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Working with the Revenue code - 1965

Arthur J. Dixon

David Zack

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Edited by

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Material from THE JOURNAL OF ACCOUNTANCY'S *Tax Clinic 1954-1965 with current comment*

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INTRODUCTION

The purpose of *The Journal of Accountancy's* "Tax Clinic" is to present items of a practical nature drawn from the experience of practicing accountants throughout the country. Included in the column are helpful tax-saving ideas, pitfalls to be avoided and other matters of interest in the tax field.

This volume is the eleventh edition of what has become an annual publication. It contains the most worthwhile and currently pertinent of the items which have appeared in the "Tax Clinic" to date. Each year, outdated comments are eliminated, others are brought up to date, and new matters are added. Each item has been reviewed by the editors to make sure that it reflects the latest developments in the particular area, including new statutes, regulations, cases and rulings.

The categorizing of the material by Code section provides for an orderly approach by a reader going through the book for general information. It also enables a researcher analyzing a specific problem to determine quickly whether any comment has been included on the matter which interests him.

The table of contents and the subject index are additional tools designed to permit easy reference. A case table is also included to further assist those attempting to determine whether any item is included in the volume with respect to a particular case.

This book continues to be a co-operative effort—the work of many minds and hands. The generous co-operation of the contributing editors and of numerous practitioners who have submitted articles over the years have made it possible to provide readers with information of breadth, scope, and real practical value. The contributing editors are:

MATTHEW F. BLAKE, CPA	ROY G. MOSHER, CPA
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We are indebted to our associates for their assistance in reviewing and editing the material contained in the volume. Included among those who rendered valuable aid are Leonard Blank, LL.B., Steven D. Oppenheim, CPA, and Moses Tatt, CPA, LL.M.

It is our hope that practitioners throughout the country will find in this book either the answers to many of those intriguing tax questions which do not seem to appear in any of the tax services, or, at least, a base from which they can carry on their own explorations.

ARTHUR J. DIXON, CPA
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September 1965

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COMPUTATION OF TAX

Certain Married Persons May Qualify as Head of Household

Sec. 1

A distinction with a difference.

The beneficial tax rates applicable to the head of a household are not available to most married persons. However, a taxpayer will be considered as not married if at the close of his taxable year he is legally separated from his spouse under a decree of separate maintenance. Thus, a husband and wife who are legally separated may each be the head of a household if he or she otherwise qualifies. If the decree of separate maintenance requires the husband to pay alimony to his wife, the amounts so paid are deductible by the husband and taxable to the wife.

Married persons may also be separated under a written separation agreement not embodied in a decree. In such situations alimony payments continue to be deductible by the husband and taxable to the wife. However, persons who are so separated may not be the head of a household for tax purposes since they are considered to be married. It is only a legal separation embodied in a decree of separate maintenance which enables an otherwise married individual to file as a head of household.

However, if the taxpayer's spouse is a nonresident alien at any time during the taxable year, the taxpayer is considered as not married at the close of the year and may qualify as a head of household if the other requirements are met.

Sec. 11 Corporate Taxes—Fiscal Years

A useful table to ease the computation of fiscal year corporate taxes.

COMPUTATION OF FEDERAL CORPORATION INCOME TAX RATES FOR FISCAL YEARS ENDING IN 1965 IN CASES WHERE THE TAXABLE INCOME EXCEEDS THE SURTAX EXEMPTION (NOTE 1)

Fiscal Year Ended (*Do not use in case of short taxable year*)	*No. of Days* *Prior to 1/1/65*	*After 12/31/64*	*Ratio for Period (Note 4)* *Prior to 1/1/65*	*After 12/31/64*	*Mathematical Formula for Computation of Tax* (*Notes 2 and 3*)	
(*a*)	(*b*)	(*c*)	(*d*)	(*e*)	(*f*)	(*g*)
December 31, 1964	366	0	100.00000%	0.00000%	50.00000% less	$7,000.00
January 31, 1965	335	31	91.53005%	8.46995%	49.83060% less	$6,957.65
February 28, 1965	306	59	83.83562%	16.16438%	49.67671% less	$6,919.18
March 31, 1965	275	90	75.34247%	24.65753%	49.50685% less	$6,876.71
April 30, 1965	245	120	67.12329%	32.87671%	49.34247% less	$6,835.62
May 31, 1965	214	151	58.63014%	41.36986%	49.17260% less	$6,793.15
June 30, 1965	184	181	50.41096%	49.58904%	49.00822% less	$6,752.05
July 31, 1965	153	212	41.91781%	58.08219%	48.83835% less	$6,709.59
August 31, 1965	122	243	33.42466%	66.57534%	48.66849% less	$6,667.12
September 30, 1965	92	273	25.20548%	74.79452%	48.50411% less	$6,626.03
October 31, 1965	61	304	16.71233%	83.28767%	48.33425% less	$6,583.56
November 30, 1965	31	334	8.49315%	91.50685%	48.16986% less	$6,542.47
December 31, 1965	0	365	0.00000%	100.00000%	48.00000% less	$6,500.00

1. If the taxable income does not exceed the surtax exemption, the tax is 22% (*or 28% in case of multiple surtax exemptions*) for the calendar year 1964 and for any subsequent taxable year.
2. *In case of multiple surtax exemptions, the amount of the tax computed by the formula must be increased by $1,500.*
3. If in case of a member of a controlled group the surtax exemption is *less* than $25,000, multiply the taxable income by the percentage in col. (f); subtract therefrom the amount of col. (g) multiplied by a fraction the numerator of which is such surtax exemption and the denominator of which is 25,000.
4. When preparing the return, the percentages in col. (d) and (e) above should be entered (short extended) on lines 4 and 5 of Schedule FY on page 3 of Form 1120, *or* in case of multiple surtax exemptions, on lines 6 and 7 of Part II of Form 3920.

Computation of Tax for Fiscal Year Taxpayer

Sec. 21

Problem re alternative tax.

Information has been received from the Internal Revenue Service that where a fiscal year taxpayer has capital gain income and desires to use the alternative tax computation he must use it in both the pre-December 31, 1963, period and the post-January 1, 1964, period in determining his total tax liability. He can also use the regular tax computation in both periods, but may not use the alternative tax computation in one period and the regular tax computation in the other.

Special Purpose Structures

Sec. 38

Favorable treatment afforded certain property.

Special purpose structures, as distinguished from other types of buildings, are afforded favorable treatment under the investment credit and guideline depreciation. A special purpose structure is one which is an integral part of the production process and normally is replaced contemporaneously with the asset which it houses, supports, or serves. Examples are oil and gas storage tanks, grain storage bins, silos, oil cracking plants, blast furnaces, kilns, etc. A disadvantage develops, however, upon disposal. The profit to the extent of the depreciation since 1961 becomes subject to recapture under Section 1245. The equivalent section applicable to real estate embodied in the 1964 Revenue Act is not so stringent. Where early disposal of an asset at a profit is recognized as a real possibility and the asset does not qualify clearly under the special purpose definition, consideration should be given to treating it as an ordinary building so as to avoid the impact of Section 1245.

Sale and Leaseback

Deterrents to sale and leaseback.

