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THE 1958 TECHNICAL AMENDMENTS ACT - ESTATE AND GIFT TAX CHANGES AND SMALL BUSINESS TAX REVISIONS

By Edward N. Polisher* and Bennett L. Aaron**

INTRODUCTION‡

THE Technical Amendments Act of 1958, amending the 1954 Internal Revenue Code, known as TITLE I, H.R. 8381, was enacted on September 2, 1958. It had as its principal objective the elimination of substantive unintended benefits and hardships in the existing income, estate and gift tax provisions. At the same time, changes were made to correct inadvertent errors in the Internal Revenue Laws, including inconsistencies in the statute, as well as instances in which the language in the statute did not carry out the intention of Congress as clearly expressed in committee reports.

The amendments concerned with technical errors and ambiguities, as a general rule, take effect as if originally enacted as part of the 1954 Code; as to income tax provisions, Dec. 31, 1953; as to estate tax provisions, to the estates of decedents dying after August 16, 1954 (except Sec. 2039 dealing with annuities); and as to gift tax provisions, to gifts made after December 31, 1954. Certain of the amendments relate to provisions of the 1939 Code and are made effective as of various dates during which the specific provisions of the 1939 Code were operative.

The substantive provisions of the 1958 Act for the most part are made effective for taxable years beginning after December 31, 1957.

The Small Business Tax Revision Act of 1958 was originally H. R. 13382 and was separately referred to the Senate Finance Committee. This Bill, however, was not reported at all to the Senate. Instead, when H. R. 8381 was considered on the Senate Floor, small business tax provisions, similar to those in H. R. 13382, were added to H. R. 8381 by amendment and became TITLE II of this Bill, known as the "Small Business Tax Revision Act of 1958".

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‡ Reference to Sections are the 1954 Internal Revenue Code, except where otherwise indicated.

Explanations of the various versions of the Bills and Amendments were published in House Ways and Means Committee Reports No. 775 and No. 2198, the Senate Finance Committee No. 1983 and the Conference Committee Report No. 2632.

The scope of this article includes only the estate and gift tax changes and the small business tax revisions enacted by the 1958 Law. The remaining Technical Amendments are not discussed.

ESTATE AND GIFT TAX CHANGES

I. INSTALLMENT PAYMENT OF ESTATE TAX ATTRIBUTABLE TO CERTAIN BUSINESS INTERESTS

One of the outstanding problems that faced estate tax planners was how the estate tax would be paid in those cases where the major portion of the estate consisted of an interest in a closely held business. Various methods of providing liquid assets were devised, with which the estate tax could be paid. These included the purchase of life insurance, the buying of easily convertible assets such as certain government bonds, the redemption of stock under Section 303, and the setting up of charitable foundations to hold the stock of the corporation.

Section 206 of the Small Business Tax Revision Act of 1958, which added Section 6166 to the 1954 Code, was enacted in order to alleviate this problem. Generally speaking, this Section permits the payment of the estate tax in ten annual installments, where the decedent was a citizen or resident of the United States, and the major portion of his estate consists of an interest in a closely held business.

A. *When Can the Election Be Made*

Section 6166 (a) provides that if the value of the interest in the closely held business exceeds either 35% of the value of the gross estate, or 50% of the value of the taxable estate, then the executor may elect to pay part or all of the estate tax in two or more equal installments, the maximum number of allowable installments being ten.

Where the decedent held interests in two or more closely held businesses, and more than 50% of the total value of each business is included in his gross estate, those businesses shall be treated as a single closely held business.[1] The Section states that in satisfying the 50% requirement, an interest in a closely held business which represents the surviving spouse's interest in

[1] § 6166 (d).

property held by the decedent and the surviving spouse as community property shall be treated as having been included in determining the value of the decedent's gross estate.

It is to be noted that the Section requires *more* than 50% of each business to be included in decedent's gross estate. A 50% interest is not sufficient. Therefore, if two partners have two businesses, each owning 50%, their interests cannot be combined. This peculiar result does not seem in line with the general tenure of the Section.

The value of the estate shall be the value determined for purposes of the Federal estate tax. Therefore, if an alternate valuation date is used, the value of the estate on that date is the value that is used.[2]

B. *Amount Eligible to be Paid in Installments*

A limitation has been placed on the maximum amount of the estate tax which can be paid in installments.[3] This limitation is based on a percentage equal to the value of the interest in the closely held business divided by the value of the gross estate.

This limitation on the amount of the estate tax that can be paid in installments may present difficult problems in certain cases where there is a large discrepancy between the gross estate and the taxable estate. While the value of the interest in the closely held business will practically all be included in the taxable estate, it may only make up a much smaller part of the gross estate, which as yet has not been reduced by debts, expenses, etc. Therefore, while the value of the interest in the closely held business may be the cause of a large part of the tax, it may only be a small part of the amount by which the tax deferment is measured.

C. *Definition of a Closely Held Business*

What is deemed to be an "interest in a closely held business"? The Act is specific in defining that phrase.[4] It includes:

(1) An interest as a proprietor in a trade or business carried on as a proprietorship.

(2) An interest as a partner in a partnership carrying on a trade or business, if

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[2] § 6166 (a).
[3] § 6166 (b).
[4] § 6166 (c).

(a) Twenty percent or more of the total capital interest in such partnership is included in determining the gross estate of the decedent; or
(b) Such partnership had ten or less partners.

(3) Stock in a corporation carrying on a trade or business, if
(a) Twenty percent or more in value of the voting stock of such corporation is included in determining the gross estate of the decedent; or
(b) Such corporation had ten or less stockholders.

These determinations should be made as of the time immediately before the decedent's death.

The Section is not helpful in answering the question as to what will constitute a "trade or business". This problem is a recurring one in the Internal Revenue Code. It is to be hoped that the regulations will clarify the meaning of that phrase as it applies to this Section.

The size of the business in which the decedent had an interest has no bearing on whether or not his interest in it will qualify. For example, so long as more than 20% of the value of voting stock of a corporation is included in decedent's gross estate, whether or not the company is large enough to be listed on the stock exchange, the interest will qualify.

The value of the stock must actually be included in his gross estate. Therefore, the stock attribution rules will have no effect in determining whether or not the 20% requirement has been met.

D. *How and When Can the Election Be Made*

As stated previously, the election can be made by the executors of estates of citizens or residents of the United States.[5] Such election must be made no later than the time allowed by Section 6075 (a) of the 1954 Internal Revenue Code for filing the estate tax return, including any extensions thereof. The Secretary of the Treasury is expressly given the authority to prescribe regulations setting forth the manner in which such election should be made.

If an election under this Section is made, the provisions of the estate tax sub-title of the Code shall apply as though the Secretary or his delegate were extending the time for payment of the tax.[6] This makes it clear that the 4% interest requirement under Section 6601, the authority given the Secretary under Section 6165 to require a bond, and the suspension of the running of

[5] § 6166 (a).
[6] § 6166 (a) (2).

the period of limitations on collection after assessment under Section 6503, will be applicable where an election is made under this Section.

There is no requirement that the executor must elect to defer payment on the full amount to which he is entitled. He can pay as much of the tax as he wants to, and defer the balance. Also, he need not stretch payments out into the full ten installments. He may elect to pay the tax in fewer than ten installments.

E. *When Must Installments be Paid*

Where an election has been made under this Section, the first installment must be paid in accordance with Section 6151 (a), which sets forth the rules for the payment of the estate tax. Under that Section, the date on which the first installment is required to be paid is the date the estate tax return is required to be filed. The succeeding installments must be paid every year on or before the date on which the first installment was to be paid. This date is determined without regard to any extension of time which was given for the payment of the first installment.

Where an extension of time has been granted for the filing of the estate tax return, the regulations will have to fill in a statutory gap. It is possible that since the executor has until the end of the extension period to make his election, that the first installment will be payable prior to the making of the election.

F. *Treatment of Subsequently Assessed Deficiencies*

Where an election has been made under Section 6166 (a) and a deficiency is subsequently assessed, such deficiency is to be pro-rated over all the installment payments.[7] This rule only applies where the deficiency, plus the amount of the estate tax for which the election to pay in installments was made, is not more than the limitation set forth in Section 6166 (b). In the case of those installments that are not yet due, that part of the deficiency pro-rated to them must be collected at the same time and as part of those installments. The executor has the option, however, of paying the deficiency or any part of it immediately, rather than spreading the payment out over the unpaid installments.

That portion of the deficiency which exceeds the limitation of Section 6166 (b), or which has been pro-rated to installments whose time for payment has already passed, must be paid upon notice and demand from the Secretary or his delegate.

[7] § 6166 (f).

Where there has been an additional tax imposed to the deficiency for negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax under Section 6653, the entire deficiency must be paid upon notice and demand from the Secretary or his delegate.

G. *Interest Payments*

Interest payments on that portion of the estate tax which remains unpaid must be paid every year as part of each installment payment.[8] The amount of the interest is computed on the entire unpaid balance from the date of the preceding installment to the date of the current installment, and it is paid with the current installment. If any advance payments have been made during the period, the proper adjustments should be made. The amount of the unpaid balance includes any deficiency which is included in the installments.

