not have any income tax problem. If the proceeds are left with the insurance company on deposit and the insurance company pays interest, then that interest is treated as taxable income. If the proceeds of the insurance are left on some installment basis, then the total of these installments is computed, and compared with the face of the policy. The excess is deemed to be an interest factor and is taxed ratably over the years.

Now the law does have a provision very helpful to widows and widowers. Of this interest factor, $1,000 each year is exempt. That only applies to a surviving spouse.

It is apparent that even the method of paying insurance has tax-planning implications.

Some insurance people have been advising plans whereby instead of taking out ordinary life insurance policies, the insured would take out a ten-year endowment policy and would finance the payment of the premiums by bank borrowings. The argument is given that this presents definite tax advantages and results in a much larger estate. What are your ideas on that?

This sort of an arrangement has a purpose. Just as the proceeds of insurance are not taxable for income tax purposes, so the premiums are not deductible. With a view towards getting an income tax deduction, many plans have been designed using the medium of borrowings to

change the character of the nondeductible premium payment to that of interest, which is deductible. Over a period of years there has been what might be termed a "tug-of-war" between the government and the taxpayers and their advisers in trying to close these so-called "loopholes," I am assuming that the plan you have outlined is one that is carefully drawn to comply with the law, in which event I would say it is all right. It is good planning to convert a nondeductible expenditure into a deductible one. However, any time this is done, I think it should be done with the knowledge that the day may come when the deductibility will be challenged.

Let us talk a little bit more about what goes into an estate for tax purposes.

Suppose an executive is covered by the profit-sharing plan of his corporation. Under the terms of this plan his wife would receive certain payments upon his death. Are those payments taxed as part of the husband's estate?

There is a rule in the law that where the individual has made personal contributions, then a pro rata share of the proceeds will be taxed. But in the type of arrangement which meets all the pension plan rules of the game, and where the employer pays the premiums, the proceeds upon death of the individual are not taxable.

Let us suppose an employee of a company dies and the company voluntarily paid a $5,000 death benefit to his widow. Is that death benefit taxable either for income or for estate tax purposes?

I give you a double-barrelled "no" answer in this case. No income tax consequences because the law says so, and no estate tax consequences since this is something that the company did voluntarily after death.

What if the $5,000 was part of a contract?

I am afraid that if this was a death benefit to which the individual had an enforceable right at the date of his death, it might be includable for estate tax purposes. In the case of income tax purposes, the answer is still "no."

Still on the question of the includability of assets in an estate, a common way of owning a residence or home is what is known as joint ownership, with the survivor taking all. Let us suppose that a husband purchases a residence and does put it in his name and his wife's name. What is the effect of that for estate tax and gift tax purposes?

Well, before the 1954 Revenue Act was enacted, it was usually claimed that when the husband put the property in the combined names of himself and his wife, he was giving a gift to the wife, although usually this was not his intention.

The 1954 law has clarified this situation most helpfully by saying that in such a situation there is no gift unless the husband wants it to be a gift. If the husband wants it to be a gift, he shows that by filing a gift tax return. However, for estate tax purposes, when the husband dies, even though he put this property in the combined names and even though the wife takes it outright, since the husband paid for the property himself, it is fully taxed in his estate.

From one of your previous comments, I got the impression that an estate was always valued as of the date of death. Let us suppose a particular asset, perhaps a security, had a value of $1,000 at date of death but shortly thereafter the market dropped and the stock declined to only $200. Is there any estate tax relief for that?

You do not have to "suppose" that the market dropped. In the history of the stock market we have had such situations, the most famous being the 1929 crash. There were cases where individuals died in 1928 or early 1929 when their securities were valued at a high point, and where after the crash there was not enough money left in the estate to pay the estate tax.

Today the law recognizes such a situation and provides that, at the option of the estate, the values may be either at the date of death or exactly one year after the date of death. In the case of any property which has been sold or disposed of within that period, the selling price is used for the valuation. This means, of course, that where an estate's values go down, where there is a depreciation within one year, there is tax relief.

In other words, you do have a certain range there. Now one more point on the question of value.

A businessman who has stock in a closed corporation or is a member of a partnership is concerned about the valuation problem, and is aware of the fact that it is entirely possible that a very excessive value might be put upon his interest. Now is there anything he can do in advance to establish that value for estate tax purposes?

Suppose, during an individual's lifetime, he makes arrangements for the disposition of his interest in a partnership or his stock in a corporation, either by way of selling it to his co-stockholders or his partners, or back to the corporation or to the partnership, and makes this a binding agreement which fixes the value or a formula for determining that value. As long as that agreement is real and not merely a sham, the valuation fixed therein will probably determine the estate tax value. I still say "probably" because the government looks upon these agreements with a jaundiced eye and they have to be awfully good — but it can be done.