The investment credit (Sections 38-48) and the depreciation recapture provision (Section 1245) tend to act as deterrents to the sale and leaseback of certain types of property, which have

Sec. 38 been used by the potential seller-lessee before the sale and leaseback. In the case of the investment credit, the disposition of Section 38 property by sale may result in a forfeiture of part or all of the investment credit otherwise obtained or obtainable. As the purchaser-lessor does not acquire new property, it cannot pass an investment credit over to the lessee to indemnify it for any credit thus lost.

Section 1245 taxes the recapture of depreciation on Section 1245 property, since 1961, up to the amount of the gain realized, as ordinary income. It may be possible to obtain a ruling from the Service that the entire deal is a financing transaction with the nominal lessee remaining as real owner for tax purposes. In that event the investment credit status will be safeguarded, there will be no recapture under Section 1245, and the taxpayer may continue to depreciate as theretofore.

Sec. 46 Investment Credit in Section 334(b)(2) Liquidation

Recapture problem for subsidiary; no purchase for parent.

When a parent corporation liquidates a newly acquired subsidiary within the two-year period prescribed by Section 334(b)(2), the Internal Revenue Service holds that such a liquidation results in the recapture of investment credit previously claimed by the subsidiary and a refund thereof is required. The theory is that there has been an early, disqualifying disposition of the assets distributed in liquidation by the subsidiary before the close of the useful life used in computing the credit.

Query: Does the disqualifying disposition to the parent constitute an acquisition of used Section 38 property acquired by the parent by purchase so that the parent's acquisition is eligible for the investment credit?

The national office of the IRS holds that the investment credit is not available to the parent corporation in this situation. Regulation 1.48-3(a)(1) provides that "used Section 38 property" means Section 38 property acquired by purchase. Regulation 1.179-3(c) defines "purchase" so as to eliminate any acquisition by one member of an affiliated group from another member of the same affiliated group. IRS takes the position that property acquired in a Section 332 liquidation is acquired from another member of an affiliated group, regardless of the required basis adjustment under Section 334(b)(2) and accordingly is not acquired by "purchase" and cannot be considered "used Section 38 property." (Also see discussion under Section 1245.) *Sec. 46*

Changes in Investment Credit Provisions re Leased Property

Intercompany sales v. *leases.*

Under prior law, where a lessor elected to treat the lessee as having purchased new property qualifying for the investment credit, the basis for computing qualified investment was deemed to be equal to the fair market value if such property was constructed by the lessor, or the lessor's basis in any other case. For transfers of possession to lessees occurring after February 26, 1964, Section 48(d) as amended provides that qualified investment to the lessee is to be based on the fair market value of the property regardless of the lessor's method of acquisition.

An exception to the amendment is provided where the property is leased by one member to another within an affiliated group, the lessee's qualified investment then being limited to the lessor's cost. Since there is no such restriction in the case of sales, affiliated groups should consider a switch from leasing to selling in order to gain maximum investment credit benefits. Of course, such factors, among others, as tax on the intercompany profit and the step-up in basis for depreciation must also be considered.

Apportionment of Tax Credit Limit to "Shell" Subsidiaries

Do not overlook inactive subsidiaries.

The regulations under Section 46(a)(5) provide that, in the absence of an agreement, the initial $25,000 tax credit limitation of Revenue Code Section 46(a)(2) is to be apportioned equally among all members of an affiliated group. This rule applies where the affiliated group does not file a consolidated return.

Corporations having one or more shell or inactive subsidiaries should not forget that this $25,000 must be apportioned pro rata among them unless an agreement is signed, each year, providing

Sec. 46 a different apportionment. Since the parent corporation is not filing consolidated returns with its subsidiaries, this point is easily overlooked.

Sec. 47 Tax Payable in a Loss Year

Investment credit recapture may result in tax.

We are all familiar with the case of the taxpayer who operates at a profit during the taxable year but has no Federal income tax liability for that year because of the deductibility of net operating loss carryovers. Well, we now have the reverse situation where a taxpayer has a Federal income tax liability for a year in which it operates at a tax loss. This anomaly results from the operation of Code Section 47, which in certain cases requires an increase in tax in the year of disposition or change in use of an asset on which an investment credit was previously allowed.

Thus, for example, when your tax planning involves the sale of assets at a gain during years when such gain will be offset against greater operating losses, care should be taken to insure not only the tax results desired from an income or loss position but also that the taxpayer has the hard cash available to pay any tax liability resulting from application of the investment credit recapture provisions.

Code Section 6164, which provides an extension of time for payment of taxes by corporations expecting carrybacks, is of no benefit in this situation because the tax payment to be extended must relate to the year immediately preceding the loss year.

Purchase That New Equipment Before Incorporating

Utilize investment credit against individual income tax.

Sole proprietors and partnerships planning to incorporate their businesses under Section 351, and also to purchase new equipment, should consider purchase of the equipment before the business is transferred to the corporation. The individuals would then be entitled to use the new investment credit against their own income tax. *Sec. 47*

Property transferred in a Section 351 transaction would not be a disposition under the law requiring a repayment of the credit. Section 47(b) of the law provides that property will not be treated as ceasing to be Section 38 property to a taxpayer by reason of a mere change in the form of conducting the trade or business, so long as the property is retained in the trade or business as Section 38 property and the taxpayer retains a substantial interest in the trade or business. The Senate Finance Committee Report (p. 152) clearly covers the incorporation of a sole proprietorship or a partnership in explaining this provision. But see page 21 for Application of New Depreciation Methods to Successor Owners.

In the event that the individual could not use all of the investment credit in the year of purchase, it would appear that the unused credit carryover remains with the individual.

On the other hand, suppose there is a disposition of the property by the corporation and there is a recapture of the credit. It is not clear whether the individual or the corporation would have to repay the credit. It would, on the one hand, be fair to require the individual to make the repayment, since he got the benefit of the credit. On the other hand, the corporation caused the loss of the credit by the disposition. Besides, other tax effects of the disposition would be borne by the corporation.

Investment Credit and "Reselection" of Used Property

The amount of used property which will qualify for the investment credit is limited to $50,000 per year for a taxpayer or an affiliated group of taxpayers. The taxpayer who acquires otherwise qualified used property in an amount which exceeds this limitation is required to select those pieces of property on which he is computing the investment credit. Questions arise as to what happens if some of the selected property is subsequently disposed of before the minimum useful life used in computing the investment credit has passed and all or a portion of the investment credit obtained is subject to recapture under Code

Sec. 47 Section 47. Is the investment credit simply lost under the early disposition provisions or is the amount of recapture reduced by the credit which would still be allowable had the taxpayer originally selected other used property?

Proposed Regulations Section 1.47-3(d) answers this question by providing for a process called "reselection." A taxpayer who acquired used property in excess of the $50,000 limitation may revise his original selection of property and thereby reduce or eliminate the amount of the investment credit recaptured when some of the property originally selected is disposed of too soon.

At least two questions remain unanswered in the proposed regulations. If the property originally selected is disposed of before the whole useful life used in computing the credit has passed but after, say, four years have passed, can other used property be reselected, or must the original selection stand as long as part of the investment credit on it will not be recaptured? The examples in the regulations avoid answering this question by assuming that the property disposed of early was disposed of after only three years and that the property reselected had a life of eight years.

Another unanswered question is whether the original apportionment of the $50,000 limitation among members of an affiliated group should be adjusted when some of the property included in the calculation of the apportionment was disposed of before four years had passed. In this case, it could be argued that the original apportionment based on the cost of used property acquired by each member of the affiliated group should be adjusted because property with a useful life of less than four years should not enter into the calculation.