The rate of interest is 4%. This is opposed to the regular rate of interest of 6%, which is normally charged on delinquent payments of estate tax and deficiencies. The 4% rate also applies where the time for payment of the estate tax has been extended due to hardship, or it is based on a reversionary or remainder interest. Any payments of installments, which are made prior to their due date, reduce the amount of interest to be paid with the succeeding installment.

The interest to be paid on that part of a deficiency which is pro-rated to the installment payments is computed at the 4% rate, whereas the interest on the balance of the deficiency is computed at the rate of 6%. Where a part of the deficiency has been pro-rated to payments which have already fallen due, the interest must be paid upon notice and demand of the Secretary or his delegate. As to the portion of the deficiency that has been pro-rated to future payments, the interest that has accrued from the original due date to the date of the last previous installment payment has to be paid on notice and demand. In regard to the period subsequent to the date of the last previous installment payment on that portion of the deficiency which was pro-rated to future payments, interest is payable each year with every installment payment.

Where the Treasury has exercised the power granted to it to extend the time for the payment of installments because it feels that such payment would result in undue hardship, interest will be payable at the rate of 4% on any such extension. The length of time for which payment can be extended under these circumstances is ten years after the original date on which the estate tax

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[8] § 6166 (g).

return was due. Such extension can apply to all or a portion of the first installment or any succeeding one, as well as to that part of an installment that is comprised of a pro-rated deficiency.

H. *Acceleration of Payment of Installment Payments*

The Section prescribes certain conditions under which the payment of installments can be accelerated.[9]

(a) If,

(1) The aggregate amount of the withdrawals of money and other property from the trade or business, an interest in which qualifies for the election to pay the estate tax installments, is equal to or exceeds 50% of the value of such trade or business; or

(2) Fifty percent or more in value of the interest in a closely held business which qualifies is distributed, sold, exchanged, or otherwise disposed of, then any unpaid part of the tax payable in installments shall be paid upon notice and demand from the Secretary or his delegate.[10]

The term "distributed, sold, exchanged, or otherwise disposed of" as a rule includes all means by which the property ceases to form a part of the estate; and also, all methods by which the heirs may divest themselves of the property, in those situations in which the property passes directly to the heirs on death.

The term is not applicable to an exchange of stock pursuant to a plan of reorganization within the definition of Section 368 (a) (1) (D) (E), or (F), nor to an exchange to which Section 355 and Section 356 apply.[11] Stock received in any of the above type of transactions will be treated as a qualifying interest in a closely held business, if the stock exchanged, or with respect to which stock was received, qualified as an interest in a closely held business. A withdrawal from the trade or business, or a disposition of an interest in a closely held business, does not include the mere turnover of inventory.[12]

Nor does such term include a transfer of property to a person entitled to receive such property under the decedent's will or under the applicable law of descent and distribution.[13]

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[9] § 6166 (h).

[10] § 6166 (h) (1) (A) (i) and (ii).

[11] § 6166 (h) (1) (c).

[12] H. C. R. No. 2198, p. 18.

[13] § 6166 (h) (1) (D), H. C. R. No. 775, p. 9.

The above limitations as to withdrawals and dispositions do not apply where there is a distribution in redemption of stock to pay death taxes, to which Section 303 applies, if, on or before the date prescribed for payment of the first installment which becomes due after the date of the distribution, there is paid an amount of the tax at least equal to the amount of money and other property distributed.[14]

The necessity to pay over the amount received on account of the tax is eliminated in the case of a stock redemption under the special income tax provisions, where it does not equal or exceed 50% or more of the value of the trade or business or of the business interest. However, the whole amount received must be paid over where the redemption is the same as or more than the needed 50%. This is so even though state death taxes and funeral and administration expenses are the basis on which the amount of the redemption may have been partly fixed.

The real value of a trade or business may be much greater in later years, even though its value for the purpose of this Section is determined by the value used for estate tax purposes. Therefore, that which was 50% of value at the decedent's death, may be much less than 50% at a later date. Nevertheless, the privilege of making installment payments will be lost, if this amount is withdrawn or distributed at the later date.

Where a partnership interest is involved, and the business has had losses for several years, the privilege of making installment payments may also be lost, even though there has been no change in the value of the interest in the partnership. If drawings during loss years are deemed to be withdrawals from capital, such withdrawals will be lumped together in ascertaining whether there have been withdrawals of 50% or more. The fact that the capital accounts are later restored will have no bearing on this determination.

(b) An estate is allowed to accumulate income without restriction during its first four years for purposes of the installment election. However, if an election is made and the estate has undistributed net income for any taxable year after its fourth taxable year, the executor must pay an amount equal to such undistributed net income in liquidation of the unpaid portion of the tax payable in installments. This amount must be paid on or before the date prescribed for filing the income tax return for such taxable year, including extensions thereof.[15]

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[14] § 6166 (h) (1) (B).

[15] § 6166 (h) (2) (A).

"Undistributed net income" of the estate for any taxable year is defined as the amount by which the distributable net income of the estate for the taxable year (as defined in Section 643) exceeds the sum of:

(1) The amounts for such taxable year specified in Section 661 (a) (1) (2);

(2) The amount of the Federal income taxes imposed on the estate for such taxable year; and

(3) The amount of the Federal estate tax, including interest, paid for the estate during such taxable year, without regard to any amount paid by reason of the application of this acceleration rule to the current taxable year or any preceding taxable year.[16]

Any payment made under the provisions of this Section shall be applied in full as a reduction of the unpaid portion of the tax payable in installments, but no part of any such payment shall be applied as a payment of interest until the full amount of the deferred tax has been paid.

In encouraging a 9 year period of administration for estates, whether or not it is necessary, the installment payment section is opposed to a policy of the Treasury that is against the unnecessary prolongation of the administration of estates. Accelerating payment where income has been accumulated appears to be an effort to guard against possible accumulations of income by estates in the lower brackets, with later tax-free distributions to beneficiaries in the upper brackets. It would be wise, in planning an estate, to give the executor as much discretion as possible in regard to determining the amount of income to be accumulated.

(c) In accordance with the rules generally applied where taxes are allowed to be paid in installments, if any installment is not paid on or before the date fixed for its payment, including any extension of time, the unpaid portion of the tax will be payable upon notice and demand from the Secretary or his delegate.[17] The interest rate on such delinquent installments is 6%.[18]

I. *Transitional Rules*

Where the Federal estate tax return had to be filed prior to September 2, 1958, thereby not qualifying for the installment privilege under this Section, a limited installment privilege is applicable only as to estate tax defi-

[16] § 6166 (h) (2) (B).
[17] § 6166 (h) (3).
[18] House Committee Report No. 775, p. 21.

ciencies assessed after that date.[19] However, the estate must qualify under Section 6166 (a) (1) and (2), and the deficiency cannot be due to negligence, intentional disregard of rules and regulations, or to fraud with intent to evade tax.[20] The election must be made within 60 days after issuance of notice and demand by the Secretary or his delegate for payment of the deficiency, and in accordance with regulations prescribed by the Secretary or his delegate.[21]

The portion of the deficiency that qualifies must be pro-rated to all those installments that would have existed had an election been made when the estate tax return was filed. That part of the deficiency which was pro-rated to installments whose date for payment would have already arrived had the election been made, must be paid at the time the election is made under Section 6166 (i). That part of the deficiency pro-rated to installments that would not have fallen due if the election had been made, will be paid at the time such installments would have been due had the election been made.

II. Election of Survivor Benefits Under Certain Qualified Plans Not Subject to Gift Tax

Section 68 of the 1958 Act, added a new Section 2517 to Sub-Chapter B of Chapter 12 of the 1954 Code relating to transfers for purposes of gift tax. Under Section 2039 (c) of the 1954 Code, the portion of the survivor benefits payable to a beneficiary other than the executor under a qualified Pension, Stock, Bonus or Profit-Sharing plan, which is attributable to the employer's contributions, is excluded from the employee's gross estate for estate tax purposes. The new Section 2517 provides, for gift tax purposes, a rule which is similar to that provided by Section 2039 (c) for estate tax purposes. Under Section 2517 (a), an employee who irrevocably exercises an election or option provided for in a qualified plan, to have certain benefits under the plan paid to a beneficiary who survives him, is not to be considered as having made a gift of that portion of such survivor benefits, which is attributable to his employer's contributions under the plan. Similarly, the employee is not to be treated as having made a gift of that portion of such survivor benefits, which is attributable to his employer under the plan where he fails to exercise an election or option whereby he could prevent the vesting of these rights in a beneficiary, or where, by failure to revoke within the necessary period, he permits a previously revocable election to become irrevocable.[22]

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[19] § 6166 (i).
[20] § 6166 (i) (1) (B).
[21] § 6166 (i) (2).
[22] Report No. 1983 of the Senate Committee on Finance, p. 228.

