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Tax Problems

BEING MET IN TODAY'S

Mobilization

Economy

COMPLETE TEXT OF PAPERS PRESENTED AT THE 64TH ANNUAL MEETING OF THE AMERICAN INSTITUTE OF ACCOUNTANTS

ACCOUNTANTS AND THE BUREAU OF INTERNAL REVENUE .... John B. Dunlap
Commissioner of Internal Revenue

FEDERAL INCOME-TAX PANEL

Hal Canary
William H. Westphal
Russell S. Bock
Walter M. Bury
W. Waller Grogan
Charles N. Whitehead

EXCESS-PROFITS-TAX PANEL

J. S. Seidman
T. T. Shaw
Wallace M. Jensen

This is one of four publications containing papers from the Sixty-fourth Annual Meeting of the American Institute of Accountants which was held in Atlantic City, October 6-10, 1951. The complete list, and prices at which each pamphlet may be bought, follow:

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Tax Problems Being Met in Today's Mobilization Economy Price $1.00

See contents on page 3.

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AMERICAN INSTITUTE OF ACCOUNTANTS

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JOHN B. DUNLAP, a native of Dallas, Texas, has been Commissioner of Internal Revenue since last August. He has been in the Bureau since 1934. During the war, Mr. Dunlap served in the Army doing Intelligence work. He was released from active duty in 1945 when he held the rank of Brigadier General.

Accountants and the Bureau of Internal Revenue

by John B. Dunlap, Commissioner of Internal Revenue

IT IS ONLY FAIR that you, as members of the accounting profession, should know how your Commissioner of Internal Revenue feels in connection with certain matters, so that we can have a meeting of minds and come together on a common meeting ground wherever the occasion demands. It was my practice in Texas—and my division covered the state of Texas—to meet with the accountants and the members of the legal profession at every possible opportunity. I even encouraged them to come to us. I published a little bulletin and kept them posted with the latest developments and procedures that we were following in the Dallas Division and in the various collector's offices and I tried to make personal friends out of every one of them for the simple reason that I knew, as I now know, that the accountants in this country can do more to help the Bureau of Internal Revenue and that the Bureau of Internal Revenue can do more to help them when we understand each other and are friendly than could ever otherwise be possible. I want you to know that one of the first things I am doing is to try to encourage in all our divisions a very, very close acquaintanceship with our accountant friends.

There are a lot of things that are for the public good, and one of them is reflected in what I told my assistants and deputies in Washington. Every time they put one of these things across my desk for me to sign, so far, I have sent it back and said, "Rewrite this thing so I can understand it." I do that knowing that if I can understand it anybody can.

So I want to repeat that I am looking forward to a very happy relationship with my friends in the accounting profession because we have very, very many mutual problems that face us all. We have one very common meeting ground, and it has been a ground which has not been plowed thoroughly on the part of Internal Revenue, and that is that it should be to both of our interests to see that the citizens of the United States pay only their just taxes. I don't like chiselers and I don't like to see any internal Revenue agent make an assessment or recommend one just because he thinks he has to make a showing. That will be cut out. The juggling of income from one year to another, for instance, just to chisel the taxpayer out of some interest is against my Bible.

There is another thing, as we begin this talk, that I wish you would bear in mind. I know that tax people are not popular with the public and, in many cases, I know that they are not popular with the accountants, but I should like to leave this little question with you: where would your business be if it were not for the Bureau of Internal Revenue?

Both the accounting profession and the Bureau face many problems where we can be of great help to each other. These problems fall into two categories, in my opinion: in the first one are the problems

of our own making and in the second one are the problems that are beyond our control. I should like to talk for a few minutes about those that are beyond our control. By "those that are beyond our control," I mean those that arise from the statutes enacted by Congress itself. After the statute is enacted, it is beyond our power or beyond yours to do anything about it except to accept it as it is, get it interpreted through the courts, or possibly get it repealed. But while we can do something in the way of influencing Congress to see that proper tax laws are enacted, by far the greatest number of our problems come from the taxes enacted into law.

One of the great problems that we are faced with today, and that you are faced with today, is the rapidly changing tax picture. We had the Act of 1950 passed late in 1950. We have the Excess Profits Tax Act which became effective in January, 1951, and now we have a new law that we hope will become effective before too much longer, not because I am anxious to see a new law, but because of the problems that are going to arise if it is delayed much longer.

The very swiftness of the passage of those acts after the Korean crisis has brought many, many problems to all of us. Even all the regulations are not yet written under those laws. It is a human impossibility to get them written and published as quickly as that. That is a tremendous problem to the Bureau, and I know that it is to you, to try to file tax returns without adequate regulations. It is a very tough proposition. You are guessing; you are in the dark; you don't know how the Commissioner is going to interpret those laws in the regulations.

One of the problems that we face, and must face, goes right back to the enactment of the Excess Profits Tax Act in January of 1951. Even before all the returns are filed, we are faced with a new Excess Profits Act, or rather amendments to the one already in existence. It was necessary for the Congress to extend the statutory provision for extensions to November 15, 1951, so you no more than get the returns filed under the '51 act, than you are faced immediately with the necessity for filing a new return under the new change. It is a very unfortunate thing. I know the problems that it creates among the accounting profession. I just want you to understand the problems it creates in the Bureau. The President has promised the Congress an early analysis of the effect of the Excess Profits Tax Act of 1951 and, of course, it has been impossible to prepare any such analysis—even though it is being demanded every day—until the returns are in. So we have a problem there as well as you.

Another problem that comes with this new Excess Profits Tax Act arises from the very fact that it will be five more years before the old one is cleaned up. True, it is the goal of the Bureau and its excess profits tax counsel to wind up its work by the end of this year, but we can't do it. There will still be some three hundred major cases left over at the end of 1951. I know the grief that will arise in some corporations until those problems are settled, but it is a job on which we are hammering away and on which we are doing the best we can. I only hope that we don't get into such a mess on the new one. At the present time, I don't see how we can keep from it.

The act that is now before Congress is going to present many, many problems to all of us. The major problem that it is going to face us with immediately is the difficulty of getting into your hands the materials with which you must work, almost as soon at it is passed. We cannot even begin to make a deal with the public printer to get our returns printed until Congress passes that act. We cannot get out the withholding tables until we know what the rates are going to be. The act is going to call, I am sure, for an effective date of November 1st. So, after final passage of the act, it is going to be necessary for the Bureau to undertake a tremendous mechanical problem of placing in your hands and in the hands of all other business people in the country the withholding tax tables under the new act.

That is going to be a major problem to us. We may have to call for outside help in getting it done. I mean by that, getting newspapers and magazines and others to

help us out by printing those figures before we can get the pamphlets from the Government Printing Office.

We cannot complete action on the income tax returns themselves. We don't know what the rate is going to be but we do know what some of the other provisions are going to be. So, at the present time, all we can do is to keep changing that dummy form every day as the conference goes along so that the minute agreement is struck we can turn those things over to the public printer. That doesn't involve only the income tax returns themselves, the Form 1040, 1040 A, and all the rest of them, it involves all the accompanying regulations, Treasury decisions, everything else that has to be published in connection with the new income tax law. So I plead with you, be patient with us. We are as helpless as we can be in the matter and only through your good will can we hope to convey to the public the problem that is going to be presented when they want blank returns and we cannot yet furnish them. We are doing our best to meet our deadlines on it, but bear in mind that you may not be able to get what you want when you want it due to the lateness of the passage of the act.

In connection with these same forms, we have another mutual problem, that is, the expense in connection with it. Last year the Bureau printed some 785 million returns. I am talking about income tax returns, not the little withholding and Social Security returns. That is a tremendous expense. Congress doesn't understand why we should have to print so many. I do, and I am sure you do. I know that the taxpayer wants a copy, the accountant wants a copy, there has got to be a scratch work copy, and the government wants a copy. But, even so, multiply the number of taxpayers by the number of returns and you come up with a lot more than that. One of the reasons, of course, is the fact that the Bureau mails out returns to all taxpayers every year and that those returns are seldom used in the preparation of the final return. You all want the unfolded smooth copies to work with and I don't blame you. That is what I always use myself. But that must be. It may be looked upon in one light as an economic waste but in another light we find that it has a very valuable psychological effect. It is one of the very few pieces of direct mail advertising that the Bureau is allowed to have.

In that connection I would like to get your reaction to an experiment we are going to try this year in only the states of Indiana and Massachusetts. Those in othe states can find out from their friends there how it works. The returns will come in package form; they will not be folded. Every schedule, the necessary returns, instructions, and everything else, will come in a preaddressed package form, so that we can eliminate the necessity of having collectors' offices stuff those returns into envelopes by hand. This is a tremendously costly job, not only in dollars, but in wasted manpower which could better be doing something else. If it works, we shall spread it all over the whole country next year. It will be a much simpler job for the Bureau. The returns will come in perfect shape, unfolded and useable. We would like to have your reaction to that experiment as you see those package deals come out.

We have another mutual problem, the cost analysis of our tax laws to enable us to recommend to the Congress methods of simplification which will benefit us all. There has been some of that done in the past, but I don't think there has been enough of it. I should like you to give serious consideration to giving the Bureau all the help you can and, I assure you, we will do our best at our end. You people are in close contact with your clients' problems, you know the effect of these laws, you know the work some of them cause—and possibly cause unnecessarily—and only through our combined efforts will we ever be successful in any simplification.

Our tax structure has gotten to the point where we must, in my opinion, do something to simplify it other than explaining them in the directives that come out. The laws themselves must be simplified. Any suggestions that you people can make to us along those lines will be deeply appre-

ciated. We should like to have your views, we want your views, and I trust that, through your legislative committees, you will have no hesitancy in recommending to us any changes that you think would be to the benefit of the American taxpayer. I am not talking about reduction of taxes, that is out of our field. I also extend to each of you as individuals an invitation to let us have your ideas along that line.

We are going to face another problem. You may not consider it mutual, but I think you will find that it is mutual before it is over. It is contained in some of the new provisions of the new act, provisions which I am certain will be enacted into law because they were enacted identically in both houses of Congress. Never before has it become the duty of the Internal Revenue Service to enforce a law passed, I feel primarily, for the public good. They passed a law like that under Mr. Volstead's direction some years back. But we are going to be faced with a major problem in the enforcement of this new gambling law. In my opinion, it is not a tax law, it is a policing statute. It is going to require that the Bureau's field officers become criminal type investigators all the way through in handling this type of tax because under it we are going to have to prove that these people are in the illegal gambling industry.

That is going to mean, I am fearful—I am really fearful of what it will mean—that we are going to have to have some four thousand additional field men and this will cost some forty million dollars a year to enforce that tax. It is going to call for the keeping of records such as no businessman was ever required to keep before and that is your end of it.

Another problem that is going to be more and more mutual is the fact that Congress is awakening to the fact that many, many taxpayers have not kept the kind of records that they should have kept and that, after the new tax law becomes effective, you are going to see bills start through Congress to tighten up the requirements on record keeping, the kind of records that must be kept. It is going to mean no reflection on the kind of clients that I am sure most of you have, but it will be a tough proposition. The failure to keep proper records will become a felony rather than a misdemeanor, and that could be a serious proposition. Already, under its present power, the Bureau has issued instructions which are being carried out. We are serving notice upon taxpayers whom we do not think have adequate records to enable us to determine their true tax liability. It is a warning calling their attention to the law and the type of records they should keep so that when we come back the following year, if the records are not there, the groundwork will have been laid for the prosecution. I should like your help in spreading that word around. That is a direct outgrowth of our activities in the racketeering field.

Another major problem that is of our own making—some of it cannot be prevented but the bulk of it can—is the time lag between the time that the income tax return is filed and the time the businessman knows his final tax answer. I am making every effort in the Bureau to adopt measures to cut down that time lag, but there again it is a problem, not only ours but yours. We are attacking it in several ways. In the first place—it has not been published yet, but it will be in the next few days—we have completely reorganized the income tax unit in the Bureau of Internal Revenue. It has been changed from a mass of unrelated activities into a few well-knit divisions operating along functional lines. This will enable us to complete our work more quickly and more efficiently in the Bureau and it will give you quicker answers to some of your problems than you have ever gotten before.

In addition to that, we are strengthening the technical staff. That is a hard thing to do but we are giving them as many more people as we can and are streamlining procedures so that we can get those cases cleared through the technical staff much more quickly in the future than we ever have in the past. The trouble is that there is a big backlog there and it will be some months before we get down to the working level that we hope to maintain in the future. We are encouraging informal conferences on the field level. By that I mean that we are instructing our

officers to hold informal conferences at the group chief's level within the agent's office. We have discovered that oftentimes some of the failures of Internal Revenue agents to complete a case or to get an agreement either through additional proposed assessment or a refund arise from pure personality reasons or a possible misunderstanding of the statutes and regulations involved on the part of the agent—sometimes on the part of the taxpayer—so we are, in those cases, requiring the group chief to hold an informal conference with the taxpayer and his representatives and the agent in an attempt close that case before it ever gets to the agent's office. It is paying big dividends in some parts of the country. I think it is a step in the right direction and I think that after you have sat in on a few of those conferences you will begin to think so yourselves. At any rate, it is a step towards reducing the work load in the Bureau so that we can cut down this time lag.

Now we come to the part where we need your help. We should like to discourage the postponement of conferences once set, in the agent's offices or the technical staff or anywhere else. Once a conference is set, the conferree on our side of the case must come up to date on it, must be ready for the conference. You also must be ready for the conference. If for some reason the conference must be postponed, the day is lost for the conferree. On the day set aside for the case he must put it aside and go to work on other cases. Whenever another conference is set he has all that work to do over again. We should like your cooperation in eliminating, so far as possible, the postponement of formal conferences set in our agents' and technical staff offices.

I have mentioned that one of the reasons for encouraging informal field conferences has been personality clashes. Of course, there are two sides to the question. I have known accountants, and so have you, who were so cantankerous that nobody could do business with them. They are always right. They are the last word. Nobody can do business with them. I know, thank heaven, only one or two. I also know Internal Revenue agents who have been so cast in iron that they cannot see but one side of the picture, and who have the habit of saying, "I won't allow this," and "I won't allow that;" "Well, that has nothing to do with it." I am trying to eliminate that frame of mind in our field people, but bear in mind that all of us are human beings. I think that after a meeting that I shall have in the Bureau, of the heads of all our field offices next week, that some of my policies will begin to spread over the country as they have already spread over Texas, and I feel that we shall have a much happier relationship. So I plead with you, do your part and we shall do ours. We do not want in the Internal Revenue Service any arbitrary, unsettled people. If you know of any such people, it is your duty to help us straighten the matter out.

Another mutual problem that we have is the terrific peak load periods that strike you and us, of course, at the same time. I should like to ask that you help us as much as you can in leveling out those peak load periods. The biggest one, of course, is the March 15 period. There is nothing much that we can do to take off the terrific load that actually hits at midnight on March 15, except to encourage people to file at the earliest possible date. That is not hard to do where they have money coming back. It is pretty hard to do when they owe it. But if you will urge your clients to get their returns in at the earliest possible date, it will be a tremendous help to us. On the other hand, we know that you are burdened down and that there is no accountant with any appreciable amount of business who can possibly do all the work he is required to do between January 1 and March 15. We know you have to have extensions and we want to give them to you, will give them to you, but you can lessen our work if you will stop asking for short extensions.