Subchapter S Election Can Cause Loss of Investment Credit

Corporations which elected Subchapter S status for fiscal years beginning after January 1, 1962, or which intend to make the election for their current or a subsequent year, should be aware of the shareholder consent requirement of Section 1.47-4 of proposed regulations. Unless all consenting shareholders also consent to be treated as if they were the taxpayers who received the investment credit on property acquired prior to the first taxable year to which the election applies, the Subchapter S election itself can constitute an early disposition of the qualifying property. *Sec. 47*

The proposed regulation requires that these consents be filed with the return of the corporation for the year preceding the first taxable year to which the Subchapter S election is applicable. This requirement cannot be met in the case of a corporation which elected for a prior year beginning after January 1, 1962, and for which the preceding year's return has been filed. The regulation as proposed does not provide the usual ninety-day grace period for compliance. Hopefully, the final regulation will provide a grace period.

In the meantime, any affected corporation which plans to rely upon its being extended the right to file timely consents within a grace period would be well advised to obtain consents from any shareholders who have sold or redeemed, or plan to sell or redeem, their stock.

Consistency would also seem to require that termination or revocation of the Subchapter S election should result in the recomputation of any credit claimed by the shareholders while the election was in effect (or some other means of recapture if qualifying property is subsequently disposed of by the corporation). This point is not covered at all by the proposed regulations.

Investment Credit on Used Property *Sec. 48*

Do your own renovating.

Taxpayers that will have an investment in used property in excess of the $50,000 limit for computing investment credit should consider the possibility of buying equipment and then renovating it rather than buying reconditioned equipment. Amounts spent in reconditioning equipment will qualify as "new Section 38 property" while the purchase cost of reconditioned property is treated as "used Section 38 property." This is evidently true even if the purchase and renovation are done in the same year (see example (5), Regs. Sec. 1.48-2(c)).

Furthermore, Regulations Section 1.48-2(b)(1) indicates that

Sec. 48 property is considered as reconstructed after work is done in accordance with the specifications.

GROSS INCOME

Sec. 61 Measuring Solvency Where Debt Is Cancelled

Liquidating value is the key.

Where there is a cancellation of indebtedness as the result of an informal settlement with creditors in an insolvency proceeding, it is imperative that a statement of affairs be prepared to determine the extent of taxable income, if any, resulting from the discharge of debt.

It is well established that a cancellation of indebtedness neither results in taxable income nor affects the taxpayer's net operating loss carryovers from prior years, if the taxpayer is insolvent before the cancellation, and after the cancellation either remains insolvent or has no excess of assets over liabilities. Income is realized only to the extent that the taxpayer becomes solvent as the result of the forgiveness. Furthermore, regardless of the solvency of the debtor, Regulations Section 1.61-12(b) states that taxable income is not realized by virtue of a discharge of indebtedness under Chapters X, XI, or XII of the Bankruptcy Act, unless the proceeding had as one of its principal purposes the avoidance of income tax.

Reference to a balance sheet may indicate that assets exceed liabilities and the company is therefore solvent. However, a statement of affairs, predicated on asset values were the creditors to enforce their claims, might indicate that the liabilities exceed the value of the assets and therefore the company is insolvent. Inasmuch as the court decisions relating to cancellation of indebtedness look to insolvency in a bankruptcy sense, the statement of affairs should prevail in determining the amount of taxable income. In this regard, the Tax Court held, in *Lakeland Grocery Co.*, 36 B.T.A. 289 (1937), that the measure of solvency after the cancellation of indebtedness was the amount of net assets retained by the taxpayer which could have been applied against its indebtedness had it been adjudicated a bankrupt. *Sec. 61*

A balance sheet is based on the company continuing in business as a "going concern," whereas a statement of affairs is predicated on the immediate liquidation of the company. Ordinarily, the liquidating value of assets would be substantially less than the book values utilized in the preparation of the balance sheet.

Sick Pay

Sec. 105

The significance of employer-employee relationship.

An employee of a corporation in the process of liquidating under Section 337 became disabled and was entitled to insurance benefits under a contributory group health and accident policy for company employees. The benefits were measured as a percentage of the employee's salary and payable for a period of ten years or until retirement date, whichever occurred sooner. (The company had a qualified pension plan which provided for employees at retirement.)

The question arose as to the taxability of the portion of the insurance proceeds attributable to the employer's contribution after the corporation was liquidated. It was concluded that the portion of the proceeds received prior to liquidation were not taxable since they would qualify under Section 105(d) of the Revenue Code as sick pay received under a wage continuation plan. No authority could be found for excluding such amounts when there was no existing employer-employee relationship after liquidation.

Application of Sections 108 and 1017 To a Partnership

Sec. 108

Partnership files consent to adjust basis.

A limited partnership in the real estate business realized income from the discharge of mortgage indebtedness, the partnership remaining solvent both before and after the transaction.

Sec. 108 The application of Sections 108 and 1017 to the transaction would exclude the item from income and reduce the basis of the partnership realty. It was desirable that the partnership as an entity consent under Section 108 in order to avoid the problem of communicating with many partners.

The national office of the IRS has indicated, informally, that Section 108 applies and that the consent should be filed by the partnership rather than by the individual partners.

PERSONAL EXEMPTIONS AND DEPENDENTS

Sec. 151-2

Confusion May Exist Between Dependent and Dependency Exemption

You may have a dependent but not be entitled to a dependency exemption.

What is a dependent? The question hardly seems to pose any great problem. However, there is a distinction between merely being a dependent and being a dependent who entitles the taxpayer to a $600 exemption.

To qualify for the exemption, an individual (a) must have less than $600 gross income for the year (except that the taxpayer's child who is a full-time student for five months in the year or is under nineteen at the end of the year may have a gross income of any amount and still qualify as a dependent), (b) must not file a joint return, (c) must receive over half of his support from the taxpayer (except for the multiple-support rule), and (d) must live with the taxpayer as a member of his household or be of a qualifying relationship to the taxpayer.

Reference to Section 151(e) reveals that you must meet the tests set forth therein even if you qualify as a dependent under Section 152.

That this is not a distinction without a difference may be illustrated by the case of the taxpayer who supported his daughter all year long, and gave her away in marriage in December. The fact that she filed a joint return with her husband rendered her ineligible as an exemption on her father's tax return. But having satisfied the conditions of support and relationship, the daughter qualified as a dependent of her father. Thus, the father was able to deduct, on his tax return, the medical expenses which he had paid for his daughter (Sec. 213(a)). Medical expenses paid for a dependent are deductible even though an exemption may not be allowable for that dependent.

There have been several novel court decisions construing the dependency provision. For example, Section 152(a)(9) does not require that the dependent be related to the taxpayer in any way. However, in *Leon Turnipseed,* 27 T.C. 758, the Tax Court denied the taxpayer, a single man, a dependency deduction for a married and undivorced woman with whom he lived as man and wife and whom he supported during the entire taxable year since taxpayer's actions were deemed to be contrary to public policy. This decision was codified by the 1958 Technical Amendments Act.