The Section gives a detailed outline of the requirements which are necessary in order for the plan to qualify to secure this exemption. It will qualify if the option or election and annuity or other payment is provided for under:

(1) An employee's trust (or under a contract purchased by an employee's trust) forming part of a pension, stock bonus, or profit sharing plan which, at the time of such exercise or non-exercise, or at the time of termination of the plan if earlier, met the requirements of Section 401 (a);

(2) A retirement annuity contract purchased by an employer (and not by an employee's trust) pursuant to a plan which, at the time of such exercise or non-exercise, or at the time of termination of the plan if earlier, met the requirements of Section 401 (a) (3), (4), (5) and (6); or

(3) A retirement annuity contract purchased for an employee by an employer which is an organization referred to in Section 503 (b) (1), (2) or (3), and which is exempt from tax under Section 501 (a) and Section 2517 (a).

The above requirements for qualification have to be met by the plan when the election is exercised or not exercised; or, when the plan is terminated if that is earlier.

Sub-section (b) of the new Section 2517 provides that the exclusion contained in new Section 2517 (a) does not apply to that part of the value of the survivor benefits which bears the same proportion to the value of the survivor benefits as the total payments or contributions made by the employee bears to the total contributions or payments made.[23]

Thus, if no contributions to the plan were made by the employee, the transfer, through exercise or non-exercise of the election, of the entire value of the survivor benefits is removed from the category of taxable gifts.

Example: An employee covered by a qualified pension trust is entitled, at age 60, to receive an annuity for life on his retirement. At that time, however, he makes an irrevocable election under the plan to take an annuity of a lesser amount for himself, so that his widow will receive an annuity after his death. At the employee's retirement his widow's survivor annuity is worth $20,000.00. The contribution made by the employee to the plan was $12,000.00. The contribution made by the employer on account of the employee was $36,000.00. The amount of the widow's survivor annuity which

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[23] Report No. 1983 of the Senate Committe on Finance, p. 228.

is exempt under the new Section is $15,000.00, arrived at in the following manner:

$$\$20,000. \times \frac{\$36,000.}{\$48,000.}$$

The exclusion does not apply to a transfer of a right under a qualified plan if the transfer is not pursuant to an election or option provided for in the plan. Nor does the exclusion apply to the value of any benefits payable to the beneficiary during the employee's lifetime.

The principles followed under Section 2039 of the 1954 Code in connection with determining the value of survivor benefits and the amount of employees' and employers' payments or contributions are equally applicable under Section 2517. As used in Section 2517, the term "employee" includes a former employee.[24]

This provision is effective for the calendar year 1955 and succeeding years. In regard to calendar years prior to 1955, the taxability of the exercise or non-exercise of the elections under this Section is to be ascertained as though this Section had never been written into the law. Under Section 2517 (c), no inference is to be drawn from the fact that the Section does not apply to years prior to 1955.

III. Election of Survivor Benefits Under Annuities Purchased by Certain Tax-Exempt Organizations

Section 2517 (a) (3) applies the gift tax exemption for such elections to retirement-annuity contracts purchased by tax-exempt organizations, referred to in Section 503 (b) (1), (2) and (3) of the Code and which are exempt from tax under Section 501 (a). Such organizations include a religious organization (other than a trust), certain educational organizations and certain charitable organizations receiving substantial support from the United States, a state or the general public.

IV. Estate Tax Exclusion for Annuities Purchased by Certain Charitable Organizations

The estate tax exclusion which is now applicable to annuity and other payments received under qualified employee benefit plans has been extended

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[24] Report No. 1983 of the Senate Committee on Finance, p. 229.

to include the value of an annuity or other payment that is receivable under a retirement annuity contract which was purchased by a religious, educational or charitable organization described in Section 503 (b) (1), (2) and (3) for the benefit of an employee. As to the part attributable to payments made by the organization and which are not taxed to the employee, the exemption applies. This new exemption applies to the estates of decedents who die after 1957.[25]

V. Estate and Gift Taxes Extended to U. S. Citizens Residing in U. S. Possessions

There are Court decisions which exempt the estate of a citizen of the U. S. from the estate tax, where at the time of his death he was a citizen of, or resided in, Puerto Rico or the Virgin Islands.[26]

To place such citizens on a parity with other U. S. citizens, Section 102 of the 1958 Act makes the existing Federal Estate and Gift Tax Laws applicable to citizens of the U. S. who, at the time of their death, reside in a possession of the U. S. This is so unless their U. S. citizenship was obtained solely by reason of the fact that they:

(1) Were a citizen of such possession; or

(2) Were born or resided within such possession.

The result is that all U. S. citizens are taxed alike if they were born or naturalized in the U. S., regardless of the fact that they moved to and now reside in a U. S. possession.[27]

As to those citizens of possessions of the U. S., who are not otherwise U. S. citizens, the new changes do not affect the existing estate and gift tax exemption.

Simultaneously, Section 102 (c) of the 1958 Act amends existing law by eliminating the existing estate tax credit for death taxes paid to any U. S. possession; and also cancels the deduction for such death taxes imposed on charitable gifts by any U. S. possession. In addition, it grants an estate tax credit for those death taxes in the same manner as is currently allowed for death taxes paid to a foreign country.[28]

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[25] § 2039 (c) as amended by § 23 (e), 1958 Technical Amendments Act.

[26] Estate of A. Fairchild, 24 T. C. 408 (acq. 1956-2 C. B. 5); Estate of Albert D. Smallwood, 11 T. C. 740 (acq. 1949-1 C. B. 3); Estate of C. S. Rivera, 214 (F. 2d) 60, (C. A.-2, 1954), aff'g 19 T. C. 271 (N. A. 1953-2 C. B. 8); G. H. Dudley, 58-2 U. S. T. C. Para. 9749 (C. A.-3), aff'g 28 T. C. 992.

[27] § 2208 as added and § 2501 as amended by § 102, 1958 Technical Amendments Act.

[28] § 2911 (a), 2014 and 2053 (d) as amended by § 102 (c), 1958 Technical Amendments Act.

The above changes in the estate tax are applicable to the estates of those decedents who die after the date on which this Act was enacted, September 2, 1958.[29]

VI. BEQUESTS TO SURVIVING SPOUSE QUALIFYING FOR MARITAL DEDUCTION UNDER THE 1939 CODE

Section 93 of the 1958 Technical Amendments Act amends Section 812 (e) (1) (F) of the 1939 Internal Revenue Code.

Section 812 (e) of the Internal Revenue Code of 1939 allowed as a deduction from the gross estate certain property interests passing to the decedent's surviving spouse. With several exceptions, no deduction was allowable under that Section in the case of terminable interests. One of these exceptions was set forth in Paragraph (1) (F) of sub-section (e). The transfer was required:

(1) To be in trust;

(2) The surviving spouse must have been entitled to all of the income from corpus of the trust during her life, which income had to be payable to her at annual or more frequent intervals; and

(3) The surviving spouse, alone and in all events, had to have complete and unrestricted power to appoint the entire remainder in the trust property to herself or to her estate, either during her lifetime or at her death.[30]

It has been held[31] that a trust under which the surviving spouse of a decedent, dying before the effective date of the 1954 Revenue Code (August 17, 1954), who was entitled to income from only a part of the trust, or had a power to appoint only part of the trust property, did not qualify for the marital deduction to any extent.

Sub-section (a) of Section 93 of the 1958 Act amended Section 812 (e) (1) (F) of the 1939 Internal Revenue Code, in order to apply rules comparable to the provisions of Section 2056 (b) (5) of the Internal Revenue Code of 1954. The latter Section provides that if an interest in property passes from the decedent to his surviving spouse, whether or not in trust, and the spouse is entitled to all the income from the entire interest, or all the income from a specific portion of the entire interest, with a power in her alone and in all events to appoint the entire interest or the specific portion, the interest which passes to her qualifies as a marital deduction in computing the taxable estate of the decedent.[32]

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[29] § 102 (d), 1958 Technical Amendments Act.
[30] Report No. 1983 of the Senate Committee on Finance, p. 240.
[31] Estate of H. P. Shedd v. Comm., 237 (F. 2d) 345 (C. A.-9, 1956) cert. den. (1957) 77 S. Ct. 590, (See also R. R. 54-20 1954-1 C. B. 195).
[32] Report No. 1983, Senate Committee on Finance, p. 241.

Sub-section (b) of Section 93 of the 1958 Act provides that the Amendment made by Sub-section (a) shall apply with respect to estates of decedents dying after April 1, 1948, and before August 17, 1954 (the effective date of the 1954 Code); and further provides that if refund or credit of any over-payment resulting from the application of such Amendment is prevented on the date of the enactment of the 1958 Act, or at any time within one year from such date, by the operation of any law or rule of law (other than Section 3760 of the Internal Revenue Code of 1939 or Section 7121 of the Internal Revenue Code of 1954, relating to closing agreements, and other than Section 3761 of the Internal Revenue Code of 1939, or Section 7122 of the Internal Revenue Code of 1954, relating to compromises), refund or credit of such over-payment may, nevertheless, be made or allowed, if claim therefor is filed within one year after the date of the enactment of this Act (September 2, 1958). No interest shall be allowed or paid on any over-payment resulting from the enactment of this Section.[33]

VII. Release of Lien on Partial Discharge of Property From Estate or Gift Tax

Section 6325 (b) of the 1954 Code provides that any part of property subject to a tax lien may be discharged, if the value of the property remaining subject to the lien is at least twice the amount of the tax lien and any prior liens. Special estate-tax and gift-tax liens, however, are indefinite in amount, applying not only to the tax now known to be due, but also to amounts which are determined later. Therefore, the 1939 Code (Section 3674 (a)) did not require retention of property equal to twice the amount of the lien in such cases, but provided that any or all of the property subject to one of these liens could be discharged, if the Secretary or his delegate found that the tax liability had been "fully discharged or provided for". This provision was inadvertently omitted in the drafting of the 1954 Code.