I would like to re-emphasize that it must be a bona fide arrangement,

and it actually must restrict disposition during the individual's lifetime. It cannot be a mere option.

Now let us talk about financing the estate tax. This is another worry that every person subject to it has to face, or at least he has to plan and let someone else face it. When is the tax payable?

The tax is payable when the return is filed and that is fifteen months after the date of death.

Can we get an extension?

Yes, you can. The law provides for a six-month extension for the filing of the return, and in the case of payment of tax, upon proper showing, the law is extremely liberal and it is possible to get as much as a ten-year extension for the payment of a heavy estate tax. Now, of course, that does not mean that there is any waiver of interest, and if there is such an extension, the interest is still payable. However, it does relieve a little of the pressure.

What are the similar rules on the payment of gift taxes?

Of course, gift taxes are figured annually. Incidentally, gift tax is not only figured annually but also on a calendar year. You cannot have a business or fiscal year for gift taxes. So the gift taxes are now due April 15 of the following year and, again, the tax is payable with the return. As with most returns, the gift tax is one on which you can get an extension up to six months for filing.

Let us take another look at our taxpayer who is a stockholder in a closely held corporation or a member in a partnership. What arrangements can he make with his company or with his associates in order to help finance his estate taxes?

I just alluded to the so-called buy-sell agreements as a method of fixing the valuation. That, of course, is also a method of obtaining funds for the payment of the tax. Provision may be made to sell a partnership interest to the partners, or to the partnership, thus obtaining funds. Likewise, stock may be sold to the corporation or to co-stockholders.

In the case of redemption of stock by corporations, there is a specific provision in the law which exempts from any possibility of dividend treatment the payment in redemption of stock as long as the amount is limited to the amount necessary to pay the federal taxes, any other death taxes, and the administration expenses. Also, certain other technical rules of the game must be met.

We have covered a number of the principles involved in estate planning—some were intricate, some were simple. Just how does a businessman go about planning his own estate to the greatest advantage?

A businessman should go about planning his estate by first consulting

advisors. This is not something that can be done without real professional help. To the extent that an estate plan will involve the drawing of a will, or to the extent that it may be necessary to draw trust instruments and the like, it is obvious that the help of an attorney is going to be required. To the extent that insurance may be involved — either in determining the amount of the estate, or to provide liquidity (because that is another way to be certain you will have enough money to pay estate taxes) — an insurance underwriter will probably be a man to consult. Also, in the case of trusteeing funds, if the individual chooses a bank or a corporate trustee, he may want to consult a trust officer.

In addition to these problems, there is the basic question of determining how much tax will have to be paid at death: how much will have to be paid in the event you follow *this* plan, how much in the event you follow *that* plan; what assets will there be at the date of death; and how are they to be valued? And there are two problems inherent in every plan: (1) how are the assets going to be valued, and (2) what tax will be payable under certain circumstances? Of course, the individual who is best qualified to give the answers to those questions is the accountant, not only because they are part of his business, but the accountant is usually the advisor most familiar with the fiscal affairs. So my answer to this question is that in planning the businessman's estate, he must consult all of his advisors, not least of whom is his accountant.

I want to emphasize the importance of proper estate planning with the cooperative guidance of your certified public accountant, your attorney, your insurance underwriter, and your banker. They are all part of an important team. This is a team that can be very important to you and, more particularly, to your family.

Now one last point. Taxes are certainly an important factor in your estate but do not let taxes dictate your entire estate planning. Rather, determine your basic objectives—you know your family situation and what those objectives should be—and then pursue those objectives with an awareness of the tax implications that are involved.

The following questions were submitted by registrants.
Mr. J. S. Seidman was moderator.

If a decedent gives away an insurance policy without reservation so as to avoid the estate tax, is the gift of the policy taxed as a gift?

Very definitely, but I should point out that the cash surrender value of a policy is not necessarily the gift tax value. The amount of the gift will depend upon what the replacement cost of that policy would be.

If the donor continues to pay the premiums, are they charged against the annual gift tax allowance?

Yes, the payment of premiums in such a case constitutes a gift. Of course, unless there are other gifts, the donor can give away $3,000 a year in the form of premium payments without fear of gift tax, and if married he can give away $6,000.

Does a gift tax return need to be filed if a gift of $2,500 is made?

No.

Suppose the amount of the gift was $3,000?

The answer is still "no."

Suppose it was $3,001?

Yes, because you must then show the exemption, and the $1 may be subject to tax.

Please elaborate on the status of a home in the name of both husband and wife. Assume there was no gift. Is the home subject in full to the estate tax of the husband?