I don't like to see our collectors grant even 30 and 60-day extensions. If you are going to ask for an extension, ask for 90 days, and if you can file a return earlier, do it. But if you ask for a 30-day extension and can't do it, you ask for another and then another which gives you 90 days anyhow but we have three clerical jobs issu-

ing the three extensions. My policy as Collector was, and it will be the policy of all Collectors, that when you write for an extension you are going to get 90 days whether you ask for it or not. That eliminates, as I said, a tremendous amount of clerical work in the collector's offices. I should like to tell you that that can be put on a more informal basis but you know as well as I that the value of these extension letters is negligible in the year a return is filed but they may be of considerable value in later years to establish the fact that the return was filed under an extension, even though the copy of the extension may have been lost from the return. So help us out in that way. Don't ask for those short extensions just because you think it is easier to get a 30-day one than it is a 90. It isn't.

I have not attempted to cover all the problems that face us mutually. I have just merely touched on them so that you and I could get to know each other better and perhaps think along the same lines.

I want to leave that field for a minute and go to one that is still more serious than anything we have mentioned yet.

I am not a politician. I know nothing about politics, I care nothing about politics, I never have, and I never will.

There is no man in the United States more anxious to see the integrity of the Bureau of Internal Revenue unchallenged than I, and I can assure you that any place I find it challenged, lightning will strike just as it struck in California a couple of weeks ago.

The Bureau is paying the penalty for the acts of some collectors of Internal Revenue. That is going to stop. I can assure you very, very conscientiously that it is going to stop. The President has told me many times personally to do whatever I thought was necessary to correct that situation. There are going to be no politics in the Bureau of Internal Revenue from now on.

Now it is time for your part of it. No deputy collector and no Internal Revenue agent who has gotten into trouble so far, that I know anything about, got into it by himself. Not one of them. It is a two-sided proposition. So you do your part.

Federal In

Panel

Status of over-ceiling payments in computing taxable income.

With the renewal of price controls renewed importance attaches to the income tax tatus of payments which exceed ceiling prices. The question presented is whether such over-ceiling payments constitute allowable deductions and whether and to what extent such expenditures are deductible in computing taxable income.

HAL CANARY

There seems to be no question but that over-ceiling payments may be properly disallowed by the Commissioner as deductions from gross income in arriving at taxable income. That point does not seem to have been contested by any of the taxpayers penalized under Regulations 111, Section 29.23(a) (16), or I.T. 3724.

But the question has arisen when the over-ceiling payments were included as a part of the cost of goods sold, rather than as a deduction from gross income in arriving at net taxable income.

This issue was first handled by the Tax Court in the case of *Lela Sullenger*, 11 T.C. 1076, and it was held that over-ceiling payments for meat were a part of the cost of goods sold, and as such were not deductions allowable by legislative grace, but were capital, the taxation of which was not authorized by the 16th amendment to the constitution. The Commissioner's appeal to the Circuit Court for the Fifth Circuit was dismissed early in 1950.

come-Tax

The Commissioner has carried several other cases on the same question to the Tax Court, has invariably lost where over-ceiling prices were paid for merchandise for resale, and has also invariably appealed the cases to the Circuit Courts.

Some of the tax commentators pointed out at the time the *Sullenger* decision was handed down (Woman CPA, February, 1949), that since the Tax Court had decided that neither Congress nor the Commissioner have power to deny any part of the taxpayer's cost of goods sold in arriving at taxable income, the way might be open to the inclusion in the cost of goods sold of wages paid in contravention of wage stabilization regulations, where the wages constituted direct manufacturing costs.

This second issue has now been decided by the Tax Court in *Weather-Seal Mfg. Co.*, 16 T.C. . . . , No. 158, in a decision adverse to the taxpayer and inconsistent with its decision in the *Sullenger* case. The former case is now on appeal to the Court of Appeals for the Sixth Circuit.

In the *Weather-Seal* case, the Court reasoned that salaries and wages are allowable under Section 23 of the Code only when reasonable in amount, and that wages paid at over-ceiling rates are clearly unreasonable. It did not explain the disallowance of the entire wage so paid, rather than only the unreasonable portion, as is customary.

The Court also failed to note that if wages are deductible under Section 23, they are deductible from gross income, and that gross income is gross receipts

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less cost of goods sold, which cost included, among other things, the cost of direct labor. Nor did the Court explain how the taxpayer's inventory, computed at cost, and including direct labor, in accordance with Section 29.22(c)(3) of the Regulations, should be reduced.

In the *Sullenger* case the Tax Court was not greatly concerned with the public good, but having since then been affirmed in the case of the optician who paid physicians "kick-backs" not illegally, but to the detriment of the public good, it became more concerned with the morals of the matter and cited that case (*Thos. B. Lilly*, 188 F. (2d) 269, affirming 14 T.C. 1066) in the *Weather-Seal* decision. Some day the Bureau of Internal Revenue may follow that line of reasoning to the point where it will attempt to deny as a deduction from gross receipts cost of liquor purchased for resale by bootleggers in dry states, as contrary to public good.

At this time, if the taxpayer is to prevail on issues of this type it will have to be on the question of constitutionality, and he cannot be sure until the Appellate Court has heard the *Weather-Seal* case.

Should capital-gains benefits be claimed by licensor under exclusive license?

In the case of* Myers, *6 T.C. 258, and numerous subsequent decisions, it has been consistently held that proceeds received by an amateur inventor under an exclusive license to make use and sell products embodying his invention constitute capital gains. The Commissioner's acquiescence in the* Myers *case established this as a recognizable precedent for the field offices of the Treasury. However, in March, 1950, the Treasury promulgated Mim. 6490 withdrawing such acquiescence. The field offices had previously ceased following the* Myers *case, apparently under specific instructions from the Commissioner's office. At the time of promulgating Mim. 6490 the Treasury was active in developing a provision for legislation to conform with the procedure stated in that mimeograph and such provision was included in the Revenue Bill of 1950. The provision was eliminated from the bill, although the corresponding provisions relating to copyrights and artistic compositions were left in the bill and became enacted into law.

What procedure should be followed by an amateur inventor for the year 1951, assuming that he holds the type of license involved in the* Myers *case?

RUSSELL S. BOCK

I believe that an amateur inventor who receives in 1951 so-called "royalty" income of the type involved in the *Myers* case should claim capital gain treatment.

The *Myers* case (6 T.C. 258) involved an exclusive license to make, use, and sell the patented articles. The courts have consistently held that such a license is in substance a sale and should be so treated for tax purposes. The Treasury originally acquiesced in the *Myers* case, but in March, 1950, issued Mim. 6490 which withdrew the acquiescence and substituted a nonacquiescence. Mim. 6490 further proclaimed the Treasury's future policy of denying capital-gains treatment on all income of this general type, regardless of the form of contract. During its consideration of the Revenue Act of 1950, Congress gave some indication that it did not sympathize with the Treasury's attitude when the Senate eliminated a provision that would have treated as ordinary income any gain on the sale of a patent. Thus the Treasury's position seems to be contrary to the attitude of Congress as well as that of the courts. Under these circumstances, so long as there is enough involved to make it worth while to litigate the matter, I believe that the inventor would be well advised to claim capital-gains benefits, until such time as the question of proper treatment of such income is finally settled.

What procedure is applicable to professional fee-splitting?

The Treasury agents are actively following the Tax Court's decision in the Lilly ***case (14 T.C. 1066) and denying deductions by surgeons for the portion of their fees paid over to other physicians who are instrumental in causing patients to use the services of the surgeons.***

To what extent is this procedure applicable? Is there any danger to lawyers and accountants in similar forwarding fee? The Institute recognizes the propriety of a forwarding fee and fee-splitting seems to be quite well recognized among attorneys.

What action, if any, can be taken by doctors to overcome the inequitable tax burden of such disallowances?

W. WALLER GROGAN

In view of the case of *Thomas B. Lilly, Helen W. Lilly*, 14 T.C. 1066, 1950, affirmed C.C.A. 4 (1951) 188 F.2d 269, certiorari granted October 8, 1951, is there any danger to lawyers and accountants in the disallowance of the deduction of forwarding fees? What action, if any, can be taken by doctors to overcome the inequitable tax burden of such disallowances?

I believe that many tax practitioners feel that the Tax Court has done some "legislating" in the *Lilly* case. This case appears to be the first instance of the disallowance of a business deduction because it opposes public policy—*stemming from a purely ethical situation.* In the *Lilly* case, so-called "kick-backs" paid to oculists by an optical firm were denied as "ordinary and necessary business deductions" on the grounds that they violated public policy. How actively the treasury agents may be following this case is a matter of conjecture—I am told that in the Louisville office of the agent in charge none are presently pending. However, I fully expect the Bureau to question and to disallow in certain instances deductions claimed in the case of a surgeon who has paid over a fee to the physician who refers the patient to him. By whatever name it may be called, it is merely another form of "fee-splitting." While fee-splitting in some form may be quite prevalent among members of both the accounting and legal professions, I believe that it is nevertheless frowned upon and that nowhere is it specifically "approved."

In the instance of the surgeon to whom a patient is referred by the physician, I believe that in order to safeguard the deduction of a fee paid to the physician, the physician should render a "service"; i.e., he should be present, and, if necessary, actually assist the surgeon in the operating room. While it is true that his presence is obviously intended to be of benefit to the patient, surely it is a plausible argument for the surgeon to advance in support of his deduction. I fully expect to see the Bureau disallow some deductions of this nature on the grounds that no service whatever was rendered, there was no compulsion to pay the physician, and lastly, if necessary, to extend this theory on the grounds of the *Lilly* case.

The taxpayer's position in this case was simply that no public policy was violated by these (oral) contracts—that there was no statutory law or rules of professional conduct condemning this practice. Taxpayer further argued that the practice did not increase the cost of the prescribed eyeglasses and that the practice of secret kickbacks was so common and so widespread that such payments must be deductible as ordinary and necessary. This failed to impress the Tax Court (Judge Leech) and likewise the Fourth Circuit (Judge Dobie).

The Tax Court opinion states, "The absence of constitutional or statutory law or rules of professional conduct condemning this particular practice is not enough to support petitioner's position." And with this the Court proceeds to legislate. The opinion further stated, "It must be remembered that the fundamental principle with which we are dealing here is not that of the relationship between the parties to an ordinary commercial transaction. We are

concerned in this case with the relationship between physicians and their patients." At this point it seems difficult to rationalize how this "relationship" can be against "public policy." The dissenting opinion by Judge Arundell and the Fourth Circuit's opinion offer various descriptions of the phrase "public policy." Judge Arundell's dissenting opinion gives the real meat of the situation when he states that "I am disturbed . . . by the majority opinion that a commission paid by an optician to a doctor . . . may not be deducted as an ordinary and necessary expense on the ground that this practice . . . is unethical and contrary to public policy." He further states as to revenue statutes, "They are none too squeamish about how the income to be taxed was realized. The profits of illegal businesses are taxed the same as the profits of legitimate businesses, and, as the tax is based on net income rather than gross income, the expenses incurred in carrying on of the illegal business have been generally allowed, as the purpose of the tax laws is not to penalize a business because it is one on which the law frowns" (*Commissioner v. Heininger*, 320 U. S. 467). Heretofore, the public policy theory to overcome the "ordinary and necessary" requirement has prevailed in situations involving agents or employees of a government or its instrumentality—or has involved deductions of sums paid as bribes or sums paid to perform an act specifically forbidden by law, which courts have obviously balked at permitting. Judge Arundell's dissent points out that "the Tax Court should be reluctant to undertake the determination of the question of what is and what is not contrary to public policy, both for the United States and for each of the forty-eight states where the act condemned as against public policy is not one shown to be in violation of any law of the land. This court in the past has taken the position that it does not possess the right to condemn undesirable trade practices as being against public policy, etc." Judge Arundell's gem is "What are deductible items should be known to a taxpayer with reasonable certainty under our income tax system." The dissent interestingly points out that the Commissioner does not claim that "expenditures of this sort fall without the purview of this statute, and in his brief in this case he does not argue that the agreements between petitioner and the doctors were contrary to public policy, but, rather, that the payments to the doctors are not ordinary and necessary expenses in that they were voluntary and incident to an unethical practice."

The Fourth Circuit's opinion condemned the practice of kick-backs in some very sharply worded statements holding that the kick-backs "corrupt the fiduciary relationship between physicians and patients and result in a violation of the duty of loyalty, they are opposed to public policy and, therefore, are not deductible as 'ordinary and necessary' business expenses." The Court made itself crystal clear in its statement, "We certainly will not lend the force of any opinion of this court to sanction, as an ordinary and necessary expense of the optician's business, the making and carrying out of such unconscionable and reprehensible contracts for secret kickbacks to a doctor."

The Circuit Court's opinion seems to have its fundamental premise that it is immaterial that the question may be one of ethics rather than of law. Pursuing this literal statement, it is not difficult to envision the disallowance by the Commissioner of fee-splitting among physicians or other professional men. However, this theory is certainly extending the more commercial situation existing in the *Lilly* case and I do not believe that the courts will follow the *Lilly* case in a situation among members of a profession on the grounds that "fee-splitting" is against policy.

The problem incident to these "kickbacks"—which are no more than commissions paid for securing customers—should be compared with the Tax Court's holding in the cases involving "black market" purchases—admittedly paid in violation of OPA ceiling prices. The leading case is *Lela Sullenger*, 11 T.C. 1076 (1948), Commissioner's appeal dismissed, CCA 5, 2/20/50, which involved the deduction from gross receipts (as cost of goods sold) the purchase of meats in OPA prices, and the following exceeding T.C. Memo De-

cisions were decided on the authority of the *Sullenger* case *Clara Eugenia Piper, Ethel L. Couch* (both involving over-ceiling purchases of used automobiles), *W. Guminski* (meat) and *Colonial Rubber Company,* side payments in purchase of used tires in excess of OPA ceilings. The opinion in *Sullenger, supra,* observes that Section 23 makes no provision for the cost of goods sold but that the Commissioner has recognized "as indeed he must to stay within the Constitution, that the cost of goods sold must be deducted from gross receipts in order to arrive at gross income." Judge Disney, dissents in this case stating, inter alia, "Why an expenditure in contravention of law, *and of public policy,* should be permitted subtraction and thus affect such taxation, is difficult to understand. On the broad question of public policy here involved, I think there is no sound reason to distinguish the present situation from those above covered." (Emphasis supplied.)

Another decision to be observed in connection with this subject is *Jerry Rossman Corporation v. Commissioner,* 175 F.2d, 711, C.C.A. 2, 1949, reversing 10 T.C. 468, involving the deductibility of a penalty, voluntarily paid to the Office of Price Administration, as an "ordinary and necessary business expense." The opinion, Judge L. Hand, states, among other things, that it is not a penalty, and "Second, we say that, even if it was the payment of a 'penalty,' that is not a 'rigid criterion' of its deductibility. Third, we say that there was positive and compelling evidence that to allow such a deduction would not 'frustrate' the policies of the underlying act."

Under what circumstances are the opening inventory and accounts receivable to be included in computing income upon a change in the income-tax accounting method to give effect to inventories and receivables (and payables)?