Section 77 of the 1958 Act amends Section 6325 of the 1954 Code, to provide expressly for the discharge of a specific property from the special estate or gift-tax lien, where the Secretary or his delegate finds that the tax liability has been fully satisfied or provided for. This restores the Rule of the 1939 Code.

VIII. Period of Limitation for Filing Claim for Credit for State Death Taxes

Under Section 2011 (c) of the 1954 Code, prior to its Amendment by Section 65 (a) of the 1958 Act, State death taxes generally must be paid within

[33] Report No. 1983, Senate Committee on Finance, pp. 241 and 242. For a fuller explanation of the operation this aspect of the marital deduction, see POLISHER, ESTATE PLANNING AND ESTATE TAX SAVING, 631-637. See also *Id.* 83-84 (1955 Supp.).

four years after the estate-tax return is filed, in order to obtain credit for such taxes for estate-tax purposes. If an extension of time is granted to pay the Federal estate tax, the State death taxes need not be paid until the expiration of four years of the period of the extension. Similarly, if a Petition for Redetermination of a Deficiency is filed with the Tax Court within 90 days after notice of a deficiency is mailed, the State death taxes may be paid within 60 days after the Tax Court's decision becomes final. However, if the Federal estate tax is paid and a refund claim is subsequently filed, no extension of time for payment of State death taxes is allowed.[34]

Sub-section (a) of Section 65 of the 1958 Act amended Section 2011 (c) of the 1954 Code, and sub-section (b) amended Section 813 (b) of the 1939 Code. These Amendments extend, in cases where payment of the Federal estate tax is made and a refund claim is filed, the time in which State death taxes may be paid and claimed as a credit for estate tax purposes. Pursuant to these Amendments, an executor who has filed a timely claim for refund, but who has not paid State death taxes within four years after the estate tax return was filed, would be able to obtain credit for State death taxes, if such taxes are paid:

(1) Before the expiration of 60 days from the date of mailing, by certified or registered mail, by the Secretary of the Treasury or his delegate to the taxpayer of a notice of disallowance of any part of such claim; or

(2) Before the expiration of 60 days after a final decision by a Court of competent jurisdiction with respect to a timely suit instituted upon such claim, whichever period is the last to expire.

The Amendment made to Section 813 (b) of the 1939 Code is applicable with respect to the estates of decedents dying after February 10, 1939, and on or before August 16, 1954; and the amendment made to Section 2011 (c) of the 1954 Code to the estates of decedents dying after August 16, 1954.[35]

IX. EXTENSION OF TIME FOR CREDIT AGAINST ESTATE TAX ON REVERSIONARY OR REMAINDER INTERESTS IN PROPERTY ATTRIBUTABLE TO PAYMENT OF STATE OR FOREIGN TAX THEREON

Section 66 of the 1958 Act amended Sections 925, 926 and 927 of the 1939 Code and Sections 2015, 6163 and 6601 (b) of the 1954 Code. Prior to its enactment, where a decedent possessed a reversionary or remainder interest in property and that reversionary or remainder interest was included in his gross estate for estate-tax purposes, the executor of the decedent's estate could elect

[34] Report No. 1983, Senate Committee on Finance, p. 226.

[35] Report No. 1983, Senate Committee on Finance, p. 226.

to postpone, until 6 months after the termination of the precedent interest or interests in the property, the payment of the Federal estate tax attributable to the inclusion of the reversionary or remainder interest in the gross estate. As surety for payment of the tax at the expiration of the period of postponement, the estate was required to file a bond. Under these circumstances, that portion of the State or foreign death taxes, which was attributable to the reversionary or remainder interest, and for which a credit otherwise was allowable under Section 2011 or 2014, would be allowed as a credit against the Federal estate tax, if such portion of the State or foreign tax is paid, and credit therefor claimed, within 60 days after the termination of the precedent interest or interests. In some cases, these 6 month and 60 day periods were too short to make the required payments of Federal and State taxes, resulting in hardships.

Section 6163 of the 1954 Code was amended by Section 66 of the 1958 Act, to permit the Treasury in hardship cases to extend the time for payment for additional periods not to exceed two years.

A corresponding Amendment to Section 925 of the 1939 Code extends a similar benefit to the estates of decedents, who died during the period covered by the 1939 Code. The extensions authorized by the Amendment to Section 6163 and to Section 925 are applicable, only if the period of postponement has not expired prior to the date of enactment of this Bill.

The Amendment to Section 926 insures to the Government the right to require, in 1939 Code cases, surety for the payment of the tax at the expiration of the hardship extension. A corresponding Amendment to the 1939 Code is not needed, since the wording of existing law is sufficient to carry the 4% rate through the period covered by the hardship extension.

In cases where a hardship extension for the payment of the Federal estate tax attributable to a reversionary or remainder interest has been granted by the Secretary or his delegate, the Amendment to Section 2015 of the 1954 Code (and the corresponding Amendment to Section 927 of the 1939 Code) extends to the expiration of the period covered by the hardship extension, the time within which State and foreign death taxes attributable to the reversionary or remainder interest can be paid and credit therefor claimed against the Federal estate tax. The Amendment made to Section 2015 (and the corresponding Amendment to Section 927) is applicable only if the period within which such State and foreign death taxes otherwise could be paid and claimed as a credit, had not expired prior to the date of enactment of the 1958 Act (September 2, 1958).[36]

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[36] Report No. 1983, Senate Committee on Finance, pp. 227, 228.

SMALL BUSINESS TAX REVISIONS

I. ELECTION OF CERTAIN SMALL BUSINESS CORPORATIONS NOT TO BE TAXED AS CORPORATIONS

Section 64 of the Technical Amendments Act of 1958 (adding Sections 1371-1377 to the Internal Revenue Code of 1954) contains perhaps the most dramatic change in Federal income taxation during the last 25 years. It permits a business to select the form under which it will conduct its enterprise on the basis of realistic economic and social considerations, without regard to tax consequences. This is accomplished by permitting an electing corporation to report its income and losses at the stockholder level and eliminates the element of "double" taxation.

Having properly elected to qualify under this Section, the stockholders on the last day of the taxable year include their pro-rata share of the corporation's current taxable income in their own income,[37] whether or not it is actually distributed to them.[38] This income is not, however, to reflect a dividend received credit or exclusion.[39] The income loses any of its special characteristics in the hands of the shareholder, except in the case of capital gains.[40].

The current taxable income, although taxed to individual stockholders, need not be distributed to them. Under these circumstances, generally, it may be withdrawn at a later date without additional tax consequence.[41] However, if amounts in excess of these retained and taxed earnings are withdrawn and the corporation had accumulated surplus from years prior to its election to be a "Pseudo Corporation", such distributions will be taxed as dividends to the stockholders [42] and will, therefore, be subjected to double taxation.

As indicated above, the corporation's net operating losses are also passed through to the stockholders.[43] This means that the corporation, per se, has no net operating loss.[44] The individuals, having received the net operating loss at their level, may apply it against their personal current income, and the excess may be carried back and then forward [45] in the same manner as the corporation would have been entitled to do. Each stockholder's portion of the net operating loss is computed, pursuant to Section 1374, by dividing the corporation's net operating loss by the number of days in its taxable year (to determine the daily

[37] S. F. C. p. 218, § 1373 (a).
[38] S. F. C. p. 218.
[39] § 1375 (b).
[40] S. F. C. p. 219.
[41] § 1375 (d) (1).
[42] S. F. C. p. 225.
[43] § 1374 (a).
[44] S. F. C. p. 220.
[45] § 1374 (d) (2).

net operating loss), by apportioning this amount among the stockholders on a *day by day* basis in proportion to the number of shares held by each stockholder on each day of the year and by totalling these daily amounts as to each stockholder.