In *Richard Farnsworth,* 25 T.C. 936, a case involving the 1939 Code, the taxpayer was denied an exemption for a dependent because he had given a prize ticket to his daughter who won $750. Since her gross income exceeded $600, the credit was disallowed. This would not have been the result under the 1954 Code as the gross income factor does not apply to children under nineteen or to children over eighteen who attend a full-time accredited school.

The Treasury has ruled (Rev. Rul. 57-561) that a student is a "full-time" student during such time as he is working in a "co-op" job with private industry, placement having been made by the educational institution at specified intervals for practical experience in conjunction with his prescribed course of study.

However, if the child provides more than 50 per cent of his support out of his earnings, or his support comes from other than the taxpayer, the deduction will be denied. This was emphasized in *Hicks,* T.C. Memo 1957-24, where a son attended college under the G.I. Bill and the father could not prove that he provided more than 50 per cent of the son's support. On the other hand, a father who provides support for a child is entitled to the deduction even though the child finishes school during the year and becomes employed. Once status as a student has been attained (five months at school) it continues throughout the year (Rev. Rul. 56-399). The foregoing highlights the

Sec. 151-2 importance of keeping adequate records to demonstrate that the child's income was not used to support him, e.g., a bank account showing that all or a substantial portion of the income had been deposited to the account of the child and had not been withdrawn would be ideal proof.

DEDUCTIONS

Sec. 162

Debenture Bonds With Warrants Attached

Make an allocation.

A corporation issued debenture bonds with warrants attached which entitled the purchaser to buy common stock of the corporation. Assume a $1,000 price for the package with the debentures having a value of $950 and the warrants a value of $50. For both tax and book purposes it was decided to allocate $50 of the proceeds received to the warrants with a credit to capital surplus. The debit was to unamortized bond discount and expense to be amortized over the life of the bonds. The bonds payable account shows a liability for $1,000. Had the corporation allocated the full $1,000 to the bonds, it would not have had a chance to obtain a tax deduction for the $50 applicable to the warrants. By making the allocation and amortizing the $50, it may be allowed a deduction for this amortization; at least an attempt should be made to obtain the deduction. If returns for prior years which are still open were filed without claiming the deduction, consideration should be given to filing protective refund claims.

This question may very well be litigated, and it will be well to have claimed the deduction in all cases possible.

Note that in GCM 7420, 1930 C.B. 80, the Service ruled that the purchaser of bonds with warrants attached should allocate the purchase price between bonds and warrants on the basis of the fair market value of each. If this ruling is correct, then the purchaser may well have original issue discount taxed as ordinary income under Section 1232.

Timing Deduction of Disaster Losses

Study election possibilities under Section 165(h).

At the election of the taxpayer, a disaster loss may be deducted in the taxable year immediately preceding the taxable year in which the disaster occurred, according to Section 165(h). To be so deductible the loss must occur no later than the normal return filing date of the subsequent year. Most taxpayers who sustain a heavy disaster loss are understandably eager to recoup as much of it by way of tax recovery as soon as possible. Therefore, they will usually want the loss deducted in the year preceding the year in which the casualty occurred.

The procedure to be followed is discussed in Rev. Rul. 63-21. However, the ruling does not indicate whether or not an election, once made, will be binding. On the other hand, it is quite clear that a taxpayer can amend his prior year's return for the purpose of claiming the loss in that year.

It would seem prudent, therefore, in a situation involving widely fluctuating income or tax rates, to advise a client to wait until the end of the taxable year in which the disaster occurs before deciding in which year to claim the deduction. With the benefit of hindsight, and by knowing exactly which tax bracket applies to each of the years involved, the client can obtain the maximum tax benefit. Section 165(h) provides for the President of the United States to designate the disaster areas. Supplements to Rev. Rul. 63-21 are issued periodically indicating the latest designation by the President.

Worthless Affiliate Stock And Historical Records

Loss of records could be costly.

The records of a subsidiary should be preserved from the beginning of its history. This includes the period of its life prior to the time the subsidiary was acquired. The importance of preserving the records stems from the provisions of Section 165(g). If the stock of a subsidiary becomes worthless, it is an ordinary loss, provided the total aggregate receipts for all years from so-called nonpersonal holding sources exceed 90 per cent. This 90 per cent factor must be measured from the beginning of its

Sec. 165 time. Any gap can dislodge the ordinary loss provision, as a result of which the worthlessness becomes a capital loss unless the total receipts for the year of lost records, when considered as personal holding company income in their entirety, should be insufficient to bring the total aggregate receipts for all years from so-called nonpersonal holding sources down to 90 per cent or less. Obviously, the only insurance is to get and keep the records covering the entire history of the subsidiary.

Loss on Worthless Shares Of Foreign Subsidiaries

Do not read the Revenue Code too quickly.

The Internal Revenue Code is replete with language the meaning of which is difficult to grasp. An example is found in Section 165(g)(3) pertaining to worthlessness of securities in affiliated corporations. It reads in part: "For purposes of paragraph (1) any security in a corporation affiliated with a taxpayer which is a domestic corporation shall not be treated as a capital asset." Experience demonstrates that readers tend to conclude from this language that a fully deductible loss may not be claimed in respect of worthlessness of the shares of a foreign subsidiary. As brought out clearly in the applicable regulations, the clause "which is a domestic corporation" modifies the term "taxpayer" and has no reference to the subsidiary. The ease with which the casual reader falls into such errors serves to underscore the thought that those who confine their research to merely a quick look at the Code are often on treacherous ground.

Sec. 167 Royalty Payments Measure Patent Amortization Deduction

The Commissioner's acquiescence in the Associated Patentees *case makes the situation described herein a basis for sound tax planning.*

Where a taxpayer purchases a patent with the price to be paid as a royalty based on use of the patent, and where the royalty payments extend over the entire life of the patent, royalty payments generally constitute capital expenditures, but the depreciation of the patent is measured by the amount of the current royalty. This in effect permits an immediate deduction of the royalties paid. *Sec. 167*

An interesting application of this general rule is possible where the purchase price of a patent may be measured by the net profits before taxes flowing from the use of the patent.

Let us suppose that an inventor, Mr. A, has a patent which he wishes to exploit, but for which he requires financing. He interests two individuals, B and C, in his patent, and they agree to finance production. One possible means to accomplish this would be for A, B and C to form a corporation with equal stock ownership, giving A stock in exchange for his patent. The organization of such a corporation would be accomplished tax free, but any payments by the corporation to A with respect to his stock would be dividend income to A and would not constitute a deduction to the corporation.

If the proper conditions exist, it would be possible for B and C to form a corporation by investing money, and then to have the corporation purchase the patent from A, agreeing to pay A one-third of the corporate profits before income taxes. If the share of profits to be paid to A extended over the life of the patent, and if A had no stock ownership or would acquire no stock ownership in the corporation as a result of the agreement, the payments by the corporation would be capital expenditures for the purchase of the patent, with depreciation on the patent measured by the same payments. (*Associated Patentees, Inc.*, 4 T.C. 979, Acq.) Thus, under this arrangement the corporation would secure a deduction for the share of profits going to A by reason of his transfer of the patent to the corporation. Thus, corporate Federal income taxes on A's one-third share would be eliminated.

When Is New Property Not New For Accelerated Depreciation?

Worth noting because the Service's interpretation is undoubtedly technically justified.

All may not be as it seems if a taxpayer assumes that equipment he plans to purchase may be depreciated under one of the

Sec. 167 accelerated methods even though the equipment was new when he started to use it and he has been the only user.