Another question which is being given close scrutiny by examining revenue agents is that which arises when income is first computed by using inventories and receivables following years in which such items were disregarded. The question of when the opening inventory is to be included or disregarded upon changing accounting method to reflect inventories where they have not been used previously is quite confusing under the decisions of the Tax Court. The procedure recognized by the Tax Court seems to be as summarized below:

1. If the books have been kept on the cash basis but the accrual method is required to reflect the income correctly, the opening inventory is disregarded for the year in which the accrual method is first used. **Z. W. Koby,** ***14 T.C. 1103.***

2. If the books are kept on the accrual basis except that inventories have not been used, it appears that the Commissioner may not require the opening inventory to be disregarded if he insists upon use of the closing inventory. **Mnookin's Estate,** ***184 F. (2d) 89, aff. 12 T.C. 744;*** **Robert G. Frame,** ***16 T.C. No. 73.***

Some weight seems to be given by the Tax Court to the identity of the side initiating the action for use of inventories after they have previously not been used. Taxpayers have lost in attempting to switch to the use of inventories by using the opening inventory for the year of change.

In the case of **Cornelius J. Dwyer,** ***decided June 29, 1951 (CCH Dec. 18, 426(m)), the Commissioner was sustained in requiring the use of the accrual method for a hotel and tavern business where sale of merchandise was an income-producing factor but sustained the taxpayer in giving effect to the opening inventory where inventories had been taken and were recorded and available.***

The subject is discussed in an article on page 109 of Research Institute Taxation Report of July 5, 1951, under caption "Penalty for Wrong Accounting Method."

The Tax Court seems to give considerable weight to the method followed in keeping the books. In the case of Carver, 10 T.C. 171, aff. 175 F.2d 29, Carver had kept his books on a cash basis for 16 years and then changed to the accrual basis. The Court upheld the Commissioner in disregarding the opening inventory for the year of the change. It would appear that if the taxpayer has used inventories in his books but not in his tax return, the Commissioner would be denied the authority to disregard the opening inventory if the Commissioner changes the method of accounting to reflect inventories in accordance with the method used in the books. Also, if the taxpayer used an inventory in his books and tax returns but used an incorrect method of computing such inventories, the Tax Court might uphold the taxpayer in using the correct opening inventory for the year of correction, particularly if the Commissioner was the party who required the correction.

WILLIAM H. WESTPHAL

A taxpayer is often required to use the accrual method of accounting because it more accurately reflects taxable net income, although the books of account are kept on a cash or hybrid basis. These are usually cases in which inventories and accounts receivable are material income-producing factors in which the Regulations and decided cases require the use of the accrual method. On the other hand, the taxpayer's books may be properly kept on the accrual basis while he erroneously reports income in his return on a cash basis. What is the result in the event the Commissioner examines the question after the taxpayer had been reporting erroneously on a cash or hybrid basis for several years and decides that he should be on the accrual basis? Under such circumstances, how should the opening inventories and accounts receivable at the beginning of the year be handled?

Actually, by setting up the opening inventories and accounts receivable in the year of the change, the taxpayer succeeds in eliminating this amount from taxable net income entirely. On the other hand, setting up the opening accounts payable results in eliminating deductions that would otherwise be allowed and this treatment of the liabilities prevents the taxpayer from ever being able to obtain this deduction.

The decision in the case of *Wm. Hardy*, 17 A.F.T.R. 615, decided by the Second Circuit, aroused considerable interest in this question. Here a taxpayer changed his books to the accrual basis and continued to prepare tax returns on the cash basis. The Commissioner decided that the taxpayer should report on the accrual basis because of the nature of his business, in which inventories and accounts receivable were material income-producing factors. In effecting the correction of the returns to the accrual basis, the method followed by the taxpayer in keeping his books, he did not adjust the items of accrual at the beginning of the year of change, but only at the end. The result of this action was to pick up, in the year of the change, the entire accrual of income over the years.

A similar result followed in the case of *Carver*, 10 T.C. 171, aff. 173 F2d 29, affirmed by the Sixth Circuit. In this case the books were likewise changed from a cash to an accrual basis, but the returns were filed on the cash basis, and the change was made entirely within one year by the Commissioner. To the same effect were other cases in point, *Michael Lovall*, Dec. 17, 790 (M) *Plantea*, Dec. 13, 946 (M), and Z. *W. Koby*, 14 T.C. 1103.

However, in the case of *Mnookin's Estate*, 184 F2d 89, aff. 12 T.C. 744, a different result obtained. Here the taxpayer was on the accrual basis on all items with the exception of credit sales, which he reported on a cash basis. The Court held that the Commissioner could not include in income of the year of the change the opening accounts receivable and disallow the beginning inventory. The

reason this was not permitted was that the taxpayer had not changed a method of accounting, but it was merely necessary that a correction be made in a consistently followed method.

Also, in the case of *Cornelius J. Dwyer*, Dec. 18, 426 (M) the Commissioner, while upheld in requiring the taxpayer to include inventories in computing net income, erred in failing to allow a beginning inventory as a deduction, since there was no change in method of accounting.

There seems to be much confusion in the cases on this subject, but the following principle appears to emerge therefrom; if the taxpayer must be changed from one method to another, the cash basis to the accrual basis because the taxpayer had been reporting by following the wrong method, the changes would be made in the closing inventories, receivables, and payables, and not in the corresponding opening items.

If, on the other hand, the taxpayer reports on the accrual basis and had been consistently doing so, but omits an item of consequence that should be taken into consideration, the Commissioner must effect his correction in the opening inventory, receivables, or payables, if such a correction is indicated therein. This is an oversimplification, however, and is subject to certain modifications and qualifications.

In the case of an incomplete reporting on the accrual basis, there may be some difference in the result if the taxpayer himself seeks to correct the errors. His very action in doing so at the time the return is prepared may indicate that he clearly understands that preceding years, likewise, should have been adjusted. It will, therefore, be more difficult to convince the government that his presentation of the facts of which he has knowledge has been complete and it may be contended that the Commissioner has relied upon the taxpayer's representations to his detriment. Under such circumstances, it is possible that the government may successfully require that the opening inventory, or receivables, be omitted and the entire income adjustment be made in the year of correction.

Since the penalty of a changeover from a cash to an accrual basis may be extremely severe if large receivables and inventories have been built up, several alternatives may suggest themselves in settling these cases administratively. The question has often arisen concerning whether or not Section 3801 can be applied. There is considerable doubt that an inconsistent position has been taken in such a manner that a correction may be effected by the taxpayer through the invocation of this section. It is possible, however, if the results of the abrupt changeover are seriously inequitable, that an equity settlement can be agreed to that will result in a tax substantially as large as the amount that would have been paid had the taxpayer reported correctly on the accrual basis for all years involved, plus interest on this theoretical tax.

Also, in the case of a corporation in excess-profits tax, the provisions of Sec. 456 pertaining to abnormal income should be thoroughly explored in the year of the changeover. It appears that it may be reasoned soundly that such an adjustment would represent abnormal income of a type applicable to preceding years, and not properly subject to excess-profits tax.

What is the situation with respect to capital gains on the sale of livestock used for breeding or dairy purposes?

WALTER M. BURY

There has been considerable litigation during the past few years as to the taxability of gains on the sale of breeding or dairy stock of farmers, particularly in those instances in which the sale of such animals constitute a long-term capital-gain transaction under section 117(j) of the Internal Revenue Code. Section 117(j) was added to the Code in 1942 and provided that the capital-gains rates would apply to gains on sale of property used in the trade or business of a taxpayer

which was of a character subject to the allowance for depreciation and to real property held for more than six months which is not property of a kind which would properly be includible in the inventory of a taxpayer if on hand at the close of the taxable year, or property which is held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Livestock used for draft, breeding, or dairy purposes and held over six months is among the kind of assets to which section 117(j) applies.

There are certain allowable procedures, however, with respect to reporting farm income for tax purposes, that are peculiar to farm income accounting. One of these is that a farmer reporting income on the accrual basis can carry as inventory animals which are used for dairy or breeding purposes, whether purchased or raised, even though such animals constitute capital assets and are subject to the allowance for depreciation. The other one is that a farmer is allowed to use the cash receipts and disbursements basis for reporting his income and does not have to recognize as inventory the animals raised by him. Expenses of raising such animals are allowed as a deduction when paid, and income is recognized when the sales proceeds are recived. As a result animals raised for breeding or dairy purposes are carried at no value and have a zero basis for computing gain or loss.

The Treasury Department early recognized these peculiarities of farm accounting when it issued I.T. 3666, 1944 CB 270, which provided that any livestock used for draft, breeding, or dairy purposes, irrespective of whether such livestock was raised or otherwise acquired, is property used in the trade or business, of a character which is subject to the allowance for depreciation and that this was equally true whether the farmer keeps his books and files his returns upon the cash receipts and disbursement basis or upon the accrual basis. The Tax Court of the United States in *Isaac Emerson*, 12 T.C. 875, was of the same opinion. Accordingly, livestock held over six months and used for breeding or dairy purposes should have the benefits of section 117(j) whether such livestock was raised or purchased, whether it was carried on the books as an inventory asset or a capital asset or, in the case of a farmer on the cash basis with respect to raised livestock which has a zero basis.

The Commissioner's main ruling on this question, I.T. 3712, 1945 CB 176, held, in effect, that breeding or dairy animals were not section 117(j) assets but rather that the breeding and dairy herd as a whole constituted such an asset and that only gain on sales which resulted in a net decrease in the herd after considering the year's replacements would constitute section 117(j) gains.

This ruling was overruled in March of 1949 by the Court of Appeals for the Eighth Circuit in *Albright v. U. S.*, 173 F2d 339, which held that gains on sale of cattle used for breeding or dairy purposes and hogs used for breeding purposes and held over six months are taxable as capital gains pursuant to section 117 (j) of the Code. The Tax Court then handed down several decisions on this issue in favor of the taxpayer: *Isaac Emmerson*, supra, *Leslie S. Oberg*, 8 TCM 544, *Fawn Lake Ranch Company*, 12 T.C. 1139, *Charles O. Fritz*, 9 TCM 81, and others. The Court of Appeals for the Fifth Circuit has joined the Eighth Circuit and the Tax Court in holding against the Commissioner on this issue in *U. S. v. John M. Bennett et al*, 186 F2d 407.

On April 18, 1951, the Commissioner issued Income Tax Release No. 3 wherein he reconsidered his former position and announced that the following principles will govern the treatment of sales of dairy and breeding animals:

"If the animal is used for draft or dairy purposes—or in the case of a breeding animal, if the practice of the taxpayer is to hold such animals for substantially their full period of usefulness—the animal will be regarded, prima facie, as used in the business of the taxpayer for the purposes of section 117(j) of the Code.

"If the practice of the taxpayer is to sell breeding animals before they have served substantially their periods of usefulness, such animals will be regarded, prima facie, as held primarily for sale to

customers in the ordinary course of the taxpayer's business, and not as property used in his business.

"Under these principles, dairy or breeding cattle, horses, etc., will ordinarily qualify as property used in the business, and gain or loss on their sale will qualify for the special treatment provided in section 117(j) of the Code. Animals which are used only temporarily as breeders or producers, including, ordinarily, hogs, chickens, turkeys, etc., will not be regarded as qualifying for such treatment." This information release was followed on June 27, 1951, by Mimeograph 6660 which revoked I.T. 3666, supra, and I.T. 3712, supra, and stated the new position of the Bureau as follows:

"It is the present position of the Bureau that gains derived from the sale of dairy, draft, or breeding animals are to be recognized as coming within the purview of section 117(j) of the Code if the taxpayer establishes that the particular animals sold were actually used for dairy, draft, or breeding purposes for substantially their full period of usefulness. If such animals are sold prior to such full period of usefulness, the taxpayer must show that they were added to the herd for substantial use in such herd and not temporarily with the object in view of an early sale. Gains derived from the sale of breeding animals which were used for the production of only one offspring or litter of offspring will not be subject to the capital-gains treatment prescribed by section 117(j) of the Code. Animals which are used only temporarily as breeders or producers, including ordinarily hogs, chickens, and turkeys, will not be subject to the capital-gains treatment prescribed by section 117(j)."

The Commissioner agrees with the principle of the *Albright* case that gain on sale of livestock used for draft, breeding, or dairy purposes is capital gain pursuant to section 117(j). However, the Commissioner requires that in order to qualify as section 117(j) assets such animals must be used for draft, breeding, or dairy purposes for substantially their full period of usefulness or that they must be added to the herd for substantial use in the herd and not temporarily with the object in view of an early sale. Apparently, the Commissioner will allow section 117(j) treatment of gains on usual or liquidating sales of culls from the dairy or breeding herd. He, however, will not allow a farmer to hold livestock until they produce one offspring before selling them and thus obtain capital-gains treatment.

There is judicial support for the Commissioner's position in *Leonard C. Kline et al v. Commissioner*, 15 T.C. 998. In that case petitioners who operated primarily a feeder ranch, purchased as feeder cattle substantial numbers of Hereford cows which had been bred prior to or after purchase. It was the petitioner's intention to hold the cows until after they had produced a crop of calves and then sell them as beef cattle. In disallowing section 117(j) treatment of the gain on the sale of these cows, the Tax Court concluded that the cows were primarily held for sale to customers and that purchasing the cows with the intention of harvesting a single crop of calves from them before putting them on the beef market did not establish the cows as breeders as distinguished from feeder cattle. The Court distinguished the case from *Albright, supra*, wherein capital gain was allowed on sows which had produced only one litter of pigs, by holding that Albright followed a trade practice in the hog industry, whereas there was no evidence in the *Kline* case that there is or has ever been any common practice in the cattle industry of regularly selling cows from a breeding herd on the beef market after they had produced one calf.

Two recent Tax Court decisions have ruled on the difficult question of determining when a young animal becomes part of the breeding herd. In the typical registered cattle breeding operation young calves are not just added to the breeding herd and retained for their substantially full production period. The more usual practice is to sell some of the calves during their first year, some during their second year, and others after they have produced one or two calves. Only by such gradual process of elimination are the cows selected which are retained for their

full productive period. The Commissioner's mimeograph ruling indicates that if the taxpayer can show that the animal was added to the herd for substantial use in the herd, gain on sale of such an animal prior to its full period of usefulness can qualify as a section 117(j) gain.

In *Walter S. Fox* v. *Commissioner,* 16 T.C. 854, promulgated April 20, 1951, the Tax Court held that in the case of a registered Aberdeen-Angus cattle operation, heifers raised, registered, and sold by petitioners before they dropped a calf should not be regarded as part of the breeding herd and those animals that dropped a calf while still owned by the petitioners should be regarded as part of that herd. Inasmuch as the evidence in the case did not permit definite classification for each animal sold, the Tax Court made a determination based on all evidence that registered heifers 26 months old or over and registered bulls 36 months old or over when sold shall be treated as having been part of the breeding herd.

In *A. Harold Schmidt et al v. Commissioner,* (CCH Dec. 18,353(M) entered May 31, 1951) the petitioners also maintained a registered herd of purebred Aberdeen-Angus cattle. Following the *Fox* case, *supra,* and applying the formula used therein to the evidence of the case the Tax Court held that only animals over 24 months of age when sold are to be considered as having been part of the breeding herd.