A stockholder's basis for stock cannot be less than zero.[46] Any amounts of the corporation's current earnings taxed to the stockholder but not distributed and the adjusted basis of any indebtedness of the corporation to the stockholder are added to the basis of his stock,[47] and any net operating losses passed through, operate to reduce his basis of the corporate stock.[48]

In order that a corporation be eligible to elect to be taxed as a partnership or sole proprietorship it must be a domestic corporation [49] having ten or fewer stockholders [50] all of whom are individuals or estates [51] and none of whom are non-resident aliens.[52] It may not be a member of an affiliated group entitled to file a consolidated return,[53] nor may it have more than one class of stock outstanding.[54] All stockholders must consent to the election.[55]

The election must be made within the first month preceding or following the first day of the year for which the election is to be effective.[56] This election may be revoked or terminated in any one of five ways. As indicated previously, in order for an election to be made, all stockholders must consent to the election. As a corollary, if a new stockholder fails to consent the election is automatically terminated.[57] If all of the stockholders agree to revoke the election they may do so.[58] If the corporation fails to retain all of the characteristics originally required to elect, there will be a termination of the election.[59] Should the corporation receive more than 80% of its gross receipts from outside the U. S., or if more than 20% of its gross receipts are from passive income, the election is terminated.[60] Where termination results from any of these factors except that of mutual consent, the revocation is effective retroactively to the beginning of the year in which the event occurred. The exception is in the case of a voluntary

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[46] S. F. C. p. 225.
[47] S. F. C. p. 223.
[48] § 1376 (b) (1) and (2).
[49] § 1371 (a).
[50] § 1371 (a) (1).
[51] § 1371 (a) (2).
[52] § 1371 (a) (3).
[53] § 1371 (a).
[54] § 1371 (a) (4).
[55] § 1371 (a) (1) and (2); T. D. 6317.
[56] Senate Finance Committee Report No. 1983, p. 217.
[57] § 1372 (e) (1).
[58] § 1372 (e) (2).
[59] § 1371 (e) (1).
[60] § 1371 (e) (4) and (5).

revocation by mutual consent which is made after the first month of the year, in which instance the revocation becomes effective only as to subsequent years.[61]

Once the election has been terminated in any manner, the corporation cannot again elect to be taxed as a "Pseudo Corporation" for a period of five years.[62]

Not only does the Act operate to avoid double taxation, but it permits a small business to be operated by its owners without personal liability, have a continuing existence without interruption at death, and makes available to its owners the so-called "Fringe Benefits". These include profit sharing plans, pension trusts, stock bonus plans, key man insurance, group insurance, split dollar insurance, major medical, accident and health insurance, deductible sick pay and salary continuation plans for the benefit of the widow of a deceased employee.

The scope of this article does not permit a complete examination of all the pitfalls and merits of Sections 1371-1377. Sufficient to say that, in addition to the advantages mentioned, opportunities are presented for avoiding the personal holding company problem, the collapsible corporation may present less of a threat, the penalty tax for accumulated surplus can be avoided, and income may be more readily split among members of the family group. Every sole proprietorship, partnership or small closely held corporation should be examined to determine whether or not the benefits of these Sections can be taken advantage of by them.

II. Revocation of Election Permitting Certain Proprietorships and Partnerships to be Taxed as Corporations

Section 1361 of the 1954 Code permits certain proprietorships and partnerships with 50 or less members to elect to be treated for tax purposes as corporations. This privilege is limited to those businesses where capital is a material income-producing factor or where 50% or more of the gross income consists of gains, profits, or income derived from trading as a principal or from certain types of brokerage commissions.

Section 1361 (a) provides that an election to come under the corporate treatment must be made in accordance with regulations prescribed by the Secretary or his delegate, not later than 60 days after the close of any taxable year. However, the Treasury Department was not able to issue regulations under Section 1361 before the last day (March 1, 1955) on which this election could be made for 1954. As a result, it issued Treasury Decision 6124 on February

[61] Senate Finance Committee Report No. 1983, p. 218.
[62] § 1372 (f).

24, 1955, which permitted taxpayers to make a binding election within a 60 day period after the close of the taxable year. It was provided, however, that this election would not be valid unless perfected by the filing of an amended return on or before the last day of the third month following the month in which the final regulations are published.

To make certain that an election under this Section will not be binding on the taxpayer before the final regulations under this Section are published, Section 63 of the 1958 Technical Amendments Act provides a specific statutory substitute for Treasury Decision 6124.

First, it provides that an election to be taxed as a corporation under Section 1361, which is filed in accordance with regulations prescribed by the Secretary or his delegate, is to be treated as a valid election. However, it further provides that a valid election may be subsequently revoked at any time after the enactment of this Act and a period ending 3 months after final regulations are published on Section 1361. Such a revocation, if made, would be effective for all years to which the election applied.

Sub-section (b) of Section 63 provides for a tolling of the statute of limitations with respect to:

(1) The assessment of deficiencies attributable to an enterprise which makes an election under Section 1361; and

(2) The credit or refund of any overpayments attributable to such an enterprise. This sub-section applies regardless of whether the election is revoked pursuant to sub-section (a).

Since the person concerned may have items of income, deduction, or credit which are completely unrelated to the enterprise, sub-section (b) does not toll the statute of limitations for all amounts of deficiencies or overpayments of such persons. Sub-section (b) relates only to deficiencies or overpayments which are attributable to the enterprise; that is, the increase or decrease in tax previously determined which results from the correct treatment of all items which pertain to the enterprise (with due regard given to the effect of the items in the computation of gross income, taxable income, and other matters under sub-title A of the 1954 Code).

Under sub-section (c) of Section 63, the period for which the periods of limitation are tolled expires 1 year after whichever of the following days is the earlier:

(1) The last day of the third month following the month in which regulations prescribed under Section 1361 of the 1954 Code are published in the Federal Register.

(2) If the election is revoked under Section 63 (a), the day on which such revocation is filed with the Secretary of the Treasury or his delegate.

Sub-section (d) provides that Section 63 does not apply to any statement of election filed under Section 1361 if such statement of election has been withdrawn with the permission of the Secretary of the Treasury or his delegate before the date of enactment of this Bill.[63]

III. Loss on Stock of Small Business Corporations

The Federal government has been seeking means by which to stimulate investment in small business. One of the reasons that investors were hesitant to put their money into risky new ventures was that if the venture failed, and the stock had to be sold at a loss, such loss could only be taken as a capital loss. Section 202 of the Small Business Tax Revision Act was enacted in order to allow such losses to be taken as ordinary losses, thereby encouraging investment in small businesses. It has been added to the 1954 Code as Section 1244.

If the stock qualifies as "Section 1244 Stock", as defined in Section 1244 (c), a loss incurred on its sale is deductible as an ordinary loss attributable to a trade or business. The loss can be taken by an individual to the extent of $25,000.00 in any one taxable year, or in the case of a married couple filing joint returns, up to $50,000.00.[64] The three year carry-back and the five year carry-forward can be utilized, if the loss is not used up during the current year.[65]

Previously, any losses incurred on the sale of stock in a corporation could only be deducted as capital losses.[66] Therefore, an individual ran the risk of having to assume a great portion of any such loss himself when he invested in a corporation. There was no opportunity for any tax reduction. However, by going into a new business as a partnership or a sole proprietorship, a deduction for business losses could be taken in full. Under this new Section, essentially the same tax opportunities as were previously available to partners and sole proprietors are now extended to individual investors in corporations.

A. *Section 1244 Stock Defined*

This Section created a class of stock called "Section 1244 Stock". The stock sold must comply strictly with all of the requirements set up by the Section in

[63] See Senate Committee Report, No. 1983, pp. 86-87 and 215-216.
[64] § 1244 (b).
[65] House Committee Report No. 775, p. 8.
[66] § 1211.

order to take advantage of the ordinary loss benefits. The following are the requirements which must be met:

(1) The stock must be that of a domestic corporation. The stock cannot qualify if it is stock of a foreign corporation.[67] However, if the stock of the foreign corporation is an asset of a domestic corporation, whose own stock otherwise qualifies, then an indirect advantage can be obtained on a loss on stock of a foreign corporation.

(2) The stock involved must be common stock, whether voting or nonvoting.[68] In no event will losses on preferred stock qualify.[69]

(3) The stock must have been issued pursuant to a plan to offer not more than a stated dollar amount of stock during a period ending not later than two years after the date the plan is adopted.[70]

(4) Such plan must be in writing and adopted after June 30, 1958.[71]

(5) At the time such plan was adopted the corporation must be a "small business corporation", as hereinafter defined. It is only necessary that the "small business" corporation requirement be fulfilled at the time the plan is adopted. It makes no difference that, at the time the stockholder incurs his loss, the corporation is no longer a "small business corporation". After the plan has been adopted the equity capital of the corporation may exceed the one million dollar limit on "small business corporations", and still a loss on the sale of the stock would qualify as ordinary loss.[72]

(6) No part of a prior offering can be outstanding when the plan is adopted.[73] No stock issued in accordance with the current plan will qualify, if there is outstanding a previous offering, which has not been withdrawn prior to the adoption of the current plan.[74] In addition, if all the stock under a valid plan has not been issued by the time a subsequent offering under a plan is made, then the stock issued under the first plan, but after the second offering has been made, will not qualify. The stock issued under the prior plan before the subsequent offering is not disqualified by reason of the offering.

The adoption of any number of plans is allowed. So long as there is not being offered any unissued stock under a previous plan, the stock will qualify.

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[67] § 1244 (c) (1).
[68] § 1244 (c) (1).
[69] House Committee Report No. 775, p. 8.
[70] § 1244 (c) (1) (A), H. C. R. No. 775, p. 8.
[71] § 1244 (c) (1) (A), H. C. R. No. 775, p. 8.
[72] § 1244 (c) (1) (B), H. C. R. No. 775, p. 9.
[73] § 1244 (c) (1) (C).
[74] H. C. R. No. 775, p. 9.

This rule would also apply to offerings made prior to July 1, 1958. Thus, a corporation must cancel any offering that still remains, if it still has unissued stock which was offered under an arrangement prior to July 1, 1958, before it can issue stock under a new plan which could be eligible for ordinary loss deduction.