This is the situation in which a husband buys a piece of property, such as a residence, and places it in the type of ownership arrangement which is known usually as a "joint tenancy" or a "tenancy by the entirety." His purpose is that upon his death the entire property shall automatically go to his wife. The law now holds that the mere act of taking this property and putting it in that type of tenancy does not constitute a gift unless the husband wants it to. He may have some reason for wanting it to be, in which event he indicates that intention by filing a gift tax return. In either event, whether he treats it as a gift or not, if he dies still having the interest in that property, the entire amount is included for estate tax purposes.

Now you state that where property is owned in the entirety or in joint tenancy, the property is part of the decedent's estate for estate tax purposes, especially if it is a home held jointly and paid for by the husband. How can you plan to avoid the estate tax on this type of property jointly held?

The husband does not have to create that type of tenancy. For one thing, he could give one-half (or any fraction) or the entire residence to his wife, in which case there would be a completed gift and no problem.

A decedent leaves no will. His spouse is entitled to one-third under the law. Is there a marital deduction?

Definitely. The marital deduction does not depend upon the will. The wife takes the property by operation of law and the property will qualify for the marital deduction.

Is the optional valuation date for estate tax purposes selective as to different pieces of property?

No, absolutely not. It is all or nothing. You either take the date of death or one year thereafter.

How does the wife indicate her consent to giving her share of a $6,000 annual gift to each child?

The law itself merely speaks about the consent being given. Actually, the gift tax return form has been so designed as to provide a space where the spouse will consent to having half the gifts treated as having been made by that spouse.

What would the tax be if I gave my wife $10,000 in any one year? And on what amount?

I think that what the questioner has in mind is how to determine the portion that is exempted and the portion that may be subject to tax. Since it is a gift to the wife, you immediately divide it by two – that leaves $5,000. You then subtract $3,000 (assuming no other gifts) and that leaves $2,000 which may or may not be taxable, depending upon whether there is any lifetime exemption left. We often speak of a $6,000 exemption for gifts to a spouse. Thus, you could have taken the $10,000, subtracted the $6,000, and then divided by two. You still would come out with the same answer: $2,000.

A gift of a large insurance policy is made to a wife. Should she die before her husband, how is the policy treated in her estate?

If a policy is given to the wife, absolutely and with no rights of ownership retained, she is the owner of that policy. Should she die first, then the value of that policy at the date of her death (not the proceeds) will be included in her estate. You can have some mighty funny things happen – a husband can give a policy to the wife and pay a gift tax. The wife dies first, and it is included in her estate. The husband is her beneficiary and he gets the policy back. He then wants to get it out of his estate, and he gives it to his children. Before he is through, three taxes may have been paid.

Is the beneficial interest of an employee in a qualified profit-sharing trust plan includable in the employee's estate?

I would say "no," unless payable to the employee's estate.

Can a plan between stockholders of a closely held corporation and the corporation to effect the redemption of sufficient stock to pay estate taxes be safely funded by a life insurance contract to provide the necessary funds for the redemption?

Yes. The fact of the matter is that such agreements for the redemption

of stock or the purchase of partnership interest are very frequently funded by insurance, and it is an ideal medium.

Would you advise a client over seventy-five years old to set up a charitable trust where he has already made major provisions for distribution of his estate in view of the new 30% provisions for individual contributions deductions?

Usually an individual sets up his own charitable foundation for one of two purposes. He may want to make charitable gifts, such as property in a closely held corporation, which he still wants to control and can control through the foundation, or he may want to level off contributions, that is making a large amount perhaps in one year and a lesser amount in another, depending upon his income, and nevertheless have the foundation give that money away separately. For the benefit of the 30% provision, it is not at all necessary to have the foundation. In fact it is better not to do so because the individual can pick his charities, whereas making a contribution through the foundation may raise a substantial problem as to whether the extra 10% is available. I would say that for a man of that age, unless he had some other motivation, the foundation is not the desirable means. He might as well give the money directly.

If a gift is held to be made in contemplation of death, does the donee recipient acquire the donor's basis or a basis equal to the fair market value at the date of the donor's death?

The new law now says that where a gift in contemplation of death is taxed in the estate, the basis is the value at the date of death.

Where the stockholder of a closely held corporation has acquired his shares at various times and prices, and, in a subsequent reclassification, a single certificate has been issued to him for the aggregate number of shares, and where the corporation has kept detailed subsidiary records of stock transactions, can the stockholder successfully designate the stock acquired on a specific date as the subject of a gift?

This is a time-honored question and always arises where various shares of stock are merged into one certificate. The question states there were very detailed records which would permit identification. That being so, I believe that by the proper written directions to the company to take the one certificate and separate it, part to be given away and part to be retained, a definite designation of the gift shares can be made as the donor wishes.