In *Joy G. Miller et al v. U. S.* (U. S. District Court, District of Nebraska, Lincoln Division, No. 14-50 Civil, February 19, 1951) the Court held that in a ranch operation consisting of breeding and raising of beef cattle, gains on sale of heifers which had been introduced to the breeding herd at fourteen months of age and proved unsatisfactory for breeding purposes, were capital gains. This case is more liberal than the above cases but the taxpayer was able to prove to the satisfaction of the court that the animals had been retained for breeding purposes.

In conclusion, it can be stated that the courts and the Commissioner agree that animals used for draft, dairy, or breeding purposes constitute section 117(j) assets. There is not such complete agreement as to when an animal becomes part of the breeding or dairy herd. The Commissioner's present position is that the animal must be used in the breeding or dairy herd for substantially its full useful period or that it was added to the herd with such intention. The courts agree, with one exception, that the production of one offspring qualifies a cow as a breeder. This would also apply to sows since using them for the production of only one or two litters is common trade practice. The exception is the *Kline* case, *supra,* in which it was held that feeder cattle which were purchased for sale but were held over for one crop of calves did not qualify as breeders.

A discussion of the situation with respect to capital gains on the sale of livestock used for breeding or dairy purposes should consider pending legislation on the matter. The Revenue Bill of 1951 (H. R. 4473) as reported by the Senate Finance Committee on September 18, 1951, provides that capital gain treatment under section 117(j) would be extended to livestock, regardless of age, held for draft, breeding, or dairy purposes, for a period of 12 months or more from date of acquisition. This provision would be applicable to years beginning after December 31, 1941, except that the extension of the holding period from 6 to 12 months would be applicable only with respect to taxable years beginning after December 31, 1950. Also with respect to taxable years beginning after December 31, 1950, livestock would not include poultry except turkeys. The Senate Committee Report on the Revenue Bill of 1951 states that new uncertainties have resulted from Mimeograph 6660 which the Bureau Agents apparently are interpreting to mean that only animals which have completely outlived their usefulness can qualify for the capital-gains treatment, and that under the Committee's bill section 117(j) will apply to livestock used for draft, breeding, or dairy purposes, and to turkeys used for breeding purposes, whether old or young; and the holding period will start at the date of acquisition, not with the date the animal or fowl is put to

such use. If this provision becomes law it should help to clarify the question of capital gains on livestock.

The effect of section 117(j) on the income-tax liability of farmers reporting income on the cash receipts and disbursements basis as compared to those using the inventory method warrants comment. Can a farmer who uses the inventory method of accounting for farm animals obtain as much benefit from the capital-gains provision as a farmer who uses the cash basis? If the farmer is on the cash basis, an animal that is raised has an adjusted cost basis of zero and if it qualifies as a capital asset, then the entire sales price is long-term capital gain. If the farmer is on the inventory basis and has included the animal in his inventory, then such amount apparently becomes the adjusted cost basis and reduces the amount of the long-term capital gain, thereby placing such a farmer at a disadvantage in comparison with a cash basis farmer.

This is a disadvantage that must be taken into consideration in counseling a farmer to adopt the accrual basis for income reporting. However, what can a farmer who already is on the inventory method do in order to get the maximum tax benefits on his sale of breeding or dairy stock which qualify as section 117(j) assets? One possibility would be to adopt that inventory method which would result in the lowest inventory value; for instance, a farmer using the farm-price inventory method could obtain permission to change to a unit-livestock-price method establishing as low a normal unit cost as is practicable. Another possibility is to retain the dairy and breeding animals in the inventory until they reach maturity and then to transfer them to a capital account and depreciate them. Moreover, all purchased dairy and breeding animals should be capitalized and depreciated rather than added to the inventory. Finally, the one sure way to secure equality in tax on such gains between farmers using the two methods of accounting for farm income would be for a farmer using the accrual method to obtain permission to change to a cash receipts and disbursements basis providing such permission could be obtained.

(Section 324 of the Revenue Bill of 1951 as reported by the Senate Finance Committee was enacted into law as section 324 of the Revenue Act of 1951 with the exception that turkeys like other poultry were excluded from the definition of livestock.)

What tax accounting procedure is applicable to payments to a corporation by an officer, director, or shareholder pursuant to Section 16(b) of the Securities Exchange Act of 1934?

CHARLES N. WHITEHEAD

Section 16(b) of the Securities Exchange Act of 1934 requires that profits from a purchase and sale of a corporation's stock by officers, directors, or certain classes of shareholders, within a six months' period be paid to the corporation. The purpose of this section was to remove the profit from speculation by insiders who were presumed to have access to inside information. The order of purchase and sale is unimportant; the amount to be paid to the corporation is the difference between the highest sale price and the lowest purchase price within six months' period. The payment has no relation to taxable income and cannot be based upon identification of stock sold. Moreover, the payment may be, and usually is, required in a year subsequent to the year of purchase and sale.

The tax treatment of such payments by the individual and by the corporation has never been adjudicated, nor have formal rulings been issued by the Bureau. Interesting problems are present on both sides; namely, whether the payment is a deduction to the taxpayer and whether its receipt is income to the corporation.

The individual's problem is complicated because the payment has no real relation

to taxable income reported on the sale, and the payment may or may not occur during the taxable year of sale. It would seem that the payment could not be an adjustment of the sale price or affect the capital gain or loss on the sale, because of the completely different basis of computation of the taxable gain and the repayment. The taxpayer will have sustained a capital gain or loss based on the sale price and cost of shares held and sold, and the repurchase at a different price can hardly affect the gain or loss realized for tax purposes. It seems equally clear that the amount paid should not be considered as additional cost basis of the shares repurchased, because it has no relation to the stock repurchased. Accordingly, it appears that the payment must be in the nature of an expense in the year of payment.

Assuming that the payment is an expense and that it is deductible, there remains the question as to whether it is deductible as an ordinary deduction, probably under Section 23(e), or whether it should be treated as a capital loss. In cases where the payment is made in a year different from the year of reporting the gain, the principle of the *Switlik* case, (13 T.C. 121 affd. CA-3) should be applicable. While the Bureau has nonacquiesced the *Switlik* case, and hence would disagree with its application, the courts have held in similar situations that such payments result in ordinary deductions. If the Bureau's interpretation of the *Switlik* case, insofar as I understand it, is considered applicable, the individual would be allowed at most a capital loss in the year of repayment.

The foregoing assumes that the payment would result in some sort of a deduction. Apparently there have been no published rulings by the Treasury Department on the question, but there are unpublished Bureau rulings to the effect that no deduction whatever is allowable to the individual on the theory that the payment is in the nature of a penalty and therefore nondeductible. Apparently this interpretation is being litigated in the case of *William F. Davis, Jr.* now pending before the Tax Court. It is difficult to see how the Bureau can contend that the payment is a penalty. As I read the law, the individual coming within its scope is required to pay the profit to the corporation, providing that he performs certain prescribed acts. The intent is to discourage the use of inside information for speculative purposes by removing the profit from such speculation, and no penalty other than the repayment of the money results from the application of the statute. Under such circumstances it seems that the Bureau's theory of penalty is farfetched and untenable.

The situation with respect to the corporation likewise has had no assistance from the Bureau or the courts. The corresponding questions are whether the receipt by the corporation is taxable as ordinary income, capital gain, or nontaxable on the theory of a capital contribution or the receipt of punitive damages. Certainly the corporation has done nothing to earn the income; the income has flowed to it by reason of the independent action of an individual. It is difficult to see how such a receipt comes within the scope of Section 22(a), or within the definition of income in such cases as *Eisner v. Macomber* (252 U.S. 207). If it is income it would appear to be ordinary income, because the sale or exchange required for a capital gain was by another taxpayer. Likewise, it would seem to be excess-profits income unless it could be excluded as abnormal income under Section 456.

It is hard to see how the receipt can be classified as a capital contribution, because the individual may or may not be a stockholder at the time of repayment and there is no intent to contribute to capital. It has many of the attributes of a gift to the corporation; however, the lack of donative intent and the involuntary nature of the payment is such as to make the gift theory difficult to substantiate. Another possibility is that the receipt by the corporation of a penalty, assuming that the Bureau's treatment of the payment as a penalty is correct, does not result in taxable income to the corporation. Cases involving punitive damages and receipts of penalties may be applicable, and in

those cases the courts have held that such damages do not constitute taxable income to the receiving taxpayer. (E.g. *Central Railroad* 79 Fed 2d 697, *Highland Farms,* 42 B.T.A. 1314).

The situation then is one in which the Bureau should publish an indication of its position. At the present time apparently the Bureau is taking the harsh position that payments are not deductible to the individual but constitute income to the corporation. Under such circumstances it is apparent that taxpayers must take the exact converse and contend that the payments are deductible as ordinary deductions, and that the corporation realizes no taxable income on receipt. It seems likely that prolonged litigation will result unless some rational and equitable ruling is announced by the Bureau.

What is tax accounting procedure for advertising funds which are subject to expenditure by the vendee?

Some manufacturers and wholesalers are using advertising plans under which the customer deposits a sum for each unit of merchandise with the vendor as an advertising fund. Under the terms of the contract the vendor becomes liable for an equal amount. The vendee has full authority to expend the funds for advertising purposes subject only to the requirement that the advertising must be in conformity with the vendor's general policy against unethical advertising. Typical provisions covering the types of advertising which are ineligible for reimbursement out of such funds are the following:

1. Containing statements that are misleading or untruthful, regardless of intention.

2. Containing statements that are derogatory to other makes of products or to other manufacturers.

3. Offering company's products for sale at other than the suggested retail selling prices.

4. Offering premiums in connection with sale of company's products even though price of company's products is raised to include premium. This does not apply to authorized combination sales of company's products.

5. Illustrating models which are not identified by model number and retail price when featuring the price of another model.

6. Violating any Governmental regulations.

Such plans ordinarily provide that upon termination of the agreement between vendor and vendee one-half of any unexpended portion of the combined fund shall be distributed to the vendee and the vendor shall be released from any further obligation.

In the appeal of the **7-Up Company,** ***14 T.C. 965, the Tax Court held that sums deposited by customers under such a plan did not constitute income to the vendor.***

Questions apparently needing clarification include the time for deduction of such advertising appropriations by the vendor and also by the vendee. Is the vendee entitled to any deduction at the time of his deposit with the vendor? And is the vendor entitled to a deduction for his liability to match the vendee's deposit at the time of the deposit or only at the time the ultimate advertising expenses accrue?

HAL CANARY

THE answer to this question depends to some extent on whether we are doing the tax accounting for the manufacturer, the distributor, or the retailer.

In the typical case the manufacturer invoices the distributor for advertising on a per-unit basis, or sets aside a reserve for advertising based on the distributor's purchases. In either case the funds are held in reserve for the distributor's use. In the case of a per-unit charge to the distributor, the amount is sometimes matched by the manufacturer.

There is a little question that the amounts charged the distributor should be treated as customers' deposits for good accounting and good tax accounting. *7-Up Company*, 14 T.C. 965; *Broadcast Measurement Bureau, Inc.*, 16 T.C.——, No. 122.

As for the reserve set aside by the manufacturer, good accounting practice and tax accounting seem to point to different directions. The manufacturer has definitely committed himself to make certain disbursements based on the sales made, and good accounting would require that the expense be taken in the year in which the applicable income was earned.

However, the taxing authorities can on occasion be very realistic, and they know that if the distributor's franchise is cancelled, the amount paid by the distributor will be refunded, and the amount set aside by the manufacturer will never be paid out. Consequently, for tax purposes, it is established that deduction may not be taken for reserves set up for contingencies. *Brown v. Helvering*, 291 U. S. 193.

Although some of the advertising fund, as well as the manufacturer's reserve, may be used for direct advertising or sales promotion by the distributor, the major portion of the amounts are passed on to the retailers in coöperative advertising plans.

Probably most of us have had our appliance distributor clients argue that when remittance is made to the manufacturer for the advertising reserve, it is an expense at that time. However, neither good accounting nor good tax accounting will countenance such treatment. The distributor's advertising expense is not necessarily related to his purchases. For example, during the shortage of appliances most of the distributors carried large advertising funds with the manufacturers. Now these funds are pretty well exhausted.

Nor is the expense based on sales. Few distributors allocate a reserve to each customer based on the sales to that customer. However, in the face of the excess profits tax 18¢ dollar, some distributors have found their claims from customers for advertising funds increasing to the point where some limitation may have to be applied.

During the year, most distributors follow the practice of setting upon their books "credits due from vendors" at the time the claims are filed with the manufacturer. At the same time the retailer is credited with the claim he has made against the distributor. When the claim is honored by the manufacturer, the credits due from vendors will clear out and the distributor's share of the expense will be transferred from advertising reserve to advertising expense. If at the end of an accounting period the manufacturer has been dilatory in honoring the claims, and if there is evidence that the claims will be honored, there should be included in the income statement the expense of the distributor as shown by claims filed.

The retailer's problem is simple. If he is a small dealer, he probably charges his advertising costs directly to expense and takes credit for the allowance from the distributor when it is received. A year-end audit should take as a credit against advertising any valid claims filed with the distributor.

What pitfalls are to be avoided in transactions involving a sale and lease-back and gift with lease-back?

During recent years there have been many transactions involving the sale of plant

properties of large insurance companies accompanied by a lease-back to the seller for a term of years. Under some of these transactions the deductibility of the rent has been questioned. Also, where the transaction has resulted in a loss to the seller, question arises regarding the deductibility of such loss.

Similarly, numerous transactions have involved a gift of business property to related persons accompanied or followed by a lease-back to the transferor.

RUSSELL S. BOCK

This is too big a question to answer adequately in a few words, but I shall try to cover a few salient points. In the first place, I'll divide it into two parts, because an ordinary sale and lease-back is not the same as a gift with lease-back.

The ordinary sale and lease-back involves the sale of plant properties to insurance companies, charitable organizations, or others, accompanied by a lease-back to the seller for a term of years. There are two important tax questions: (1) can the seller deduct a loss on the sale, and (2) are the rentals fully deductible?

As to deduction of a loss, the Tax Court has passed on this question in three recent cases. In *Standard Envelope Manufacturing Co.*, 15 T.C. 41, and in *May Department Stores Co.*, 16 T.C. No. 67, losses were allowed. The Commissioner has acquiesced in both of these cases. In *Century Electric Co.*, 15 T.C. 581, a loss was disallowed, on the ground that the sale was in substance a tax-free exchange of a fee interest in real estate for a leasehold interest running over 30 years. The regulations have long provided that a leasehold for 30 years or more is property of "like kind" to a fee interest. In both cases where losses were allowed the lease was for less than thirty years.

The question of the deductibility of the rentals in the type of sale and lease-back deal which has been common in recent years apparently has not yet been litigated. However, we have some guidance in cases such as *Judson Mills*, 11 T.C. 25, and *Chicago Stoker Corp.*, 14 T.C. 441, where rentals and royalties were disallowed on the theory that the lessee was acquiring an equity in the property. In those cases the Court laid down the rule that the lessee is acquiring an equity if the rental payments exceed the depreciation in value of the property. I don't think this apparently simple rule can be applied in every case, but it is an indication of the Tax Court's attitude.

Where the lease provides for a very high rental in the later years, it is conceivable that a portion of the rent might be disallowed in the early years and allocated to the later years of the lease. We have no cases on this point to date, but I think this possibility should not be overlooked.