Consider the case of the taxpayer who has had new equipment installed under a lease arrangement and a few months later is given an option by the owner of the equipment for its purchase. Since the taxpayer first started the physical use of the equipment and it was new when he received it, at first glance it would seem that accelerated depreciation would be available after the purchase in view of the provisions of Section 167(c)(2). However, the regulations define original use as meaning "the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer." In interpreting this clause, the Internal Revenue Service is considering business use as well as physical use. Thus, the Service takes the position that the first business use of the leased equipment was for the production of rental income by the lessor and when the lessee purchases the property he is the *second* instead of the first user. Therefore, the taxpayer would be denied the advantages of accelerated depreciation.

However, the Service has ruled that a taxpayer who, as the original purchaser and user, acquires and occupies a personal residence after 1953 and later converts it into rental property is entitled to accelerated depreciation (Rev. Rul. 60-67).

Is Maximizing Depreciation Always Desirable?

The answer to the captioned question is: No. Examples of situations where it is not desirable to maximize include: (1) the taxpayer with a poor earnings outlook who lacks a reasonable expectation of using the extra depreciation currently or as part of a carryover or carryback net operating loss; (2) the taxpayer on percentage depletion where it is expected that one or more of the properties may have income at or near the 50 per cent of income limitation on percentage depletion (once lost, percentage depletion is not recoverable, while depreciation which is deferred to later years will be realized ultimately); (3) the personal holding company situation involving a taxpayer who plans to avoid that category by maintaining adjusted income from rents at a level of 50 per cent or more of the adjusted ordinary gross income. This taxpayer should not try to expand depreciation deductions because that lowers rent income and may undermine reaching the required 50 per cent figure. *Sec. 167*

Tax Treatment of Lease Purchase Agreements

If an ostensible lease agreement is in substance a time-purchase, it should be so treated under Service rulings — even though the taxpayer benefits thereby.

There has been a growing interest in recent years in the leasing, with or without option to buy, rather than the outright purchase of various types of equipment used in industry.

In most instances, sound economic reasons account for the growth in the popularity of the leasing arrangements. For example, a company which of necessity must maintain a large number of, say, fork-lift trucks might find it advantageous to have the use of such trucks without having to tie up substantial funds which are otherwise required as working capital.

On the other hand, there have, no doubt, been instances where the purpose of the leasing arrangements was to obtain a tax deduction for rentals paid when the transactions were in fact time-purchases.

This latter aspect has been of growing concern to the Internal Revenue Service; and in a series of rulings (Rev. Rul. 55-540, Rev. Rul. 55-541, Rev. Rul. 55-542) the Service outlined certain elements which, if existent in a contract, would require that for Federal income tax purposes the transaction be treated as a time-purchase and not as a lease.

True enough, these rulings will be effective in denying the "fast" write-off of assets in cases where this is flagrantly the motive; but what of the situation where the chief reasons for the lease contracts are valid business ones but where, nevertheless, some of the elements cited in the rulings exist? Can the rulings be interpreted literally enough to give the taxpayer a tax "break"?

For example, suppose Company X normally maintains eight trucks, each costing $2,500. The trucks have a life of four years and a salvage value of $250. They were originally purchased at the rate of two trucks per year, and are replaced at the end of useful life, the estimated salvage being realized. During 1956, it was decided to lease new trucks as the old ones were replaced, since it was felt that the arrangement would release additional

Sec. 167

working capital. Under the leasing arrangement, the "rental" was based upon the amortization of the truck cost over, say, sixty months, plus interest at a specified rate on the unamortized cost. The lease specified that the lessee would maintain the trucks, and that title would pass to the lessee at the completion of the "amortization" payments.

Undoubtedly, the transaction would, under a literal interpretation of the Service rulings, be considered a time-purchase, rather than a lease.

How would this affect the taxpayer? Let us assume that the taxpayer had adopted the double-declining-balance method of depreciation. The tabulation below indicates the annual deduction for Federal income tax purposes under that method and under the lease amortization schedule.

As disclosed by the computations, the company would obtain a greater deduction in the earlier years under the time-purchase concept than under the lease concept. Will it be permitted to do so—i.e., can the taxpayer invoke Revenue Ruling 55-540 to its own benefit?

$5,000 Annual Addition
DECLINING BALANCE DEPRECIATION

Year of Purchase	*1956*	*1957*	*1958*	*1959*	*1960*
1956	$2,500	$1,250	$ 625	$ 313	$ 157
1957		2,500	1,250	625	313
1958			2,500	1,250	625
1959				2,500	1,250
1960					2,500
	$2,500	$3,750	$4,375	$4,688	$4,845

RENT

Year of Lease	*1956*	*1957*	*1958*	*1959*	*1960*
1956	$1,000	$1,000	$1,000	$1,000	$ 500
1957		1,000	1,000	1,000	1,000
1958			1,000	1,000	1,000
1959				1,000	1,000
1960					1,000
	$1,000	$2,000	$3,000	$4,000	$4,500

It would appear that it should be able to do so. Revenue rulings are not one-way streets and in the case of this particular ruling, it is the *substance* of the arrangement that is being sought. Therefore, substance should prevail, whether it is the Government or the taxpayer who benefits therefrom. *Sec. 167*

Application of New Depreciation Methods to Successor Owners

The accelerated depreciation methods are available to the first user of the property. Where ownership changes hands in certain tax-free transactions, Section 381 permits the transferee corporation to step into the transferor corporation's shoes and to continue the use of the new methods where they had been applied by the transferor.

This provision does not apply to transfers of property owned by individuals or partnerships in a tax-free incorporation under Section 351; nor does it apply to certain other situations where basis is carried over — as where an heir receives property purchased by an estate during the period of administration.

Depreciating Additional Investment Credit Basis

What rate for depreciation?

The Revenue Act of 1964 repeals the requirement that the basis for depreciation be reduced by 7 per cent of the qualified investment. It also permits a taxpayer to add back the previous reduction of basis with respect to property placed in service before January 1, 1964 (Act Section 203(a)(2)). This add-back takes place on the first day of the first taxable year beginning after December 31, 1963.

The operation of this provision is explained in the Senate Finance Committee Report, Part I, page 43:

"With respect to property placed in service before (January 1, 1964) but in 1962 or 1963 and still on hand at the beginning of the taxpayer's first year beginning after that time . . . the basis on which depreciation is taken . . . is to be increased by the same 7 per cent by which the basis was reduced when the property

Sec. 167 was acquired. This addition to basis in the case of those computing depreciation on a straight-line basis will be recouped ratably by the taxpayer over the remaining life of the assets. . . ."

Rev. Proc. 62-21, however, provides for the abolition of so-called "penalty rates" (page 3). Under this procedure, straight-line depreciation is computed by applying the appropriate rate to the unadjusted basis until basis has been recovered, assuming no salvage, regardless of the amount of depreciation previously taken (TIR-399, question 58, example 9). Where a lesser rate of depreciation has previously been used, the effect of this method is not to recover basis over the remaining life.

There is, therefore, a possible inconsistency between the method of depreciating the amount restored to basis with respect to 1962 and 1963 acquisitions as prescribed by the Committee Report and the method prescribed by present Internal Revenue Service policy. In many instances where relatively small amounts are involved it may be simplest merely to adjust the basis of the underlying asset and depreciate at the same rate in accordance with apparent Internal Revenue Service policy.