Tax Changes Slated for 1956

J. S. SEIDMAN

In looking at the prospects for a change in tax law, I think it is fair to approach it in the recognition that 1956, being 1956, will be affected by the presidential elections. The likelihood is therefore that emphasis will be placed on tax reduction for individuals rather than for corporations. In that respect, my guess is that there will be both increases in exemptions and reductions in rates. As far as exemptions are concerned, they will probably be increased from $600 to $700. As far as rates are concerned, I think that in the lowest brackets there will be a rate reduction of approximately 10%, and then the reduction will taper off and either expire somewhere in the middle-income brackets or reduce the very top bracket to 90% from 91%.

As far as corporations are concerned, I do not anticipate that any rate change will be made. The present 52% rate will continue. The only area of rate relief that I can envision for corporations will probably be for those that are doing business abroad. There my guess is that the rate will be reduced to 38% on certain types of foreign business.

So much for the broad, general pattern. Let us consider what is likely to be ahead in the technical area. This year Congress repealed the allowance of expense reserves and the deferment of pre-collected income. It may intrigue you to know that in 1956 both those provisions are likely to be brought back into the law. True, they will only be ghosts of their original selves, in that when they are brought back this time, they will be highly circumscribed in scope. Also, there will no longer be a concentration in one year of expense reserve deductions as well as the actual expenditures. My guess is that the actual expenditure portion, as it relates to prior years, will not be allowed at all as a deduction

in the year of changeover, but rather will be deferred for deduction until the wind-up of the company.

On depreciation, a problem has arisen under the present setup as to whether it is possible to depreciate assets below their salvage value. The government now, administratively, is taking the position that it can't be done. In my opinion this will soon be confirmed by law.

I also believe that in the new law you will find provisions designed either to eliminate traffic in loss companies, or certainly to squelch a good deal of it. The position that is likely to be taken is that no matter which way the form of the transaction runs, it will be treated as if the buyer bought assets rather than stock.

Stock redemptions have produced a few problems and a few inequities. The "family" has been very narrowly described at present so that brothers and sisters are not, for this purpose, considered as part of the family. My guess is that the new law will include them.

A tax-saving possibility still subsists in the purchase of bonds at a premium where the bonds can be called within a short period of time. I think you will find that the present opening is going to be completely closed.

Under the present law treasury stock can be freely disposed of by a company without gain or loss imputed to it. One Congressman has described that as being a tremendous loophole in the law. My own notion is that it is no such thing. To the contrary, it conforms with good accounting in that there is no essential difference between disposing of treasury stock and disposing of brand new stock by a company. Nevertheless, my guess is that the present rule will be eliminated and that we will go back to the old rules that attribute to a company gain or loss on the disposition of treasury stock where it is bought and sold in the same way as any other asset.

On the administrative front, a big change is ahead about returns to be filed. There has been proposed now for two years a plan that has to do with the integration of reports for social security purposes and federal income tax withholding purposes. I think it will pass in 1956. If it does, then instead of the detailed quarterly reports that now must be filed for social security purposes for each employee, and the withholding statements or Form W-2 at the end of the year, the social security reports will be eliminated and the W-2 put to work for both purposes. That will eliminate about 100 million returns.

Now I would like to indicate to you items that are likely to come up but that, in my opinion, will not be enacted.

You are going to hear a good deal about the averaging of income, instead of figuring it on a year-by-year basis. The American Institute of Accountants has testified before the Congress in favor of averaging. There is now a bill before the Congress that proposes a form of averaging. In my opinion averaging will not pass at this next session.

Along the same lines, it will be proposed that unused charity deduc-

tions and medical expenses be carried forward from one year to another. I do not think that it will pass at the next session.

There is a bill before the Congress to give the right of carryback and carryforward to foreign tax credits. I doubt very much that it will pass.

There will be a great push made in the next Congress to give self-employed people or partners the right to participate in pension programs, just as is now available to an employee. In my opinion, that will fail of passage, primarily because of the revenue situation.

Partnerships now have the right to be treated as corporations under certain circumstances. Corporations do not have the right to be treated as partnerships. Our organization has recommended that corporations have such a right. Effort will be made to put that into the law this next year. In my opinion, the law will emerge without that provision.

There will be a great to-do made about the fact that cooperatives today enjoy a tax advantage over commercial organizations, and that both ought to be put on the same tax wave length by taxing the cooperatives. In my opinion, that will not be done in 1956.

Inequities are alleged to exist in the present provisions about the transition from an accrual basis to an installment method of accounting. An effort will be made to deal with that area. Again, in my opinion, that will fail of passage.

Finally, another effort will be made to permit companies that compute their inventories on the last-in, first-out cost to value those inventories at market, if lower than cost. That is what companies on first-in, first-out can now do. In my opinion, the effort will not succeed this year.

Obviously, no special weight attaches to my point of view any different from the next fellow's. I am here indulging merely in a personal "guess-timate" of the prospects.

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