(7) At the outset it is required that the stock be issued to the taxpayer pursuant to the plan. If the stock is acquired from the original stockholder, whether the transferee receives it by purchase, gift, inheritance, etc., an ordinary loss cannot be claimed. Therefore, in those cases where the issue is handled by an underwriter, the only way in which the stock bought by the investors can qualify is if the underwriter, in selling the shares, acts as the corporation's agent. The shares will not qualify if they were issued to the underwriter and sold to investors for his account.[75]

(8) The stock cannot be issued for other stock and securities. It must be issued for money or other property.[76] If the stock is issued for services or in exchange for the stock or securities of another corporation, it will not qualify.[77] Thus, stock received in a reorganization, including a divisive reorganization, does not qualify, subject to an exception contained in sub-section (d) (2) of Section 1244, discussed below.

Stock is considered to have been issued for "money or other property", if it is issued by a corporation in payment of a debt that it owes, and the debt arose from the receipt of money or other property. The stock issued in payment will not qualify if the debt arose out of services rendered. It appears that this latter point will need some clarification.

(9) More than 50% of the aggregate gross receipts of the corporation, for its five most recent years ending prior to the date when the stockholder sustains his loss on the stock, must be derived from sources other than royalties, rents, dividends, interest, annuities and sales or exchanges of stock or securities. Where the corporation has been in existence for less than five years, the period of the corporation's existence is used as the test period. Only the amount of gains from sales or exchanges of securities are included in gross receipts.[78]

The gross receipts for the five year period (or the period of the corporate existence, if less) are combined in arriving at the 50%. Thus, a corporation may have had gross receipts from sales of $200,000.00 in a year during which it was an operating corporation. However, during the next four years its only income

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[75] H. C. R. No. 775, p. 9.
[76] § 1244 (c) (1) (D).
[77] H. C. R. No. 775, p. 9.
[78] § 1244 (c) (1) (E), H. C. R. No. 775, p. 10.

was from dividends and interest, about $40,000.00 a year. Therefore, although of the five years, four of them failed to meet the test, more than 50% of the corporation's aggregate gross receipts were from non-dividend and rent sources.

As to a corporation which has no gross receipts, the law is not clear as to whether its stock can qualify. As in the case of a corporation that ceases to operate prior to any sales having been made, or a corporation which owns only unimproved real estate from which it derives no income, the regulations will have to clarify this point since it would be inequitable to hold that, because a corporation has no gross receipts its stock cannot qualify.

B. *A "Small Business Corporation" Defined*

In order for loss on stock to qualify as a fully deductible ordinary loss, the stock must be issued by a "small business corporation."

It makes no difference the number of stockholders that the corporation has, the size of its profits, or the volume of its sales. The corporation's capital set-up is the only test in determining whether or not it is a "small business corporation".

To qualify as a "small business corporation" the following two requirements must be met:

(1) The sum of the aggregate dollar amount of stock which may be offered under the plan, plus the aggregate amount of money and other property which has been received by the corporation after July 1, 1958 for its stock, as a contribution to capital and as paid-in surplus, must not exceed $500,000.00.[79] In determining gain to the corporation, "other property" is taken into account at its adjusted basis at the time received, reduced by those liabilities to which the property was subject or which were assumed by the corporation; and

(2) The sum of the aggregate dollar amount of stock which may be offered under the plan plus the equity capital of the corporation (determined on the date of the adoption of the plan) must not exceed one million dollars. For this purpose, equity capital is the sum of money and other property (in an amount equal to its adjusted basis for determining gain) less the amount of the corporation's indebtedness, other than indebtedness to shareholders.[80]

C. *Recapitalization Changes in Name, etc.*

Sub-section (c) (1) provides that stock may not qualify for the benefits of Section 1244, unless it is received by the taxpayer in exchange for money or

[79] § 1244 (c) (2) (A), H. C. R. No. 775, p. 9.
[80] § 1244 (c) (2) (B), H. C. R. No. 775, p. 9.

other property (not including stock or securities). Absent anything further in Section 1244, this would deny ordinary loss treatment to any stock received as a stock dividend, in a recapitalization, or in any other type of reorganization. However, Sub-section (d) (2) authorizes the regulations to provide an exception to the rule of Sub-section (c) (1). Under this exception, if—

(1) A taxpayer holds stock of a corporation, which meets all of the requirements for Section 1244 stock that may be determined prior to sustaining a loss on the stock; and

(2) He subsequently receives stock of such corporation, the basis of which is determined in whole or in part by reference to the stock described in (1), then, to the extent provided in regulations, the stock so received shall be treated as meeting such requirements. The requirements that may be determined prior to sustaining a loss are all of the requirements of Sub-section (c) (1), except sub-paragraph (E) thereof. The following is an illustration of the above rule:

B purchases 100 shares of corporation X stock for $1,000.00 and these shares meet all the requirements of Section 1244 stock that may be determined at that time. In a later non-taxable stock dividend, he receives 50 additional shares, the basis of which is determined by reference to the 100 shares that he purchased. The 50 shares shall also be treated as meeting such requirements. If at the time the stock dividend is received, B also has stock of the corporation, which does not meet the requirements of Section 1244 stock, then the shares received in the stock dividend must be allocated between the stock that does meet such requirements and the stock that does not. Only the shares allocated to the former are treated as fulfilling the requirements.

The principle discussed in the preceding paragraph also applies to stock of a successor corporation received in a Section 368 (a) (1) (F) reorganization (mere change in identity, form or place of organization). Sub-section (d) (2) provides that, to the extent provided in regulations, such stock shall be treated as meeting the requirements of Sub-section (c) (1) (other than sub-paragraph (E) thereof), if it is received in exchange for stock of a predecessor corporation, which meets such requirements.

The common stock referred to in Sub-section (d) (2) is subject to the limitations of Sub-section (d) (1) to the same extent as the stock with respect to which the basis of such common stock is determined. Thus, for example, if Sub-section (d) (1) (A) would impose a limitation on ordinary loss on stock of the predecessor corporation in a Section 368 (a) (1) (F) reorganization, the limitation is also applicable to the stock of the successor corporation.

The last sentence of Sub-section (d) (2) provides that for purposes of paragraphs (1) (E) and (2) (A) of Sub-section (c), a successor corporation in a 368 (a) (1) (F) reorganization shall be treated as the same corporation as its predecessor.

Since it is viewed as being the same corporation as Corporation X, it is considered to have used up its quota of stock.[81]

The effect of sub-paragraph (d) (2) of Section 1244 is to close a possible tax saving loop-hole by converting a capital loss into an ordinary loss. Thus, if the owner of a capital asset with a high basis and low value transferred the asset tax-free to a controlled corporation, he would get the same basis for the stock as he had for the asset. If he then sold the stock at the lower actual value of the asset in the corporation, he would have had an ordinary loss under the new rule, although it arose out of a capital asset, except for the operation of sub-paragraph (d) (2), which bars it.

D. *Who May Claim Loss and How It Is Determined*

Only the original investor, if it is an individual or partnership, can claim ordinary loss treatment. If the investor is not the original investor, or if it is a corporation, trust or estate, the ordinary loss treatment is not available.[82]

The tax benefit created by this Section applies only to losses. The treatment of gains is not affected, and they continue to enjoy capital gains treatment. Thus, another tax provision is added to the Code, which treats gains as capital gains but losses as ordinary losses. The other provision is Section 1231, dealing with property used in trade or business and involuntary conversions.

The special treatment of losses on such stock is also available to stock issued to partnerships. The ordinary loss treatment on stock can be passed through to the individual partners where a partnership invests in stock of a small business corporation. The individual partners are treated as if they owned their proportion of the partnership's stockholdings directly and for the purpose of arriving at the $25,000.00 or $50,000.00 limitations, this share is combined with any other personal stockholdings that they may have.

Since only the original investor is permitted ordinary loss treatment, the individual partners of a partnership will not be able to claim ordinary loss treatment on stock of a small business corporation which the partnership had distributed to them prior to the loss being sustained.[83]

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[81] H. C. R. No. 775, p. 9.
[82] § 1244 (d) (4).
[83] Conf. Committee Report No. 2632, p. 43.

Any loss on stock, which otherwise would be considered as a loss on the sale or exchange of a capital asset, is entitled to have the ordinary loss deduction applied to it. Therefore, whether the loss arises from stock becoming worthless, a corporate liquidation, or the sale or exchange of the stock, the ordinary loss is allowed.

E. *Timing the Loss for Maximum Benefit*

By spreading the losses over several years, a deduction in excess of the $50,000.00 limitation can be gotten. This for the reason that the $25,000.00 and $50,000.00 limitation is not a maximum limitation for losses from qualifying small business stock, but an annual limit on the stock.

A case in point would be the following:

A married person invests $120,000.00 in qualified stock. He decides to give up the business when it proves to be unsuccessful. He would be able to deduct a total of $100,000.00—$50,000.00 in the first year and $50,000.00 in the second—if he could sell one-half of his stock in one year for $10,000.00, and the balance in the next year.