Sec. 170 Contributions Carryover for Individuals

The provision in the 1964 Act for carryover of contributions applies only for those contributions which qualify for the additional 10 per cent limitation. Thus, anyone facing the prospect of a carryover should plan, in the year of contribution, to make only gifts qualifying for the carryover, deferring other types of gifts to the following year. This secures the maximum carryover and hence the maximum ultimate aggregate charity deductions possible.

Contribution Deductions for Fractional Interests

A gift plan will frequently involve a series of conveyances of fractional interests, calculated to keep amounts within the allowable deduction limit each year. One way of providing for this is transferring the entire property to a revocable trust, with arrangement for the trustee to deliver a fractional interest to the donee each year, and with provision for any remainder at the death of the donor to be delivered to the donee. *Sec. 170*

A situation may exist in which the donee organization has to be certain that it can obtain the property. To insure this the donee organization should have an irrevocable option to purchase the property at a specified price. This should agree with the basis of valuation for deductions of the fractional interests previously conveyed to the exempt organization.

Sales of Securities at Cost to Charity

Possible tax advantage over contribution of securities.

Suppose an individual owns securities which cost him $10,000, and are now worth $20,000. He wishes to make a $10,000 contribution to a charity. If he takes one-half of the securities he owns and donates them outright, he will end up with the other half of the securities, with a basis of $5,000 and worth $10,000. However, if he sells his entire holdings to the charity for his basis, $10,000, he achieves the same $10,000 contribution deduction, but now has $10,000 in cash. If he turns around and reinvests this $10,000 in the same security, he has the same number of shares he would have had in the first alternative method, but those securities now have a basis of $10,000 to him instead of $5,000. Of course, his holding period will begin with the date of the repurchase of the stock.

Moral: Sale at cost, and use of the proceeds to re-establish a position in the asset, can be a tax advantage, as compared with an equivalent donation without a sale.

Query: Is there a possibility the Service may contend that there has been a sale of one-half of the property for $10,000, resulting in a $5,000 taxable gain, and a gift of the other one-half?

Contributions of Copyright Interests

This item suggests a smart way to be charitable.

A generous author, desiring to make a gift to a charitable, educational, or religious organization might well be encouraged to consider making it in the form of a copyright interest. Revenue

Sec. 170 Ruling 58-260 permits an inventor to make a contribution of an undivided interest in a patent, take a deduction for the fair market value of the interest contributed, and subsequently exclude from his income the royalties earned on the share contributed. This ruling should be equally applicable to undivided interests in copyrights. Furthermore, the Service has also ruled that the right to exploit a copyrighted work in a particular medium is a separate, transferable property (Rev. Rul. 54-409). If, for example, an author makes a gift of all his right, title, and interest in the dramatization rights to his novel necessary for its production in a specific medium, such as radio, television, motion pictures or on stage, such gift is effective for income tax purposes (Rev. Rul. 54-599). If the gift is to charity, he would also be entitled to a contribution deduction for the fair market value of the interest donated.

Conceivably, the gift of the copyright (whether of the taxpayer's entire interest, an undivided interest in the whole, or the exploitation rights in a particular medium) could produce an aggregate benefit in tax savings in excess of the amount that the author would have been able to retain out of the royalties. For example, assuming that $1,000 in aggregate royalties were forthcoming to an author in the 60 per cent bracket, his retention would be but $400. If he were to make a present gift to charity of the copyright, he has a current tax deduction for the present fair market value thereof, say $900, with an immediate benefit of $540 (60 per cent of this $900 value). Furthermore, the cash resulting from the tax saving is available quickly, while the royalty income might be spread out over a period of years.

Substantial tax benefits resulting from charitable contributions are not new, but they can be most dramatically illustrated, as above, in the case of ordinary income assets such as copyrights and inventory. However, compare the different results reached in *Wodehouse* v. *Comm'r,* C.A.-4, 1949 with *Wodehouse* v. *Comm'r,* C.A.-2, 1949.

Charity Deductions and Capital Gains

Watch alternative tax computations.

Many times, taxpayers will take capital gains, and figure that they can then make additional charity payments within the 20 to 30 per cent limit. A sad reawakening is in store in some cases. Sec. 170

To illustrate, suppose the only income is a capital gain of $800,000. There are two ways of figuring the tax. One is to consider half the $800,000 or $400,000 as regular income. That would result in a tax of over $300,000. The other is 25 per cent of $800,000 or $200,000.

Obviously, the $200,000 would be selected. Now here's the point: the tax on that capital gain can't be less than $200,000. A charity deduction of 30 per cent of $400,000, or $120,000, would be available if the tax were figured on $400,000 as regular income. The net taxable income would be $280,000 on which the tax would still be over $200,000. The charity deduction was hence of no avail.

Actually, what holds good about charity applies to all other deductions. What this brings out is the importance of tax planning long before the close of the year instead of reliance on conventional generalizations.

Illustration of a Charitable Contribution of Property

Note, too, that XYZ Corporation will realize more after-tax dollars than would have been realized if the University had been ready and able to purchase at $1 million.

The item below from *The New York Times* illustrates a use of the contribution deduction which is probably known in theory to almost everyone, but in practice appears to be infrequently employed. Names have been deleted for obvious reasons.

"ABC University announced today the receipt of a $350,000 grant from the National Science Foundation for the purchase of a high-speed electronic computer. XYZ Corporation (manufacturer of the computer) has granted the University a 60 per cent allowance on the $1 million cost of the data-processing machine."

Assuming a cost to XYZ Corporation of $400,000, it will doubtless claim a contribution deduction in the amount of $600,000 and consequently will realize $700,000 (50 per cent of $600,000 plus $400,000) from the computer. Therefore, it will make a profit on this transaction which could not have been consummated at the regular selling price (since the University presumably was

Sec. 170 not in a position to spend more than $400,000) and will also get credit for a substantial act of philanthropy.

Sec. 172

Avoidance of Net Operating Loss Carryover Expirations

Operators of two large office buildings constructed within the last ten years, in reporting depreciation on the double-declining-balance method, have been faced with potential expiration of net operating loss carryovers. The solution adopted by both operators was to collect advance rentals from tenants, using as an inducement a discount concession.

Sec. 177

Deductions in Connection With Trademarks or Trade Names

Expenditures made in connection with the purchase of a trademark are, of course, not amortizable.

For taxable years beginning after December 31, 1955, Section 177 of the Internal Revenue Code provides an election for amortizing certain expenses, including legal expenses, incurred in connection with the acquisition, protection, expansion, registration or defense of a trademark or a trade name. However, it is necessary that the taxpayer submit a statement with his tax return covering the year during which the expenditure was made, electing to so amortize such expenses in accordance with Section 177.

It is suggested that accountants carefully analyze the legal expense account during their audit to determine if any of the expenses are in connection with trademarks or trade names and thus eligible for election under Section 177. Should a timely election to amortize not be included with the return when filed, the expense may be later disallowed as a capital expenditure and it will then be too late to elect to amortize under Section 177.

Deduction of Legal Fees In Connection With a Divorce Proceeding

Sec. 212

Where possible make an allocation.