A study of authorities suggests the following rules which should be followed, if possible, to obtain favorable tax treatment of sale and lease-back transactions:

1. The sale price should be fair and reasonable.
2. The lease should be for a period of less than 30 years.
3. There should preferably be no renewal option in the lease.
4. There should preferably be no repurchase option in the lease.
5. If the lease includes options to renew or to repurchase, the options should be for reasonable amounts, based upon the best possible estimate of values at the time the option may be exercised.
6. The staggering of rates within the lease period should be kept within reasonable limits; in other words, an attempt should be made to avoid an unreasonably high rental for the first few years with a reduction to an unreasonably low rental for later years.
7. The lessee should be prepared to establish the amount of interest and depreciation that should be allowed, if it is held that the transaction is essentially a loan or a purchase arrangement and the rents are disallowed.

The gift and lease-back presents quite

different problems. These situations involve some of the same questions as the family partnership and family trust cases. The authorities are conflicting, with the cases being decided largely on the basis of their own special facts. The decisions seem to look with disfavor on transactions where the property is given to the wife or children who are not independent in their business affairs. They also frown upon arrangements where the rentals are purely arbitrary and are fixed by the donor of the property in excess of a fair rate.

It appears that a gift and lease-back arrangement has little chance of success unless the property is given away outright with no strings attached and unless the parties bargain for the lease on an arm's length basis. This is often difficult to accomplish in the type of family situation which is usually involved in a gift and lease-back transaction. It is possible that the new family partnership rules will have some effect on these transactions.

Is taxpayer entitled to the benefit of capital-gain rates on sale of fully depreciated assets?

Revenue agents are taking the position that if the cost of an asset has been fully recovered through depreciation deductions, the proceeds from the sale thereof are taxable at ordinary rates instead of capital gain rates. Their theory is that if 100 per cent depreciation has been taken, it must be presumed that the asset has been retired from use, whether or not it is in actual use, and that, accordingly, such asset no longer qualifies as a depreciable asset used in the business and thus does not qualify as a capital asset under Section 117(j), I.R.C.

If the position of the revenue agents is correct, it is evident that it is highly important for accountants to give careful attention to depreciation deductions in order to avoid complete depreciation of assets in actual use.

W. WALLER GROGAN

It appears that revenue agents are taking the position that where the cost of an asset has been fully recovered through depreciation, the proceeds from the sale (whether or not held more than six months) are to be treated as ordinary income rather than capital-gain income. Their theory appears to be that if 100 percent of depreciation has been claimed, it *must be conclusively presumed* that the asset was *retired* from use, whether or not it is in *actual use,* and therefore the asset does not qualify as one "depreciable" used in the trade or business and does not qualify under Section 117(j) I.R.C.

I do not think revenue agents are *generally* taking this position, nor do I believe they will prevail in that position. The "key" word in this situation is "character". The statute, Section 117(j)(1)—definition of property used in the trade or business—states that "(it) means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in Section 23(L)." Though property may be fully depreciated, if it is still in use or can be used by the taxpayer—that is, held for future use, and *has not been abandoned,* the asset has not lost its character as "depreciable". It seems clearly wrong to *presume* that because no further depreciation may be taken or allowed the asset has been *retired* from use. It seems equally true that the property would deteriorate and therefore is of a "character which is subject to the allowance for depreciation".

Two situations will ordinarily be found with respect to fully depreciated assets; (1) it will still be in use, or (2) it may be retired from use but held by the taxpayer for possible further use either in an emergency or for salvage as spare parts or components of the asset. In the

latter situation, the leading case is *Wilson Line, Inc.* 8 T.C. 394, 1947, acquiesced, 1947—1, CB 4. There, the taxpayer dismantled parts of a marine railway and carried this on its books as an asset at the estimated salvage value of $2,500 and thereafter claimed no depreciation. It was held in storage for future use and was therefore property used in the taxpayer's business and (from the opinion) "was of a character subject to the allowance for depreciation and was not includable in inventory or held for sale to customers in the ordinary course of petitioner's business." In the alternative, the petitioner argued that the asset, in its dismantled state, was a capital asset held for more than six months, since it was not stock in trade nor property held for sale to customers in the ordinary course of business, and therefore, in any event, was a capital asset, under Section 117(a)—if not under Section 117(j).

That the asset was not actually in use is not conclusive. It is only necessary to show that the asset "could have been used by the petitioner." Under such circumstances it is therefore not conclusive that because the property has been fully depreciated, it no longer qualifies as "depreciable" property.

The decision in *Wilson Line, Inc., supra,* was followed by the Tax Court in *Alamo Broadcasting Company,* 15 T.C. 541, 1950, wherein the opinion stated, "we have previously held that 'used in a trade or business' means 'devoted to the trade or business' and includes property purchased with a view to its future use in the business even though this purpose is later thwarted by circumstances beyond the taxpayer's control."

Explain correct inventory procedure by automobile dealers for their used cars.

Increased attention by revenue agents is being given to inventory valuation of used cars in the hands of automobile dealers. This question apparently involves basic inventory principles but increased attention being given to the problem as it arises in the audit by revenue agents of the returns of automobile dealers seems to warrant some special attention at this time.

Undoubtedly many automobile dealers have understated their used car inventories to their own detriment by causing the resulting income to be realized in later years at higher tax rates.

WILLIAM H. WESTPHAL

Second-hand cars acquired by automobile dealers as trade-ins should be valued at bona fide selling prices less direct cost of disposition regardless of whether inventories are valued at cost or at the lower of cost or market. This rule is set forth in Regulations III, Sec. 29.22 (c) (2), which provides that second-hand goods should be valued on this basis.

As a practical matter, inventories of used cars are usually priced in accordance with the values shown in a list published by the National Automobile Dealers Association. This is then reduced by an offsetting reserve for reconditioning used and repossessed cars. The net effect of such treatment at the end of the accounting period is to take the used cars into account in the closing inventory at their market value less the cost of disposition.

In the *Lord Motor Company* case, 5 B.T.A. 818, this estimated cost of disposition was considered to be 25 per cent of the sales price and in the average case its range is between twenty and twenty-five per cent.

Before effecting a change in method of computing inventories, it should be demonstrated satisfactorily that the inventories are incorrect as to basic principle, and it is well to bear in mind this cardinal rule—that consistency in method is of great importance, but the perpetuation of gross error on the grounds of consistency should not be permitted.

But let us suppose that the method of inventory computation is shown to be gross-

ly in error. What method of correction may be followed? In cases involving inventory changes, we have situations in which (1) the correction of the opening inventory would reduce the tax, and (2) the correction of the opening inventory would increase the tax.

In the case of the former, we are likely to find that if the preceding year is barred by the statute of limitations, it will be very difficult to effect the adjustment of the opening inventory. There is a line of cases involving the application of the doctrine of estoppel that can cause a taxpayer undertaking such a correction the greatest difficulty. The Commissioner can show that the error is one of fact, that the taxpayer was in possession of the true facts at the time of the preparation of the return, and that the Comissioner relied upon this representation to his detriment. Therefore, it will be very difficult to persuade him that he should now allow the adjustment. Interesting cases in point are those of *Eureka Fire Brick Works,* 5 T.C.M. 998, and *Swift Manufacturing Company v. United States* 12 F. Supp. 453.

On the other hand, the Commissioner is on sound grounds in insisting on an opening inventory adjustment where it works to his advantage to do so, and is supported by cases in point if he wishes to make this change. His position under such condition was supported by the Court in *Commissioner v. Gooch Milling and Elevator Company,* 64 S. Ct. (1948).

What, then, can the taxpayer do to heal a troublesome situation of this type and establish his inventories once and for all time on a sound income tax basis without subjecting himself to terrific tax penalties? It is suggested that, if a year is yet open in which the tax rates are fairly low, the correction be made in that year, adjusting the closing inventory but not the opening inventory. It is quite probable that the government will permit the correction to stand. If, for example, a tax return is prepared for an automobile company that sets forth grossly erroneous valuations of used cars, and the current year looms before the taxpayer as an excess-profits-tax year, the oldest open years in the pre-excess-profit-tax days may be considered as a possible place in which to make the correcting adjustment, if it serves to increase the inventories. If the taxpayer is in a 38 per cent bracket for the year 1948, which is yet open, it appears that the correction can be made in that year, leaving the opening inventory unadjusted, but changing the closing inventory.

Suppose, however, that the correction is made by the Commissioner? In all probability, he will not reduce the opening inventory to correspond with the closing inventory if the previous year is barred by the statute of limitations. What recourse, then, will the taxpayer have to prevent the imposition of an unjust pyramiding of tax?

Section 3801 has been suggested as a possible remedy, but there is considerable doubt that an inconsistent position within the purview of that section is involved, although it has been applied administratively, in principle, to prevent gross inequity. It is possible, however, that an equity adjustment may be worked out administratively so that the taxpayer will pay the tax that should have been paid had the inventory been correctly computed for all years. Also, in the case of a corporation in excess-profits tax, the provisions of Section 456 pertaining to abnormal income should be thoroughly explored in the year of the changeover. It appears that it may be reasoned soundly that such an adjustment would represent abnormal income of a type applicable to preceding years, and not properly subject to excess-profits tax.

Bringing the family partnership situation up to date. What are the recent Court interpretations of what should constitute a family partnership? What can be done to solve the problems which exist?

WALTER M. BURY

A large number of decisions on the family partnership tax problem still leaves uncertainties as to what types of plans will be recognized as effective and what types

are to be avoided. Explanation of two or three of the outstanding highlights might serve a useful purpose.

The Senate Finance Committee has brought the family partnership situation up to date by stating in its report on the Revenue Bill of 1951, that the determination of the status of a family partnership under existing law has been extremely uncertain and that a state of confusion still exists with respect to the possible settlement of many cases pending with the Bureau of Internal Revenue. Our intention is to review briefly the high spots of the current situation.

Since the Revenue Act of 1948 allowed splitting of the income of a husband and wife for income-tax purposes, the family partnership question does not have much significance as to husband and wife partnerships for years subsequent to 1947. However, it does have significance for family partnerships consisting of members other than a husband and wife and also as to husband and wife partnerships for years prior to 1948.

Following the United States Supreme Court's decisions in the *Tower* and *Lusthaus* cases (*Commissioner of Internal Revenue v. Francis E. Tower* 327 U.S. 280 and *A. L. Lusthaus v. Commissioner of Internal Revenue* 327 U.S. 293) which were handed down in 1946, the Tax Court's approach to the partnership problem was that it considered as essential to membership in a family partnership for tax purposes the contribution of capital originating with the member or substantial participation in the control and management of the business or the performance of vital services. It was not material that the partnership was not formed for tax avoidance purposes. The circuit court decisions apparently were more concerned with whether the facts indicated that a real bona fide partnership had been formed.

On June 27, 1949, the United States Supreme Court gave further consideration to the family partnership problem in its decision in *Commissioner of Internal Revenue v. Culbertson, et al*, 337 U.S. 733. The Supreme Court stated that its decision in the *Tower* case was misinterpreted by the Tax Court and that the question of whether a partnership exists for income-tax purposes is not whether services or capital are contributed by a partner, "but whether, considering all the facts . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise." Thus the Supreme Court shifted the emphasis in testing a family partnership from the contribution of capital and vital services test to the reality test. The question which now must be answered is: Does a partnership exist in substance as well as in form?

There has been no indication, however, of substantial liberalization on the part of the lower courts as a result of the *Culbertson* case. Although orginal capital and vital services may not be considered as a decisive test, nevertheless, they serve as the best proof of an intention to form a valid partnership. Tax Court decisions since the *Culbertson* case indicate that the formation of a partnership in order to save income taxes through an intrafamily gift of a partnership interest where the donee performs no substantial services will not result in a valid partnership for tax purposes. Just as in tax-free reorganizations "business purpose" seems important. Some of the Circuit Courts of Appeals appear more liberal than the Tax Court. Thus, the Fifth Circuit affirmed a district court's recognition of minor children as partners though they acquired their interests with promissory notes and contributed no valuable services. (*Arnold v. Harry B. Green*, 186 F.2d 18). The Tenth Circuit affirmed a district court decision recognizing a husband and wife partnership wherein a husband who was about to be sent overseas by the armed forces gave his wife half interest in several partnerships in order to provide for her financial independence in case of his death (*Schaaf Baker v. Jones*, D. C. Oklahoma 7-6-50, affirmed CCA-10, 5-21-51).

The Tax Court, however, is not averse to recognizing bona fide partnerships as valid. The court recognized a son in the armed services as a partner with his father in a lumber business where the son was made a partner and rendered valuable services before he enlisted in the army, but

it did not recognize as a partner the second son who was made a partner after he had joined the Navy (*Joe Denton Harris, Jr. v. Commissioner of Internal Revenue*, 10 TCM 477). In *Theodore D. Stern* (15 T.C. 521) the Tax Court recognized trusts for taxpayer's wife and children as valid limited partners in a partnership organized under Illinois law.

The unfortunate aspect of the family partnership problem is that it has not been possible for owners of sole proprietorships to give away property interests in such a business to other members of the family and thus to have the income attributable to such property taxable to the donee owner. Why this can be done easily with respect to other assets, such as real property and stock and bonds even if the transfer is made solely to save taxes but not with respect to an interest in a business, is not understandable. The Senate Finance Committee is fully aware of this particular discrimination as is evident from its comments on Section 339 of the Revenue Bill of 1951 in its committee report on the bill. It appears that if the proposed section is enacted into law a fair rule should be established for the recognition of family partnerships. To quote from the committee report ". . . the bill provides that in the case of any partnership interest created by gift, the allocation of income, according to the terms of the partnership agreement, shall be controlling for income-tax purposes except when the shares are allocated without proper allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the allocation to the donated capital is proportionately greater than that attributable to the donor's capital. In such cases a reasonable allowance will be made for the services rendered by the partners, and the balance of the income will be allocated according to the amount of capital which the several partners have invested. However, the distributive share of a partner in the earnings of the partnership will not be diminished because of absence.

This amendment at the election of any member of a family partnership is to be effective with respect to any open taxable year since December 31, 1938, but will be valid only if any other members of the partnership whose taxable income would be increased or decreased consent to the resulting adjustment of their tax liability.

Certainly, the enactment of this section into law will not solve all the family partnership problems. Partnerships to be recognized will have to be genuine and bona fide and the gifts complete. However, it should be a long step forward in placing the family partnership on the same basis with other property, recognizing that income from property which is the subject of a completed gift is properly attributable to the donee and that income from personal services is properly attributable to the person rendering the services and is not assignable for tax purposes to someone else.

(Section 339 of the Revenue Bill of 1951 as reported by the Senate Finance Committee was enacted into law as section 340 of the Revenue Act of 1951 with the important change that the amendments made by this section were made applicable with respect to taxable years beginning after December 31, 1950. The retroactive application of the amendment to years beginning after December 31, 1938, was thus eliminated.)

What procedure is applicable for accounting for income from royalties under a patent acquired by inheritance?

CHARLES N. WHITEHEAD

Assuming a patent to have been valued at $100,000 for the purpose of the federal estate tax and to have a remaining life of ten years, questions arise as to whether such valuation is to be recovered for income-tax purposes by applying proceeds against the basis until the basis is recovered, by depreciation deductions, or only to the extent resulting from application of section 126(c), I.R.C.