F. *Annual Loss Limit Not Increased by Carry-Back and Carry-Over*

For the purposes of Section 172 (relating to net operating loss deduction) any amount of loss treated by reason of this Section as a loss from the sale or exchange of an asset, which is not a capital asset, shall be treated as attributed to the trade or business of the taxpayer.[84]

The $25,000.00 or $50,000.00 limitation is applicable to the entire loss for a taxable year, even if it is carried back or over.[85] For example, an investor, who is married, loses in one year $100,000.00 on stock in a small corporation. His other income amounts to $25,000.00. Therefore, from the income of the current year he deducts $25,000.00. In spite of the fact that his real loss was $100,000.00, he is limited to a maximum ordinary stock loss deduction of $50,000.00. As a result he has only $25,000.00 to carry back or carry over as a deduction. On the other hand, there does not appear to be any restriction in deducting, in one carry-back or carry-over year (if both losses are carried back or over to the same year), the full $100,000.00 if an individual sustains a $50,-000.00 loss on the qualifying stock in one year and $50,000.00 in another year, and neither one can be used in the year of the loss.

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[84] § 1244 (d) (3).
[85] H. C. R. No. 775, p. 12.

As before, capital loss treatment is accorded to a loss which is sustained in excess of the permissable maximum for ordinary loss deduction.

G. *No Ordinary Loss on Contributions to Capital*

After a stock has qualified for ordinary loss treatment, the cost of that stock to the stockholder is increased by later contributions to capital. In effect, this could, without limitation, allow an indefinite increase of qualifying stock.

Section 1244 (d) (1) (B) provides that if there is any increase in the basis of qualifying stock due to either contributions to the capital or otherwise, it should be treated as allocable to the basis of non-qualifying stock. The effect of this rule may be illustrated by the following example:

For \$10,000.00 an individual purchases 100 shares of stock which if sold by him would qualify as Section 1244 stock. He later makes a \$2,000.00 contribution to capital that increases the total basis of his 100 shares to \$12,000.00. Subsequently, he sells the 100 shares for \$9,000.00, resulting in a loss of \$3,000.00. Of this loss, only \$2,500.00

$$\left\{ \frac{\$10{,}000.00}{\$12{,}000.00} \text{ of } \$3{,}000.00 \right\}$$

may be treated as an ordinary loss under Section 1244.[86]

He is deemed to have sold stock of both the qualifying and non-qualifying variety. The former cost \$10,000.00 and the latter \$2,000.00. There is an allocation of the real loss to each in proportion to their cost basis to the investor, thereby resulting in \$2,500.00 of ordinary loss and \$500.00 of capital loss.

H. *Effective Date*

This change applies to all 1954 Code years. The practical effect, however, is that it is limited in application to years ending after June 30, 1958, since the only stock that can qualify is stock issued after that date.

I. *Regulations to Be Issued*

Sub-section (e) of Section 1244 provides that the Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this Section. This would include authority to require the maintenance of records sufficient to establish the identity of stock that qualifies as Section 1244 stock.[87]

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[86] H. C. R. No. 775, p. 12.

[87] § 1244 (e), H. C. R. No. 775, p. 12.

J. *Some Important Effects of Section 1244 in Business Transactions*

In regard to thin incorporation, it may now be advisable to replace debt to stockholders in those cases where a corporation has been capitalized with a large amount of such debt, so as to preserve a possible bad debt deduction and to permit repayment out of corporate earnings at minimum tax cost. Ordinary loss treatment will be given to a subsequent loss on the newly issued stock, which can be carried back and carried over. At best, in thin incorporation situations, the Internal Revenue Service will resist ordinary loss treatment for the debt. This places the investor on the horns of a dilemma, requiring him to choose whether he wishes to freeze his entire investment as equity capital and have a Section 1244 stock loss, should it prove unsuccessful, or to restrict some of it as repayable business loans, with the expectation of withdrawing the loans by repayment, without income tax implications, out of the earnings of the corporation.

It is attractive to invest in many new ventures as a corporate set-up, instead of the unincorporated form, now that the right to take a full loss exists, which can be carried back or forward. There is now an affirmative tax benefit which insulates against losses, in addition to the inherent advantages of the corporate form which allows an ease of operation and a freedom from liability.

Investors in speculative ventures can now get a capital gain if they are successful, and an ordinary loss if they fail, if the venture is carried on in corporate form.

An election is available to certain corporations not to be taxed as corporations.[88] Stockholders of these "Pseudo Corporations" can deduct the operating losses of the corporation on their personal income tax returns. In those cases where the corporation can qualify for such treatment the stockholder may be better off having the corporation elect, allowing them to take current loss deductions.

Since a loss taken by the stockholders of one of these "Pseudo Corporations" will reduce the basis of stock qualifying for ordinary loss on sale or exchange, no double deduction can be obtained even though some corporations can qualify for both treatments.

IV. ADDITIONAL 20% DEPRECIATION FOR FIRST YEAR

Section 204 of the 1958 Small Business Act adds a new Section 179 to the Code, which provides a new type of quick, one-shot, first year 20% depreciation. The property to which this election applies cannot exceed $10,-

[88] Sub-Chapter S. §§ 1371-1377, added by 1958 Technical Amendments Act. See discussion above.

000.00 in the taxable year for any taxpayer, or $20,000.00 if a joint return is filed.[89] This is in addition to any other accelerated or regular depreciation methods under Section 167 for the property to which the taxpayer is entitled.

All taxpayers, except trusts, are allowed an election to take an immediate 20% depreciation deduction on a specified amount of certain property.[90] This benefit is available to an estate and can be passed through to an heir, legatee or devisee who receives the income. Property entitled to this benefit may also be owned by the heir, legatee or devisee. In computing the limitation of $10,000.00 or $20,000.00, separate treatment is accorded the property of the estate as opposed to the property of the heir, etc. The limitation on his or its own property is computed by each separately.[91]

A. *What Property Qualifies*

"Section 179 property" is defined in sub-section (d) as follows:

(1) It must be new or used tangible personal property purchased each year.

(2) It must have a useful life of six years or more, at the date of acquisition.

(3) It must be property subject to allowance for depreciation for use in taxpayer's trade or business or held for the production of income.

(4) It must have been acquired after December 31, 1957.

The new 20% deduction can be taken for years ending after June 30, 1958.

Any acquisition of property described above will qualify as a purchase for purposes of this Section, except the following:

(1) Property that is obtained from someone whose relationship would prevent a loss on a direct sale between the persons under Section 267, or in those cases where a loss would not be recognized in sales between partnerships and controlling partners under Section 707 (b). However, for the purpose of a Section 267 loss, brothers and sisters are not counted as members of the family. Property bought from a brother could therefore qualify. Even where the purchase is a valid one at a fair price, the ban will apply if the forbidden relationships exist.[92]

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[89] § 179 (b); For a discussion of how this applies to partners in a partnership, see Official Instructions accompanying Form 1065, 6 CCH 1959, Para. 8790.

[90] § 179 (d) (4).

[91] § 179 (d) (5).

[92] § 179 (d) (2) (A).

(2) Property acquired by one member of an affiliated group from another member of the same affiliated group.[93]

The Section provides that all of the members of an affiliated group are to be treated as one taxpayer in order to prevent, through various controlled entities, a multiplication of $10,000.00 or $20,000.00 units. The apportionment of the limitation will be explained by the regulations.[94] For this purpose, an affiliated group means a group of corporations which would be eligible to file a consolidated return, if the affiliation tests were 50% instead of the usual 80%. Thus, the dollar limitations are made applicable to the entire affiliated group, since purchases among the group do not qualify as purchases for which a 20% first year depreciation is permitted.[95]

(3) Property acquired whose basis (cost) is determined, wholly or in part, by reference to the basis of the property in the hands of a person from whom acquired, or is determined under Section 1014 (a), having been acquired by bequest, devise or inheritance, or by the decedent's estate from the decedent. Property obtained by gift or bequest is therefore barred.[96]

B. *Scope of First Year Depreciation Deduction*

The 20% first year depreciation deduction applies to only $10,000.00 of additional depreciable, tangible, personal property purchased each year, or in the case of a joint return, $20,000.00.[97]

The limitations of $10,000.00 and $20,000.0 on property that is entitled to the 20% deduction apply only to property purchased during the year. The taxpayer's fixed assets need not increase by the amount of $10,000.00 or $20,-000.00. The property purchased can simply be a replacement property previously owned.

If qualifying property in excess of $10,000.00 is purchased in one year, the taxpayer can elect to use the 20% deduction for the $10,000.00 of items which he selects. The reason for this is that the 20% first year depreciation deduction is limited to $10,000.00 ($20,000.00 in the case of married taxpayers) of property bought in any one taxable year.

Even if the asset is owned only for a fraction of the year, the taxpayer can deduct the full 20% depreciation in the year of purchase. Thus, if on December 31, 1958 a machine was purchased for $10,000.00, a deduction of

[93] § 179 (d) (2) (B).
[94] § 179 (d) (6).
[95] § 179 (d) (7); Congressional Record of August 12, 1958, p. 15, 793.
[96] § 179 (d) (2).
[97] § 179 (b).

$2,000.00 or 20% will be allowed in 1958. Also, if property acquired on April 1, 1958 was sold on May 1, 1958 due to a change of plans, the entire 20% can be claimed in 1958.

The 20% is taken on the cost of the asset and the salvage value is disregarded. However, depending on the method of depreciation selected, it may be necessary to take salvage value into account in determining the regular depreciation on the balance.