Despite the Supreme Court decisions in the *Gilmore* and *Patrick* cases (372 U.S. 39, 53) there is authority for continuing to deduct legal fees in connection with the production or collection of amounts includable in gross income, such as alimony. See *Ruth K. Wild,* 42 T.C. No. 51.

Transportation Expenses Incurred In Connection With Medical Care

Sec. 213

These include in-town transportation expenses.

Most individual taxpayers are aware that transportation expenses incurred primarily for and essential to medical care are deductible as medical expenses, subject, of course, to the limitations contained in Code Section 213. However, what is frequently overlooked is that such deduction is not limited to out-of-town expenses – it includes in-town transportation.

For example, a taxpayer having a prolonged illness in his family requiring frequent trips to a doctor, hospital or clinic, either by private car or by public transportation, is entitled to and should claim a deduction for the cost of such transportation.

85 Per Cent vs. 100 Per Cent Dividend Received Deduction

Sec. 243

Difference may be more than 15 per cent.

The 1964 Revenue Act introduced the 100 per cent dividend received deduction by adding new Paragraph (3) to Section

Sec. 243 243(a) of the Code. Prior to such addition, most intercompany dividends were eligible for only the 85 per cent dividend received deduction under Paragraph (1) of Section 243(a). Now, beginning in 1964, intercompany dividends fall into the 85 per cent category in Paragraph (1) unless the taxpayer elects the 100 per cent deduction in Paragraph (3).

In determining the effect of choosing either the 100 per cent deduction or the 85 per cent deduction, the rules limiting the deduction must be considered, since the "spread" between the two can exceed 15 per cent. This results from the fact that under Section 246(b)(1) the 85 per cent deduction is subject to certain limitations based on taxable income, whereas the 100 per cent deduction is not. This can be illustrated by the following example, which indicates that the 85 per cent deduction, after limitation, becomes a 72.25 per cent deduction:

Gross dividend income	$100,000
Loss from "other" operations	(15,000)
Taxable income before dividend deduction	$ 85,000
Dividend deduction (limited to 85 per cent of taxable income)	$ 72,250

The "effective" rate of the "85 per cent" dividend deduction can thus go below the 85 per cent, depending on the results of other operations. Since the 100 per cent deduction is not subject to these limitations, any decision involving a choice between the two should consider this important difference.

Sec. 246 Quirk in Limitation on Dividend Deduction

It is now apparent that the draftsmen of the section contemplated this result. Companies with a high proportion of dividend income should bear it in mind near year's end. A slight shift in income or deductions may be significant.

The dividends-received deduction limitation (85 per cent of taxable income before the dividends-received deduction, Sec. 246(b)(1) does not apply in any case where, by the lifting of the limitation, a net operating loss results (Sec. 246(b)(2)).

An astounding situation apparently can result from this quirk. For example: Sec. 246

1962

Dividends received	$100,000
Other income	300,000
	400,000
Deductions (other than dividends-received deduction)	315,001
Taxable income (before dividends-received deduction)	84,999
Dividends-received deduction under the general-rule limitation is $72,249 or 85 per cent of taxable income before the dividends-received deduction. However, inasmuch as the dividends-received deduction computed without reference to the general-rule limitation creates a net operating loss, the general-rule limitation does not apply.	
Dividends-received deduction = 85% × 100,000 =	85,000
Net operating loss	$ 1

If the taxpayer had but $2 more net income, it would have quite a different result, i.e.:

Taxable income (before the dividends-received deduction)	$85,001
Dividends-received deduction is computed under the general-rule limitation since the lifting of that limitation does not create a net operating loss.	
Dividends-received deduction = 85% × $85,001 =	72,250
Taxable income	$12,751

In this instance, the taxpayer would have tax to pay.

This twist in the 1954 Code deserves careful consideration. Two dollars less income could convert the above taxpayer's taxable income of $12,751 into a net operating loss of $1!

Indeed, two cents difference could produce a substantial amount of tax!

Public utilities should note that under Section 172(d)(6), the dividends-paid deduction (Sec. 247) is not limited by reference

Sec. 246 to taxable income in computing a net operating loss. Here is another possibility of converting taxable income into loss.

Sec. 264 Interest Paid by Employee To Carry Life Insurance

The date of organizing the policy and not its issuance controls.

A corporation maintains key-employee insurance on the lives of selected officers and executives. When an insured employee retires, the company offers him the right to take over the policy for its then cash surrender value. The policy was purchased by the company in 1950. In 1964 the employee takes over the policy and borrows the funds in order to pay the cash surrender value to his former employer.

Amendments to Code Section 264 by the Revenue Act of 1964 disallow interest deductions for any amount paid or accrued during the taxable year on indebtedness incurred or continued to purchase or continue in effect a life insurance contract if such indebtedness is incurred pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract.

Does the take-over by the retiring employee constitute a "purchase" which would bring the transaction of the policy originally issued in 1950 within the post-August 6, 1963, provisions? Regulations 1.264-4(e) appear to make the answer "yes." This regulation provides: "With respect to contracts entered into on or before August 6, 1963, but purchased or acquired whether from the insurer, insured or any other persons (other than by gift, bequest, or inheritance or in a transaction to which Section 381(a) of the Code applies) after such date, the rules of this section apply after such purchase or acquisition."

Moral: the change in law is not confined to policies "taken out" after August 6, 1963.

Sec. 265 Interest to Carry Tax-Exempt Securities

Preserving the interest deduction.

Interest to carry tax-exempt securities is not deductible. But how about this: A controlled corporation borrows money to acquire assets from its controlling stockholder. The controlling stockholder uses the money to purchase tax-exempt securities. Thus, although he has used these funds to acquire tax-exempt securities, he has no interest deduction to be disallowed. Conversely, the corporation has paid interest, but it has not used the funds from the borrowing to purchase or carry tax-exempt securities. Assuming the corporation is otherwise recognized for Federal income tax purposes, both the tax-exempt income and the interest deduction should be preserved.

Temporary Investment of Borrowed Funds

The effect of investment in tax-free obligations.

A taxpayer who borrows for the purpose of financing a construction program frequently finds it impracticable to time the borrowing with the need for the funds. Therefore, excess funds are on hand for a period of time following the borrowing and prior to the expenditure for construction. Code Section 265(2) provides that no deduction shall be allowed for interest on indebtedness incurred or continued to purchase or carry tax-free obligations. Does Section 265(2) operate to prevent a deduction of interest on the borrowing when the excess funds are temporarily invested in tax-free obligations?

Apparently not. Section 265(2) is directed toward the purpose of the borrowing and not toward the temporary use of the funds borrowed. This position is made clear in Revenue Ruling 55-389. Informal discussions with the Internal Revenue Service in Washington indicate that this is still the feeling of the Service, but the length of time the tax-free bonds are held is considered to be a persuasive indication of the purpose of the borrowing. Should the tax-free bonds be liquidated in the year following the borrowing, chances are that no questions would be raised. On the other hand, if no commitments were entered into in connection with the expansion or construction program during the year subsequent to the borrowing, the taxpayer's position as to the purpose of the borrowing is considerably weakened. The vague intention of building sometime in the future certainly does not justify the investment of borrowed funds in tax-free obligations. For a court decision involving the question as to whether an investment was temporary, see *F. W. Drybrough,* 42 T.C. No. 82.

Sec. 265 Deduction of Trust Expenses

A clear explanation of an unclear provision in the law.