Revenue Agents have urged that the applicable procedure is to allow deductions

only to the extent permitted under Code section 126(c). In support of such position they cite the decision in the case of *Estate of Thomas Remington v. Commissioner*, 9 T.C. 99, applicable to insurance commissions for personal services.

In the recent case of *Estate of John W. F. Hobbs v. Commissioner*, 16 T.C. 153, (CCH Dec. 18,336) the Tax Court held that the value of a leasehold as determined for estate-tax purposes should be recovered for income-tax purposes by means of amortization over the remaining term of the lease. The *Hobbs* case involved a property value and not any factor of personal earnings.

In a case involving personal earnings for years 1941, 1942, and 1943, the Circuit Court of Appeals (Second) held that the value of an employment contract which had been subjected to estate tax should be amortized over the remaining life of the contract. *May D. Hatch v. Commissioner*, June 29, 1951, reversing and remanding 14 T.C. 237.

Inherited rights under patents, including patents which have become the subject of exclusive licenses of a type classifiable as a sale, constitute property rights rather than contracts for services. Regardless of the procedure applicable to personal service contracts, it appears that the basis of such a patent or exclusive license should be recoverable for income-tax purposes either by amortization deductions or by applying the proceeds against the basis until the basis has been recovered, as in the case of *Burnet v. Logan*, 283 U.S. 404, involving payments under a mineral lease.

Is section 126(c) involved to any extent in the case of royalties from inherited patent interests? And how can the decision in the *Remington* case be reconciled with the *Hatch* case?

In the case of *Whitehurst v. Commissioner*, 12 BTA 1416, (1928) the Board allowed depreciation on inherited patents to be based on the estate-tax value. The Commissioner announced nonacquiescence, which apparently is still a hurdle for revenue agents although the technical staff has recognized the propriety of depreciation based on the estate value.

The question really covers two classes of patents and patent rights: (1) Patents owned by decedent at the date of death which had not been sold prior to death and (2) patent rights in which the decedent had executed a sale or an exclusive license tantamount to a sale under patent law. It appears that the tax consequences of the two situations are different.

It is my opinion that the heirs will be entitled to annual depreciation deductions over the life of the patent in which the cost basis (i.e., the fair-market value of date of death) will be recovered. Section 113(a)(5) provides that an asset has a basis to the heirs for income-tax purposes equal to the fair-market value at the date of death or the optional valuation date depending upon the election made in the estate-tax return. The patent here considered was owned by the decedent at date of death and is a capital asset, hence section 113(a)(5) should determine the basis. This holding should follow regardless of whether the patent was owned subject to or without a license at the date of death. Other than the *Whitehurst* case, there appears to be no decided cases and that case is nonacquiesced by the Treasury Department. The reason for the nonacquiescence is difficult to determine; the case was an early case in which section 126 was not considered. On the other hand, settlements apparently have been made in the Technical Staff on the theory that the taxpayer is entitled to a basis for the patent and that the basis should be recovered over the life of the patent.

The recent decision in the *Estate of Remington* (9 T.C. 99) apparently has been used by the Bureau as authority for disallowance of a new basis subject to depreciation. Instead, income from the patent is held by the Bureau to be section 126 income. This treatment I believe to be erroneous. In the case of *Hatch* (14 T.C. 237, affd. C.A. June, 1951) the decedent was the owner of a contract with a corporation providing for annual payments of $30,000 after his death for a period of ten years. In the *Hatch* case the Tax Court and the Circuit Court determined that the estate was entitled to the fair-market value of the contract as of the date of death as a basis and that only the excess over such

value received from the contract consituted taxable income. In the *Remington* case, the decedent was an insurance broker who had arranged with his employer for a payment based upon income from certain accounts over a period of years in the event of his death. When the amounts were received after death, the estate took the position that the agreement was tantamount to a sale of a capital asset, but the Tax Court held that the income, that is, insurance commissions and renewals, was section 126 income.

It seems that the distinction between the cases is that in the *Remington* case there was involved only uncertain future income which would be paid to the decedent's heirs if collected and that there was no sale made to the decedent's employers. The Tax Court held that the arrangement did not constitute a sale or exchange of a contract, but was merely a sharing of profits which, had the decedent lived, would have constituted ordinary income. Accordingly, the Tax Court held that the income received by the decedent's estate in the *Remington* case constituted section 126 income. Apparently the estate would have been entitled to a deduction for estate tax had the estate been subject to federal estate tax. In the *Hatch* case there was a definite contract for payment of $30,000 per year for a period of ten years after the death of decedent. This was a definite and certain contract susceptible of valuation, and the Tax Court held that, to the extent of its fair-market value as shown on the federal estate-tax return, the estate was entitled to recover its basis (the estate-tax value). No reference was made to section 126 in the *Hatch* decisions.

Thus, while the two cases may appear inconsistent, the difference in decisions can be rationalized by the essential difference in the nature of the payments. In the *Remington* case the payment was contingent and uncertain; in the *Hatch* case the payments were definite, certain in amount, and completely susceptible of valuation. The Tax Court held that the *Hatch* contract constituted a capital asset of the decedent's estate whereas the agreement in the *Remington* case was considered to be different. Parenthetically, the Circuit Court held that the gain (i.e., the difference between the total payments and the present value at date of death) was to be spread ratably over the life of the contract, and the first payments were not to be applied against the basis until the basis had been recovered.

The rationale of the *Hatch* case appears to be supported by the cases such as the *Burnett* case (2 T.C. 897A) involving the value of no-cost livestock as of the date of death of the decedent. In such cases the fair-market value of the livestock becomes the basis in the hands of the estate regardless of the fact that no income had been reported on the livestock prior to the decedent's death and the entire expense of raising such cattle had been deducted as expense by the decedent during his lifetime. In the *Hobbs* case (16 T.C. 153) the Tax Court held that the date of death value of a leasehold interest held by a decedent lessee should be amortized over the remaining life of the lease.

Accordingly, as to patents in which the decedent had an ownership interest, even though subject to a nonexclusive royalty, it would appear that the decedent's estate is entitled to a deduction for amortization over the remaining life of the patent equal to the value established in the estate-tax return. Based upon the Circuit Court's decision in the *Hatch* case, it would seem almost certain that the recovery of such cost basis would be over the life of the patent rather than by applicaion of royalties to the tax base until the tax base had been recovered.

In cases where the decedent, prior to his death, had transferred his patent rights under an exclusive license to make, use, and sell (See *Meyers v. Commissioner*, 6 T.C. 258) in a contract tantamount under patent law to a sale, the situation appears different. In such cases the decedent made a sale for an indefinite consideration prior to his death, and up to the date of death the sale proceeds had not been received. After death, however, it appears that the gain on the sale comes squarely within the provisions of section 126. Section 29.126-1 of Regulations 111 treats as section 126 income amounts received by the estate where the decedent had made a sale of

property but had not received payment therefor prior to death. Apparently under Mim. 6490, the Bureau would contend that the proceeds from such a patent sale contract were ordinary income for years begining in 1951; therefore, for such years, the amounts would be taxable as ordinary income under section 126 providing that Mim. 6490 is substantiated by later court decisions. In any event, whether the income is capital gain or ordinary income to the estate, and to the extent that the value of the contract had been included in the estate-tax return, the estate would be entitled to an estate tax deduction.

In summary, it is my feeling that the estate is entitled to depreciation on a patent owned by the decedent at date of his death based upon the fair-market value of the patent as of the date of death spread over the remaining life of the patent. It is my opinion that there is no statutory basis for treating the income from such a patent as section 126 income. Unfortunately, there appears to be no decided cases covering the latter situation, and only one old nonacquiesced case on the first point. If the patent has been sold prior to the date of decedent's death under a contract for an indeterminate sale price or otherwise, then it seems that the amounts receivable under that contract would constitute section 126 income in the hands of the heirs reduced only by the deduction for federal estate tax provided by section 125(c) on the estate's income-tax return.

Excess-Profits-Tax Panel

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What exemptions can the predecessor or the successor allow in reference to the company earning experience in a complete take-over? What can be expected taxwise in a partial take-over? What types of transactions can be considered to be partial take-overs or split-ups?

J. S. SEIDMAN

[*The material which follows is a part of the address given by J. S. Seidman. The initial part of his presentation is unavailable, due to circumstances beyond our control.* EDITOR]

WHAT HAPPENS if the succession takes place within the base period? Well, for that purpose again let's raise a few principles. The predecessor, when there is a take-over, is considered as if it went out of business entirely and was born anew the day after the take-over.

Conversely, the successor is considered as if it suddenly acquired whiskers and had the age and the vintage of the predecessor company. But the point is that if you remember that the effect of a take-over is as if a successor goes back to the life of the old company and the predecessor, as of the day of the take-over is reborn, you will have in your possession, the general ideas. It is really the infusion of tax hormones in the reverse; the predecessor acquires monkey glands and is born anew, and the successor acquires social security glands.

Now with that principle, we revert to the original question: what happens when the take-over takes place, we will say, in the beginning of 1948. Well, within the framework of those principles, these conclusions would logically follow and do follow as a matter of law, that the successor taking over in 1948, inherits the predecessor's earnings experience for 1946 and 1947. The predecessor continuing in business in 1948 and 1949, has its own earnings experience in 1948 and 1949 to make use of on its own.

There are also some wrinkles that weave into this problem where I said an acquisition is made for cash. It doesn't come under the succession arrangement, but you can see that instead of acquiring for cash, what might happen is this: a successor first acquires all of the stock of a predecessor and pays cash for that stock, and then liquidates the predecessor. That is a complicated subject, which time does not permit us to investigate further here.

Let's go to the phase of this inheritance and take-over that may have some more appeal. In the first place, this entire scheme that we are talking about merely deals with the problem of the determination of the exemption of the predecessor or the successor when that exemption is figured by reference to the earnings experience of either company, but you know that there are some other ways of figuring the exemption. You can figure the exemption by reference to the capital investment of a company. You can figure the exemption by reference to a $25,000 minimum. You can figure the exemption or at least figure the tax by reference to a fixed maximum 62 per cent rate, without any worry or concern about the earnings experience or the capital investment.

Obviously, where those factors are involved, then none of these provisions has any meaning. On the other hand, look at this interesting possibility: let's suppose the predecessor company figures its investment by reference to capital investment. When the predecessor company transfers assets to the successor, the fact that it has to give up some of its earnings experience doesn't mean anything, because it isn't interested in earnings experience; it is figuring its exemption by reference to capital investment. On the other hand, a successor inherits an earnings credit, an earnings experience over and above its own experience; it inherits from the predecessor a right to add to its own revenues or earnings, the earnings experience of that predecessor without the predecessor losing that experience, or without that loss having any significance.

So you have got an interesting play there of being able to organize subsidiaries and being able to make transfers from one company to another to the tax profit of both. I point out that while this

mechanism deals with the inheritance of earnings of the successor company from the predecessor, there isn't a corresponding inheritance of any net loss or anything. There isn't any corresponding inheritance of the unused credit carryback or carryforward. Quite to the contrary, as you all know, some serious problems can arise about net losses and carryforwards and carrybacks of unused credit whenever there is a shift from one company to another.

On the other hand, in spite of that, there are some more interesting possibilities. Suppose you have a situation where you have a subsidiary that has higher earnings with a low exemption. You have a parent that has high exemption but low earnings. All you have to do is shift one into the other, match the two, have the parent company inherit the earnings of a subsidiary and make use of its own exemption. The net result should be a tax saving. As a matter of fact, you can go much further. You can have the type of situation that lends itself to interesting tax possibilities. Suppose the subsidiary is a Western Hemisphere company. It had large earnings during 1946-49, but the Western Hemisphere company pays no excess-profits tax. The parent company liquidates the Western Hemisphere company into itself and inherits the earnings though those earnings would never have been the basis of an excess-profits tax exemption. It adds those earnings to itself, increases its own exemption, and then perhaps starts doing business through some other company or in some other area through a new company; a brand new Western Hemisphere company, and again there is considerable advantage in the tax picture.

My own feeling is that this provision is pregnant with many interesting tax possibilities.

Well, so much for the complete takeover. Now, let's consider the partial takeover, where there is an inheritance of only part of a company. In the common vernacular, that is referred to as split-ups. More technically, what is involved is that when one company transfers only part of its assets to the successor company and the transfer is made on the circumstances that involve either a tax-free reorganization, or where the transferring company takes back an 80 per cent control in the successor company, or it may be a partnership that makes the transfer, the typical outlet for it is perhaps the organization of a subsidiary by a parent company, with the parent company just transferring part of its assets.

You also may have the type of situation where one company transfers its assets to two successors, or you can have a partnership transferring to one or more corporations. In any event, inherent in what is involved for our purpose and the keynote is that there has been a transfer to a successor of only part of the assets of the predecessor.

Now, let's see what the effect of that is. I indicated at the outset that with earnings following assets, the logic of the situation was that when part of the assets are transferred, part of the earnings are inherited by the successor. How do you measure that part? Well, the primary mechanism is that the earnings being related to the assets, the size of the inheritance by the successor is measured on the basis of the relationship of the value of the assets that it had inherited, compared with the total assets of the predecessor.

Now, we know from grim experience that that raises value problems not only of the assets that we see, but also the intangibles. There must be an evaluation given to good will if there be good will, whether that good will be transferred to the successor, or retained by the predecessor. In recognition of that difficulty, and also in recognition of the fact that it doesn't always follow that earnings may be related to the value of the assets at any particular time, there is an alternate mechanism permitted in the law, and that is that the size of the inheritance by the successor company can be measured in relation to the identified earnings of the particular assets to which it has succeeded.

That is all very beautiful if it weren't for the fact that there was just one slight "if" injected in the provision. You can do all that to your heart's content; you can

have an agreement between the predecessor and the successor as to how much earnings have been inherited by the successor; as I say, that is all very easy as long as you get the Secretary of the Treasury to participate and join in and consent to that agreement.

Well, here again, as in the case of complete succession, I want to point out that although there is a split-up of earnings between predecessor and successor, there is no split-up of net loss, there is no split-up of an unused credit. As a matter of fact, one of the interesting things, one of the things that sort of baffles me a bit is that when a partnership transfers some of its assets to a corporation, there is a split-up for this purpose and there is an inheritance of part of the earnings experience of the partnership. On the other hand, when a proprietorship makes a transfer, there is no inheritance. A proprietorship for this purpose cannot be a decedent, cannot be a testator, cannot bequeath anything.

Obviously, the way out, if you are seeking a way out of an intent upon having a succession of earnings, is to have the proprietorship first devolve into some partnership and then have the partnership make the transfer. But as we stand now, there is the discrimination between partnership and proprietorship, and I am not clear that I understand why.

Now, let's have some interesting questions on the problem, and these, I think, may have some appeal.

Question No. 1: If a transfer is made by a parent company to its subsidiary of assets, but the transfer is made into the paid-in surplus of the subsidiary as distinguished from the receipt of stock, does that constitute a split-up?

If you read the law as it is written, the answer is no, it isn't a split-up, because the law distinctly says that the transfer must be for stock or securities. As a matter of fact, it is very clear in the law that they knew about paid-in surplus because there is some technical provision that does refer to paid-in surplus, but not in this respect.

So that I take it that anyone who wants to get around the split-up provisions, if the split-up would have an adverse effect taxwise, could get around it by making the transfer to the paid-in surplus of the subsidiary instead of the capital stock. We as accountants know that for practical purposes there isn't any particular difference between capital stock and paid-in surplus. I don't know whether it was intended by the law to create that difference. I merely submit to you that reading the law it reads, there is that difference.