C. *Effect of Traded-in Property*

The first year depreciation deduction is 20% of the cost of the property. The cost in this case does not include any part of the basis, which is determined by reference to the basis of other property held at any time by the taxpayer acquiring such property. Thus, where a new machine is purchased for a cash outlay of $5,000.00 and a trade-in of a used machine having a basis of $4,000.00, you can only apply the 20% to the $5,000.00. The depreciation on the remaining $4,000.00 is determined by reference to other property once held by the taxpayer.[98] It would seem, therefore, that it would be more advantageous taxwise to buy the replacement property separately for cash without a trade in. The used equipment could then be sold for cash.

The election to use the first year 20% depreciation must be made within the time prescribed by law (including extensions thereof) for filing the taxpayer's return for the taxable year, and such election is irrevocable except with consent of the Secretary or his delegate. Similarly, the selection of items of property to receive the new allowance, as shown in the election, may not be changed by the taxpayer except with such consent.[99]

D. *Effective Date*

This Section is applicable with respect to taxable years ending after June 30, 1958. However, only property acquired after December 31, 1957 is subject to the new additional allowance.

V. ACCUMULATED EARNINGS CREDIT INCREASED TO $100,000.00

Section 205 of the 1958 Small Business Tax Act amends Section 535 (c) of the 1954 Code (relating to accumulated earnings credit), so that the minimum accumulated earnings credit for corporations other than a mere holding or investment company, as provided in Section 535 (c) (2), and the credit

[98] § 179 (d) (3).
[99] § 179 (c) (1) and (2).

for holding and investing companies, as provided in Section 535 (c) (3), are both increased from $60,000.00 to $100,000.00. This Section also makes a technical conforming change in Section 1551 of the Code (relating to disallowance of the accumulated earnings credit).

As in the case of the $60,000.00 credit, the allowance of the $100,000.00 minimum credit does not create an inference that accumulations in excess of that amount are unreasonable in relation to the needs of the business. The new $100,000.00 minimum credit is, of course, subject to the restrictions contained in Section 1551 of the 1954 Code (relating to disallowance of surtax exemption and accumulated earnings credit) in the case of multiple corporations formed to avoid income tax.

The amendments made by Section 205 are effective with respect to taxable years beginning after December 31, 1957.

VI. Net Operating Loss Carry-Back Extended to 3 Years

Section 203 of the Small Business Tax Act amends Section 172 of the 1954 Code relating to the net operating loss deduction. For years on or before December 31, 1957, an operating loss sustained by a business could be carried back and be deducted from its income of the past two years, thereby securing refunds of taxes paid for those two years. Moreover, the taxpayer could carry over and deduct from income of the next five years any part of the operating loss not consumed after deducting it from income of the past two years.

For losses incurred during the year 1958 and thereafter, this amendment increases the carry-back period from two years to three years. The five year carry-over period is left unchanged.

First, the operating loss must be carried back to and deducted from income of the earliest of the three years, as in the case of the two year carry-back. If there is a loss in excess of income for that year, it is then carried back to and deducted from income of the second year. Then if there is any excess loss remaining, it is deducted from income of the year immediately prior to that in which the loss was incurred.[100]

The three year carry-back is applicable to losses for those years ending after 1957, but only for losses incurred after 1957. Losses for the calendar year 1958 will be carried back first to 1955.[101]

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[100] § 172 (b) (2).

[101] § 172 as amended by § 203 (d) of the 1958 Small Business Tax Revision Act.

Partial Allowance for Fiscal Year Straddling January 1, 1958

The three year carry-back privilege applies to that portion of a taxable year which comes after December 31, 1957. Therefore, where a fiscal year straddles January 1, 1958, the privilege of carrying the loss back three years applies only to the net operating loss for the fiscal year multiplied by the number of days in the year which fall after 1957 and divided by the number of days in the full fiscal year.

The current loss in going through the third year must be reduced, in order to determine the amount which the taxpayer is allowed to carry back or carry over to the other seven years, as follows:

(1) Only by the taxable income of the third preceding year computed under Section 172 (b) (2), or if smaller by

(2) That portion of the loss which can be carried back to the third year under Section 172 (i). Thus, the loss is not reduced by more than could have been used that year, when the current loss is carried through the third preceding year.[102]

VII. THE SMALL BUSINESS INVESTMENT ACT OF 1958

On August 21, 1958, the Small Business Investment Act of 1958 was enacted into law. It was received by prospective investors with a great deal of interest, because of the exceptional tax advantages that it offers to them. In those cases where a new venture is unsuccessful, unlimited ordinary losses will be allowed. If it proves to be successful, capital gain and tax-free dividend income is available.

The responsibility for administering the Act was given to the Small Business Administration (hereinafter identified by the initials S. B. A.).

A. *General Provisions*

In general, the Act allows ten or more private individuals to set up a small business investment company, such company's purpose being to make equity capital investments and long-term loans to small businesses. The companies will be chartered under local law where local law allows it. If not, a direct Federal charter will be issued by the S. B. A.

To begin operations, a company must have, in cash, at least $300,000.00 of paid-in capital and surplus. S. B. A. is authorized in those cases where the $300,000.00 cannot be privately raised, to advance up to one-half of this

[102] § 172 (h).

amount to the company. In addition, S. B. A. can loan the company up to 50% of its paid-in capital and surplus, including capital invested by S. B. A. Therefore, a company can start business with a fund of $450,000.00, having invested only $150,000.00 of its own.

However, S. B. A. has indicated that at present it will deal only with those companies that can invest their own funds. The reason for this is that S. B. A. has a limited number of personnel with which to administer the Act and a limited amount of funds available. S. B. A. will charge a 5% interest rate on the funds it advances to these new companies.

B. *Equity Capital Investments v. Long Term Loans*

The small business investment companies are encouraged by the Act to make equity investments in small businesses in exchange for convertible debentures. The Act also allows for long-term loans. The interest rate is to be governed by the legal limit under local law, or in the absence of such limit, by an advance agreement with S. B. A.

C. *Tax Advantages*

1. To the investment company:

a. Dividends received by the small business investment company on stock that it has in a small business is entirely tax-free, as opposed to the 85% dividends received credit given to other corporations. This does not apply to dividends received on the preferred stock of a public utility.[103]

b. Losses, whether by sale or worthlessness, on convertible debentures (including stock, if the conversion privilege was exercised) of a small business concern are allowed as fully deductible losses and not as capital losses.[104]

2. To the stockholder:

a. Losses, whether by sale or worthlessness, on stock owned in the investment company, are allowed as fully deductible losses rather than capital losses. No limit has been set on the losses to be claimed under this provision. It should, therefore, not be confused with Section 202 of the Technical Amendments of 1958, discussed above, which limits ordinary losses on "small business stock" to $25,000.00 on a separate return, or $50,000.00 on a joint return.

b. For the purpose of the net operating loss deduction, such losses are considered as attributable to the taxpayer's trade or business.[105]

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[103] § 243 (b) as added by § 57 Technical Amendments Act of 1958.
[104] § 1243.
[105] § 1242 as added by § 57 Technical Amendments Act of 1958.

D. *Tax Dangers*

These new companies must be cautious to avoid the personal holding company status. A major portion of their income will consist of personal holding company income, such as dividends, interest and capital gains.

The Internal Revenue Service has ruled that the 75% and 85% penalty surtax will apply if, at any time during the last six months of the company's taxable year, more than 50% of its stock is held by five or less persons and 80% of its income is personal holding company income, unless the income is distributed to the stockholders.[106]

If the stock in the company is kept fairly equally distributed among ten or more unrelated persons, the personal holding company problem can be safely avoided. In that case, it is not likely that more than 50% of the stock will ever be held by five or less stockholders.

As to the penalty surtax on unreasonable surplus accumulation, while this should not be any problem, the Internal Revenue Service has not given any assurance on this matter yet.

E. *Businesses Eligible to Receive Money From Small Business Investment Companies*

Not all businesses will be eligible to receive money from the new small business investment companies. In order to qualify, the business must be a small business, as defined by the S. B. A.

A small business is one which is independently owned and operated, and not dominant in its field of operations. In addition, the S. B. A. considers a business to be small if:

1. In the retail and service trade area, its gross sales are $1,000,000.00 a year or less.

2. In the wholesale field, its gross sales are $5,000,000.00 a year or less.

3. In the case of a manufacturing firm, they employ less than 250 workers. They are large if they employ more than 1,000 workers. Between 250 and 1,000, it will depend upon the particular type of industry.

Regulations on how to organize a small business investment company will be prescribed by the S. B. A., along with approved forms for filing applications for charters and licenses under the Act.

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[106] T. I. R. No. 110, November 21, 1958.

CONCLUSIONS

The Authors have not attempted in this article to cover all of the changes made in the tax laws by the Technical Amendments Act of 1958, the Small Business Tax Revision Act of 1958, and the Small Business Investment Act of 1958. These changes are much too numerous to be dealt with adequately in an article of this scope.

The Authors have tried to select those Sections which appear to have the greatest significance. This is not to say that the Sections omitted here are unimportant. All of the changes should be carefully studied by those interested in keeping abreast of the tax laws.