Now, of course, if you are looking for a way out on a transfer, or to avoid a split-up, you can, in any event, do it by transferring assets to the subsidiary for a loan or open account of a subsidiary rather than stock or paid-in surplus, and that avoids a split-up.

Question No. 2: (This to me is a far more significant and important one.) When a parent company transfers only cash to a subsidiary in exchange for stock, is that a split-up? I am envisioning the situation where you even have a new subsidiary that is getting started, or an old subsidiary that is existing and the parent company financing it by transferring cash in exchange for stock. I must confess that I have rather dogmatically answered to clients and others when I was asked that question, "Of course it is a split-up." To begin with, under World War II the regulation specifically characterized it as such, under the provisions of split-up in World War II.

Secondly, the Bureau has several times held that cash is property for the purpose of measuring whether there is a continuing 80 per cent control. On the other hand, I must also acknowledge that the new regulations say nothing on this subject, and very interesting is the fact that I have with me a ruling from the Bureau that holds that a transfer for cash is not a split-up. Now if a transfer of cash for stock is not a split-up, then here are some of the interesting possibilities: a company organizes a subsidiary. The subsidiary, since there is no technical split-up involved, gets its own $25,000 exemption, if Section 123 has been kicked out of the bill. In any event, we will have the status of a new company with all of the favorable provisions that apply under the existing law

as to new companies and that are likely to apply if some of the Senate provisions of the bill pass and the parent company will still retain its own earnings experience and be able to continue to use them, which I rather imagine may be an interesting way of playing fast and loose with taxes, but I suppose we have given up a long time ago looking for a perfect tax law. We had probably better reconcile ourselves to the fact that we are going to have taxes until death. As a matter of fact, I have always been amused by the fact that death and taxes have been placed together as being conjointly in area. I have always found a very distinct difference between death and taxes, because at least in the case of death, it doesn't get worse every time Congress meets.

Maybe you can get some consolation out of the fact that Adam Smith, one of our famous classical economists, once said that taxation is a badge of democracy. Well, if taxation is the badge of democracy, I can give you these reassurances: this country of ours is safe for democracy for a long time, and we are going to have a mighty big badge to show it.

An explanation of the purpose of Part III of the Excess Profits Tax Act and its effects. Section 471—what transfers does it cover? What does the term "incorporate liquidation" mean as used in Section 470 and 472? In what cases do the provisions of these sections apply?

T. T. SHAW

I would like to comment on section 471 before section 470, as sections 470 and 472 both pertain to intercorporate liquidations and should therefore be considered together.

This section relates to transfers of property by one corporation to another as paid-in capital under the historical invested capital approach in transactions where a substituted basis applies. The corresponding provision under the asset approach is section 441(g).

The purpose of section 471 is to limit the amount includable in invested capital by the transferee corporation to the excess of the amount of the transferor's basis for the property over any debt obligations issued or assumed by the transferee or to which the property was subject, or over any money or the fair value of any other property given by the transferee as part consideration for the transfer.

The effect of this rule is to allocate the basis of property received in an exchange first to any consideration given by the transferee other than its own stock, with only the remaining portion of the basis included as paid-in equity invested capital.

For example, if property with an adjusted basis of $1,000,000 and subject to a mortgage of say $800,000 were transferred by one corporation to another as paid-in capital in a transaction where a substituted basis applied, the amount includable in the transferee's invested capital would be limited by section 471 to $200,000.

Section 471 covers only transfers by corporations and only transfers where a substituted basis applies. The section seems to be deficient in this respect. For instance, nowhere does it say what you should do where the transfer is by an individual or a partnership in a section 112(b)(5) transaction, and nowhere does it say what the rule is where a substituted basis does not apply and property is paid in subject to the transferee corporation issuing or assuming a debt obligation as part consideration for the transfer of the property.

If no special provision is needed to cover transfers by individuals and partnerships, and no special provision is needed where a substituted basis does not apply, it raises a question as to why a provision such as section 471 is necessary where the transferor is a corporation or where a substituted basis does apply.

Where property was acquired by one corporation from another as paid-in capital in a transaction which under the law when it occurred did not qualify as an ex-

change with a carry-over of basis, but subsequently, by reason of a change in the law did so qualify, the law as of the time of acquisition is disregarded and the exchange is considered as qualifying for the carry-over method of determining basis if the property is still held in the excess-profits-tax year or, in the case of property disposed of, if the law had been changed when the disposition took place.

For income-tax purposes the law prescribes in all cases of a substituted basis the usual adjustments for depreciation, amortization, and depletion in respect of the period during which the property was held by the transferor. In most cases a further adjustment must be made by increasing the transferor's basis, as adjusted for depreciation, etc., by the amount of any gain recognized to the transferor upon the exchange. An example of this kind is the acquisition of property by a corporation in connection with a reorganization.

Both of these adjustments may be different for purposes of section 471 from what they are for ordinary income-tax purposes. With respect to the period prior to the receipt of the property by the transferee, the adjustments are those prescribed for the computation of earnings and profits. For example, discovery or percentage depletion are not taken into account in computing earnings and profits, and consequently they are not the kind of depletion to be used in adjusting the transferor's basis to convert it into the transferee's unadjusted basis for invested capital purposes. Likewise, the amount of any gain or loss recognized to the transferor upon the exchange in question affects the basis to the transferee for invested capital purposes only to the extent to which it is taken into account in computing the earnings and profits of the transferor.

The liabilities assumed, or the additional consideration given by the transferee, may in some cases exceed the basis of the property it receives. For example, assume that property with a basis of $600,000 has a current value of $1,000,000, and is subject to a mortgage of $700,000. In this case the liability to which the property is subject exceeds the basis of the property. In a situation of this kind section 471 would require the daily invested capital of the transferee of the property to be reduced by $100,000 as a result of the transfer; that is, by the excess of the mortgage over the basis. The regulations state that the daily invested capital may be a minus amount after a transaction such as this. If the transferor were an individual or a partnership, section 471 would not of course apply. In that event the transferee would seem justified in not reducing daily invested capital in a situation of this kind.

Section 471 is limited to transactions wherein property is paid in for stock or as paid-in capital, and consequently does not apply to exchanges which constitute intercorporate liquidations. These are covered by sections 470 and 472.

Section 470

The term "intercorporate liquidation" as used in sections 470 and 472 means the receipt of property by one corporation in complete liquidation of another under a provision of law by which no gain or loss is recognized to the recipient corporation. Liquidations under section 112(b) (6) are the most common form of intercorporate liquidation. Also included are liquidations during consolidated return periods since 1929. For years prior to 1929 liquidations during consolidated return periods were considered taxable and so would not qualify as intercorporate liquidations unless they were erroneously treated as nontaxable when the liquidation occurred. In that event even a pre-1929 liquidation during a consolidated return period would be treated as an intercorporate liquidation for excess-profits-tax purposes unless the taxpayer decided to take an inconsistent position and pay any tax that might be due on the old liquidation.

A liquidation in connection with a reorganization other than a statutory merger or consolidation should not be treated as an intercorporate liquidation. This is because such a liquidation is merely a step in the reorganization and not really a liquidation in the regular sense. (*San Joaquin Fruit & Investment Co.* 28 B.T.A. 395.)

The provisions of section 470 apply

only where the stock of the liquidated subsidiary had a cost basis in the hands of the parent company. However, before concluding that stock of a liquidated subsidiary did not have a cost basis, it is necessary to study carefully the rules regarding determination of basis, which are set out in detail in the regulations pertaining to section 472, but which apply also to section 470. It would be well to note that stock may have a non-cost basis for ordinary income-tax purposes and have a cost basis under the intercorporate liquidation provisions.

The general purpose of the intercorporate liquidation provisions in so far as they relate to cost basis stock, is to adjust the invested capital of the transferee (parent) for the difference between the basis of the stock and the underlying assets attributable to the stock at the date 80% or more control of the subsidiary was acquired. The theory of this adjustment is that the invested capital of the parent company after the liquidation should be the same as it would have been if the parent company had acquired the subsidiary's assets directly rather than by the indirect route of first acquiring the stock and then acquiring the assets in liquidation. It is the same line of reasoning as that followed in the *Kimbell-Diamond Milling* case and other cases dealing with acquisition of stock for the purpose of acquiring assets.

The basis of the liquidated subsidiary's assets is, in effect, rewritten for equity capital purposes, to conform to the basis of the underlying stock and this rewritten basis continues to be used by the parent company after the liquidation for equity capital purposes. Depreciation, depletion, and amortization must be recomputed for all periods after the control date whereever necessary to conform to the rewritten basis of the assets, but the recomputed depreciation, etc. is used only for adjusting invested capital. In the excess-profits-tax return it is the regular depreciation, etc., and not the recomputed amount, which is allowed as a deduction.

While section 470 relates to intercorporate liquidations affecting asset approach invested capital, it also may have a bearing on the excess-profits credit under the income method. If a cost basis intercorporate liquidation occurred during the last two years of the base period, the base period capital addition could be affected by it. If such a liquidation took place during an excess-profits-tax year it could have an effect on the capital addition or capital reduction. This is because the assets as restated for purposes of the intercorporate liquidation would have to be taken into consideration.

In cases where the stock of the subsidiary is held by the parent company with a basis other than cost the rules regarding restatement of assets upon intercorporate liquidation do not apply.

A parent company which acquired some of the stock of the liquidated subsidiary by purchase and other stock on a non-cost basis must make computations to restate that portion of the subsidiary's assets which is allocable to the cost basis stock. No adjustment would ordinarily be necessary with respect to the portion of the assets allocable to non-cost basis stock.

Section 472

Section 472 deals with the effect of intercorporate liquidations on historical invested capital.

In the case of cost basis stock, intercorporate liquidations under the historical method are, like those under the asset approach, based on the substitution of the parent company's cost basis of the stock, for the subsidiary's basis of its assets. However, there is an added feature of reflecting by plus or minus adjustment the increase or decrease in the subsidiary's net worth between acquisition of 80% or more control by the parent company and liquidation of the subsidiary. This plus or minus adjustment is treated, for invested capital purposes, as a recognized gain or loss realized by the parent company on the day after the intercorporate liquidation. It is reflected in the parent company's earnings and profits for the particular year and also in its accumulated earnings. In the case of a cost basis intercorporate liquidation, the Sansome rule does not apply.

Where there is an intercorporate liquidation involving cost basis stock and it

occurs in an excess profits-tax year, it is advisable not to allow the liquidation to occur on the last day of the taxable year if a plus adjustment is involved, but to allow it to do so if a minus adjustment exists. For example, if a liquidation involving a plus adjustment occurred on the last day of the taxable year, the plus adjustment would be considered a gain realized by the parent on the first day of the next taxable year and so presumably would not be includable in the parent company's accumulated earnings at the beginning of that year and consequently would not be includable in the parent's equity invested capital until the beginning of the following year. By liquidating the subsidiary the day before the end of the year any plus adjustment will be treated as a gain realized by the parent on the last day of the year and so will be includable in the parent company's accumulated earnings (and equity invested capital) at the beginning of the new year. Where the plus or minus adjustment is large this point can be important.

In computing the plus or minus adjustment in an intercorporate liquidation, the transferee's stock investment must not be reduced by losses (if any) availed of during prior consolidated return periods. This rule applies whether the stock has a cost or a non-cost basis.

Where the subsidiary's stock had a non-cost basis, the subsidiary's assets are not restated upon the intercorporate liquidation as they are where cost basis stock is involved. However, any gain or loss on the intercorporate liquidation is treated as a plus or minus adjustment which is added to or deducted from the parent company's equity invested capital. In this case the plus or minus adjustment is treated as a separate item and is not merged with the parent company's earnings and profits. In addition, in the case of non-cost basis stock the Sansome rule must be given effect to. It could happen in a non-cost basis intercorporate liquidation that there would be a minus adjustment on the intercorporate liquidation and at the same time the parent company would have an addition to its earnings or a reduction of its deficit by application of the Sansome rule. In such a case the parent company would have to make a further adjustment in its invested capital under section 458(e) (3).

About the only case in which there can be an intercorporate liquidation where the parent company owns less than 80% of the stock of the subsidiary is in the case of a statutory merger or consolidation. If one corporation owns stock in another (whether or not more than 80%) and the two are merged or consolidated in a statutory merger or consolidation, the transfer of the property of the corporation whose stock was so held to the resulting corporation is treated as an intercorporate liquidation. The regulations, however, deny a cost basis to the resulting corporation unless, immediately after the merger or consolidation, the shareholders of the former parent corporation are in 80% or more control of the resulting corporation.

The basis of stock of a subsidiary for the purpose of intercorporate liquidation computations is not always the same in amount as it is for ordinary income-tax purposes. The regulations state that it is to be the basis for determining loss upon a sale or exchange, adjusted by amounts proper under section 115(1) for determining earnings and profits. The implication of the reference to adjustments under section 115(1) is that section 472 requires a new determination of the source of pre-liquidation distributions by the transferor. For example, distributions which under section 113(b) are to applied in reduction of the stock basis, because made from March 1, 1913 appreciation realized, would not be so applied under this rule.

Anyone determining the excess-profits-tax effects of an intercorporate liquidation should be familiar with the following four special adjustments: pre-control adjustment, post-control adjustment, transferee adjustment to earnings, and post-liquidation adjustment. These adjustments are technical, but they should be understood as they can have a bearing on the invested capital of the parent company after the intercorporate liquidation of a subsidiary.

I believe the Treasury recognizes that to apply the provisions of Part III literally and completely, would in many cases be impracticable and impossible.

What are the purposes of Sections 463 and 464? What happens when an existing corporation acquires all or part of the component assets of another corporation? How must one treat differences in base periods when there is a transfer between two corporations? How well does the law cover such a situation?

WALLACE M. JENSEN

When a corporation computes its excess-profits credit under the income method it is permitted to include as a part of its credit 12% of the base period capital addition and must take into account 12% of its net capital addition or reduction since the base period. If a Part II transaction occurs during the last two years of the base period or at any time thereafter, and if the average base period net income is determined under Part II, then the base period capital addition and the net capital changes to be taken into account must be determined under the rules provided in sections 463 and 464.

The rules provided in these sections and in the proposed Part II regulations, which were released on August 16, 1951, are quite complicated but can be segregated into certain basic provisions as follows:

1. Whether the transaction occurred during the base period or subsequent to the base period.

2. Whether the acquiring corporation acquired all of the assets or only part of the assets of the component.

3. Whether any part of the stock of a component was purchased for cash or other assets at or prior to the time that the assets of the component are acquired in a Part II transaction.

Rather than deal with the rules in the order in which they are presented in the Regulations, I believe that a clearer picture can be obtained if the rules are considered as they relate to three specific types of Part II transactions. These transactions will be discussed in the following order:

1. The typical situation where an existing corporation acquires all of the assets of another corporation.

2. The splitting up of an existing corporation into two corporations, involving the transfer of assets to at least one newly formed corporation.

3. The less frequent situation where an existing corporation acquires only part of the assets of another existing corporation in a Part II transaction.

When the Part II transaction occurs during an excess-profits-tax year of the acquiring corporation the base period capital addition of the component is added to that of the acquiring corporation so that the resulting base period capital addition is the sum of the two separately determined amounts. For the year of the transaction, however, only a portion of the base period capital addition of the component is taken into account, measured by the ratio of the remaining days in the year after the transaction to the total number of days in the year.

If the transaction occurred during the two years preceding the first excess-profits-tax year, the base period capital addition of the acquiring corporation is computed by combining the yearly base period capital of both the acquiring corporation and the component. For instance, if the transaction occurred during the first taxable year preceding the first excess-profits-tax year of the acquiring corporation, then the yearly base period capital of the component for both the first and second preceding years are added to the corresponding items of the acquiring corporation. Where the transaction took place in the acquiring corporation's second preceding taxable year, only the yearly base period capital of the component for its second preceding year is taken into account.

The Regulations (Sec. 40.464-1(b) (4)) provide that, if the transaction occurred prior to July 1, 1950, it is then necessary to determine constructive taxable years ending after the transaction; that is, the component is deemed to have as many taxable years as are necessary for it to have a first excess-profits-tax year so that what would have been its first excess-profits-tax year and two immediately preceding years can be identified. Wherever it

is necessary to determine a yearly base period capital for any constructive date after the Part II transaction, the amount is to be determined as of the day of the transaction.

Perhaps an example will better illustrate how these rules are applied. We are dealing with the situation where an existing corporation acquires all of the assets of a component, and let us assume that both corporations were in existence during the entire last half of the base period and are on a calendar year basis. Then, if the transaction occurs after January 1, 1950, the separate base period capital additions of each corporation are combined. If the transaction occurred in 1949, then we combine the separate yearly base period capital as of January 1, 1948, and as of January 1, 1949. If the transaction occurred in 1948, we combine only the separate yearly base period capital as of January 1, 1948.

But suppose these two corporations had different taxable years. Assume that Corporation A is the acquiring corporation and is on the calendar year basis but that Corporation B, the component, had a fiscal year ended June 30; then the result would depend upon the time of the transaction. The several possibilities would be:

Assume that the Part II transaction occurs after July 1, 1950, i.e., after the beginning of the first excess-profits-tax year of both corporations. Then the separate base period capital additions of the acquiring corporation and of the component are combined to obtain the base period capital addition of the acquiring corporation for any taxable year thereafter.

Assume that the Part II transaction occurs on April 1, 1950, i.e., after the beginning of the first excess-profits-tax year of the acquiring corporation but during the first taxable year of the component corporation immediately preceding the first excess-profits-tax year which the component is deemed to have. Then the *base period capital addition* to be combined would be separately determined using the following dates:

Corporation A: 1/1/48, 1/1/49, and 1/1/50
Corporation B: 7/1/48, 7/1/49, and 4/1/50

Assume that the Part II transaction occurs on April 1, 1949, i.e., during the first preceding taxable year of the acquiring corporation and during the second preceding taxable year of the component. Then the separate *yearly base period capital* would be combined as follows:

Corporation A: 1/1/48, 1/1/49, and 1/1/50
Corporation B: 7/1/48, 7/1/49 ————

The component may have been a subsidiary or an affiliated corporation and, therefore, the Regulations (Sec. 40.464-1(c)(1)) provide rules for excluding intercompany transactions. Although there appears to be no specific statutory provision in section 464, comparable to section 463(a)(7) which leaves the rules for intercorporate transactions to be determined by regulations, the need for them is evident. The Regulations provide that, in computing the yearly base period capital of either corporation, the intercompany stock holdings are to be excluded from equity capital and inadmissible assets. Likewise, daily borrowed capital, the related interest adjustment, and the loans to members of a controlled group are determined as if the indebtedness between the two corporations did not constitute borrowed capital.

The intent of the Regulations seems to be that the acquiring corporation and the component are treated as a unit and that all intercorporate transactions are to be disregarded as would be the case if consolidated financial statements were prepared. However, where the two corporations had different taxable years and as a result the *yearly base period capital* of each is determined as of a different date, then the amounts to be excluded from each corporation may not be identical. Just what the result might be in any given case would depend upon the facts, but it would seem that the rules may have to be mixed with a little common sense in their application to obtain an equitable result.

Where the transaction occurs after the base period and the general rule is that the separately determined *base period capital additions* of each corporation are then combined, the Regulations are not clear as to whether such amounts should

be redetermined on the basis of eliminating intercorporate transactions. It is my thought that it should be done. Take, for instance, a situation where all of the borrowed capital of a subsidiary consisted of loans from its parent corporation. In that case the base period capital addition of the subsidiary has been penalized by an interest adjustment on borrowed capital but no corresponding offsetting interest adjustment has been permitted to the parent even though its yearly base period capital has been reduced because of the loan to a member of a controlled group. Unless the yearly base period capital of each corporation is redetermined it would seem that the intercompany transactions would not be eliminated entirely from *all* of the factors affecting the income credit.

It should be pointed out that the intent of the statute and of the Regulations seems to be that the base period capital addition of the acquiring corporation is computed by combining the separate *base-period capital additions* in some instances and by combining the separately determined *yearly base-period capital* in other instances. The exact method followed depends upon whether the Part II transaction occurs before or after the end of the base period. There is no provision for combining the equity capital of each corporation, the borrowed capital of each, etc. Each of these factors is taken into account in its appropriate place, and only the computed base period capital addition or yearly base period capital is combined.

Thus, where the Part II transaction occurs during an excess-profits-tax year and the separate base period capital additions are combined, the fact that one of the corporations had a zero base period capital addition (because its yearly base period capital decreased rather than increased) would not operate to reduce the base period capital addition of the other corporation. The result is the sum of the two, separately computed. But, where the transaction occurred during the base period and the separately computed yearly base period capital is combined, a decrease in the case of one corporation would offset an increase in the yearly base period capital of the other.

So far I have dealt only with the base period capital addition in the situation where one corporation acquires all of the assets of another. Turning now to the net capital changes subsequent to the base period, section 463 applies only when the Part II transaction occurs in an excess-profits-tax year and only when the average base period net income is being computed under Part II.

The proposed regulations dealing with this point are also quite complicated but may be broken down into two situations; namely, whether the transaction occurred before or after June 30, 1950. If the transaction occurred after June 30, 1950, then any property paid in during the year for stock of the component or distributions made during the year which were not out of earnings and profits are taken into account by the acquiring corporation beginning with the day after the transaction. Also, where the transaction occurs after June 30, 1950, the difference between the equity capital of the component at the beginning of that year as compared with the beginning of its first excess-profits-tax year is taken into account in computing the acquiring corporation's daily capital addition or reduction beginning with the day of the transaction. This rule applies only for the year of the transaction, and for subsequent years the equity capital of the component as of the beginning of its first excess-profits-tax year is combined with that of the acquiring corporation as of the beginning of its first excess-profits-tax year.

Likewise, the daily borrowed capital of the component as of the beginning of its first excess-profits-tax year and the original inadmissible assets are added to the corresponding amounts of the acquiring corporation. In the year of the transaction the same amounts are added to the daily borrowed capital and daily inadmissible assets of the acquiring corporation for each day preceding the transaction so that as a result it has a zero effect for the part of the year prior to the transaction, and any subsequent changes are reflected for the remainder of the year. Loans to members of a controlled group and inadmissible assets representing stock of members

of a controlled group are similarly handled.

If the transaction occurred after the beginning of the first excess-profits-tax year of the acquiring corporation but prior to July 1, 1950, then all computations which are ordinarily made as of the beginning of the first excess-profits-tax year of the component are made as of the time immediately prior to the transaction. For instance, if both of the corporations were on a calendar year basis and the transaction occurred April 1, 1950, the base period capital addition would have been determined for each corporation to and including January 1, 1950. But for the purpose of determining the net capital changes subsequent to the base period, the transaction date of April 1, 1950, is used in lieu of January 1, 1950, for all computations necessary to determine the respective items of the component to be added to those of the acquiring corporation as of January 1, 1950. The Regulations distinguish between transactions which occurred before or after June 30, 1950. It is at variance with the theory of constructive taxable years which the component is deemed to have under Section 40.464-1(b)(4) relating to base period capital addition. For instance, January 1, 1950, is used as the end of the base period for the purpose of computing the base period capital addition of such a component but April 1, 1950, would be used to measure the equity capital and borrowed capital of the component to be added to the respective original amounts of the acquiring corporation determined as of January 1, 1950. To the extent that such items of the component changed between January 1, 1950, and April 1, 1950, the result would be inequitable.

The Regulations also provide for the elimination of intercompany transactions in determining the net capital changes since the base period. In order to accomplish that purpose intercorporate stock holdings and intercompany loans are excluded as of the same dates as of which the original inadmissible assets and original equity capital are determined, and again the date depends upon whether the transaction was before or after June 30, 1950.

The Regulations under section 463 and 464 supply rules to apply the limitations under section 462(j) (1) relating to the elimination of a possible duplication in transferred capital additions in cases where after December 31, 1945, the acquiring corporation purchased stock of a corporation in whole or in part for cash or other assets and that corporation subsequently becomes a component. The effect of the rules is to eliminate the appropriate portion of the base period capital addition and the net capital changes prior to the purchase of the stock. For instance, if the acquiring corporation had purchased 30% of the stock of the component on April 1, 1949, then 30% of the yearly base period capital of the component as of January 1, 1948, and January 1, 1949, would be eliminated. If the purchase had occurred on April 1, 1950, then 30% of the entire base period capital addition would be eliminated and also 30% of the original equity capital, original inadmissible assets, and the other factors necessary to determine the starting point for computing the net capital addition would not be taken into account.

No adjustment is necessary under section 462(j)(1) except to the extent duplication of experience occurs. Section 40.-462-10 of the proposed Regulations recognizes that no duplication of base period experience may have occurred where the stock of the component is acquired through the use of money obtained through a bona fide increase in the capital structure (whether equity or borrowed) for the purpose of acquisition. The Regulations under sections 463 and 464 follow through in such a situation and provide for the exclusion from the base period capital addition or the net capital changes of such amount as is necessary to prevent the acquiring corporation having not only the benefit of the base period experience but also a possible duplication as a result of increased capital. These provisions in the Regulations are in very general terms and are not too clear. For instance, it is provided (Section 40.464-1(c) (2)) that there shall be excluded from the base period capital addition of the acquiring corporation so much thereof as is attribu-

table to *assets* obtained for the purpose of acquiring the stock in the component in such a transaction. If the purchase occurred during the base period, it would appear that the yearly base period capital for any date after the purchase would have to be recomputed to eliminate the increased capital structure by which the funds were provided. In addition, the Regulations provide that in the case of determining the net capital changes so much of the *increase* in equity capital and of the *increase* in borrowed capital as is attributable to *assets* obtained for the purpose of acquiring the stock shall be excluded.

It would have been helpful if the Regulations had provided specific examples to illustrate how this general rule should be applied. For instance, suppose that some of the stock of a component had been purchased from its stockholders for $100,000 in cash, all of which was obtained by a new bank loan. Such loan would have been included in the amount of $75,000 as borrowed capital in computing the base period capital addition or the net capital changes of the acquiring corporation, less an appropriate interest adjustment, but how much is attributable to the assets obtained for the purpose of acquiring the stock; that is, what amount must be eliminated? Is it the entire cost of $100,000? Is it the $75,000 which was included in borrowed capital? Or is it 75% of the unpaid balance of the note payable on the dates that the necessary computations are made? Also, is a portion of the interest adjustment excluded as well? It is my own opinion that it might be logical to require the elimination of whatever amount may have been includable in either equity or borrowed capital as the source of the funds at the moment of the purchase and that the same amount might justifiably be required to be eliminated in all subsequent computations. Such a rule, however, might work inequities where the financing was arranged on a temporary rather than a permanent basis, and perhaps it is just as well that the Regulations deal with this point only in a general way. The fact remains that the computation to be made is vague and uncertain and subject to controversy.

The general situation in section 461(a)(1)(E), where only part of the assets of the component are transferred to an acquiring corporation, would be the case where an existing corporation is split up into two corporations, a subsidiary corporation is created, or the assests of a partnership are transferred in part to a corporation. In most cases the acquiring corporation will be a new corporation created incident to the transaction.

In such a situation, if the transaction occurs after the beginning of the first excess-profits-tax year of the component, then the acquiring corporation takes over that portion of the base period capital addition of the component measured by the ratio of the fair-market value of the assets transferred to the fair-market value of all assets of the component immediately prior to the transaction.

Since the transaction may have occurred during the first excess-profits-tax year of one corporation ànd during the preceding taxable year of the other corporation, special rules are necessary. Where the transaction occurs during a preceding year of the component, then the yearly base period capital of the acquiring corporation for the year of the transaction is computed as of the day following the transaction, which thereby would include the assets transferred. If, however, the transaction occurs in the first excess-profits-tax year of the acquiring corporation and in a preceding year of the component, then the yearly base period capital addition of the acquiring corporation for its first preceding year would be the portion of the yearly base period capital of the component for the first day of its year in which the transaction occurred. Here again the portion is determined by the ratio of the fair-market value of the assets transferred. While these rules are quite complicated, a simple example might help to clarify them. If the component corporation had a fiscal year ended June 30 and transferred some of its assets to a newly formed corporation on April 1, 1950, and the acquiring corporation adopted the calendar year basis, then July 1, 1948, July 1, 1949, and April 1, 1950, would be

the dates to be used in computing the yearly base-period capital transferred to the acquiring corporation.

While the portion of the base period capital addition or the yearly base period capital transferred to the acquiring corporation in an "E" transaction is measured by the ratio of fair-market value of assets, the same yardstick is not used for the purpose of determining the transferred net capital addition. In such a case, section 463 applies where the transaction occurred in an excess-profits-tax-year and it becomes necessary to determine for the acquiring corporation the original equity capital, original borrowed capital, and original inadmissible assets as of the beginning of its first excess-profits-tax-year. In this situation the equity capital of the component as of the beginning of its first excess-profits-tax year is allocated to the acquiring corporation in the proportion that the equity capital transferred bears to the equity capital of the component immediately prior to the transaction. Likewise, the borrowed capital of the component at the beginning of its first excess-profits-tax year is allocated in the ratio that the borrowed capital transferred is to the total borowed capital of the component immediately prior to the transaction. In the same manner the original inadmissible assets of the component are allocated in the proportion that the inadmissible assets transferred to the acquiring corporation bear to the total inadmissible assets of the component immediately prior to the transaction. This may result in some unrealistic allocations. For instance, equity capital is measured by the adjusted basis of the assets transferred, which may be substantially more or less than their fair-market value. In many cases it may well result that the ratios of equity capital and borrowed capital transferred are not in line with the fair-market value ratio used in allocating average base-period net income and the base-period capital addition.

In most cases where a component transfers only a part of its assets to an acquiring corporation, the acquiring corporation will be a new corporation created incident to the transaction. In those unusual circumstances where the acquiring corporation had been in existence prior to the "E" transaction, however the statute left the rules to be prescribed by the Regulations.

The Regulations (Section 40.461-7(b)), provide that in such a case the component will be deemed to have transferred a part of its assets to an imaginary corporation and that such an imaginary corporation then transferred all of its assets to the acquiring corporation. In that way the general rules of an "E" transaction apply to the first assumed transfer to the imaginary corporation, and the general rules relating to the transfer of all assets apply to the second assumed transfer.

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