Expenses allocable to tax-exempt income are nondeductible *unless* the tax-exempt income is interest income and the expense is other than interest expense. In no event may the deduction be taken under Section 212 (Sec. 265(1)).

In other words, expenses relating to tax-exempt interest are deductible if such expenses come under Section 162, but not deductible if they are Section 212 expenses.

Apparently, there has been no clear-cut decision by the Service or the courts as to when a trust is in business and its expenses deductible as business expenses under Section 162, and when they are deductible under Section 212 for the production of income. In the preparation of fiduciary returns, no allocation of expenses to tax-exempt interest income should be necessary whenever the activities of the trust are sufficient to constitute the conduct of a business. Section 162 of the Code, which requires no allocation, would then apply. It may ultimately develop that the activities of a trust, per se, would be regarded as the conduct of a business, in which case Section 212 would not be applicable. Only Section 162 would then govern, and the expenses would be fully deductible.

It should be noted that state income taxes allocable to exempt interest are not affected by Section 265, since they are specifically deductible as taxes rather than as expenses. (See Rev. Rul. 61-86, C.B. 1961-1, p. 41.)

Sec. 267 Bonds Held by Related Taxpayer

Even bond interest may be nondeductible if not paid within two and one-half months after the end of the year.

It could easily be overlooked that bond interest may be disallowed as a deduction under Code Section 267.

Assume that an accrual-basis corporation accrues interest at the end of its taxable year payable to a controlling stockholder on a cash basis, and such interest is not paid to (or constructively received by) the related taxpayer within two and one-half months after the close of the corporation's taxable year.

The specific situation in which application could be easily overlooked is the one relating to bond interest payable more than two and one-half months after the close of the corporation's taxable year. The IRS issued a ruling under the 1939 Code (I.T. 3319, 1939-2 Cum. Bull. 161) that such bond interest satisfied all requirements of the then pertinent Section 24(c) denying the deduction, even though the bonds were in coupon form. *Sec. 267*

CORPORATE DISTRIBUTIONS AND ADJUSTMENTS (Subchapter C)

DIVIDENDS AND OTHER DISTRIBUTIONS (INCLUDING REDEMPTIONS, ETC., TAXED AS DIVIDENDS)

Distributions of Property by Foreign Corporation *Sec. 301*

Effect on dividends differs from effect on earnings and profit.

The Revenue Act of 1962 changed the rule with respect to distributions of property in kind from a foreign corporation to a domestic corporation, effective as to distributions made after December 31, 1962. Such distributions are now taxable at the fair market value of the distributed property to the extent the distribution is treated as coming from foreign-source income. However, in determining the effect on earnings and profits of the distributing corporation, the provisions of Section 312 apparently still apply. Therefore, it appears that earnings and profits of the distributing corporation are generally decreased only by the adjusted basis of the property distributed.

The following example illustrates the strange result that could occur in a distribution by a foreign subsidiary to a domestic parent corporation:

Pretax income of foreign subsidiary	$200
Foreign income tax paid by subsidiary	100
Accumulated profits after tax	$100

Sec. 301

Let us assume a foreign-source dividend in kind having a fair market value of $100 and a zero basis.

In this situation, if "gross up" applies, the domestic parent would report $200 of taxable income and would presumably be entitled to a $100 deemed-paid foreign tax credit. The foreign subsidiary, however, would apparently still have $100 of earnings and profits, since the property distributed had a zero basis.

Sec. 302

Comments on Stock Redemptions

Based on understanding of informal Service policy.

Redemptions:

1. It is informal Internal Revenue Service policy that where a shareholder owns (directly or indirectly) less than 25 per cent of the common stock, the redemption of any preferred stock which he may own will qualify under Section 302(b)(1) as a redemption not essentially equivalent to a dividend.

2. Where the redeeming shareholder had control prior to, but not after the redemption, a substantial argument may be advanced that the redemption is not essentially equivalent to a dividend, even though it fails to qualify under Section 302(b)(2).

3. Where part of the shareholder's stock is sold and part is concurrently redeemed so that the total transaction meets the percentage tests for a disproportionate redemption, capital gain rather than dividend consequences will likely result. The regulations are silent on this point.

Attribution Rules in Redemptions Terminating an Interest

File the necessary agreements and avoid controversy.

Section 302(c) of the Internal Revenue Code provides that in stock redemptions effecting a termination of a stockholder's interest under Section 302(b)(3), the family attribution rules will be inapplicable in determining whether a complete redemption has, in fact, occurred, provided an agreement is filed by the distributee as required by Section 302(c)(2)(A)(iii). In the agreement, which must be filed with his return for the year of the redemption, the distributee agrees to notify the District Director in the event he reacquires an interest in the corporation within ten years from the date of the distribution.

In order to insure capital gains treatment for Section 302(b)(3) redemptions it is important that the agreement be filed as required by Regulations 1.302-4. In *Archbold* v. *United States* 311 F. 2d 228 (CA-3, 1963) the Court of Appeals recently affirmed a New Jersey District Court decision sustaining the refusal of the Commissioner of Internal Revenue to permit Archbold to file the required agreement at a later date with an amended return. As a result the entire distribution received by Archbold was held not to qualify as a sale or exchange entitled to capital gains treatment and instead was taxed as a dividend.

Subsequent to the decision in *Archbold,* in *U.S.* v. *Van Keppel,* 321 F. 2d 717 (CA-10, 1963), the Tenth Circuit distinguished the former case. On somewhat similar facts, it held that inadvertent failure to file the agreement under Section 302(c)(2)(A)(iii) with the returns for the year of redemption did not foreclose capital gains treatment when it was subsequently filed after the defect was discovered upon an audit of the return, but before the Director had made a deficiency assessment. The Court held Van Keppel had "substantially" complied with the provisions of the Code requiring the filing of the agreement. Accordingly, the constructive stock ownership rules did not apply for purposes of determining whether the taxpayer's interest had been terminated and the redemption was taxed as a capital gain.

The court noted that the taxpayer in *Archbold* did not offer to file an amended return appending the required agreement until after the Director had made a deficiency assessment.

Taxpayers would be well advised to avoid a controversy by meticulously complying with the requirement of the regulations that the agreement be filed with a timely filed return for the year in which the redemption occurred.

Redemption of Stock Preceding a "C" Reorganization

The rule is not the same for common stock as it is for preferred.

In issuing advance rulings, the Reorganization Branch of the National Office, Internal Revenue Service, has indicated a liberal

Sec. 302 view as to the separability of a preceding *preferred* stock redemption from a subsequent "stock for assets" reorganization under Section 368(a)(1)(C)IRC – provided the redemption is not a condition to or step in the plan of reorganization. The IRS has indicated that:

1. The redemption of the preferred stock is not a part of the reorganization and need not be taken into account in determining whether the requirements for a nontaxable reorganization are satisfied. For example, in determining whether "substantially all" of the redeeming corporation's assets have been acquired, the test will be satisfied if 90 per cent or more of the net assets (as of the date of the reorganization) are acquired, even though the 90 per cent test could not have been met before the redemption occurred.

2. The taxability of the preferred stock redemption is determined under Section 302, after giving effect to the constructive ownership provisions of Section 318.

To obtain the desired result, it will be necessary for the shareholders of the transferor corporation to work out the redemption unilaterally. The redemption must be an accomplished (or agreed upon) fact before any reorganization is effected with the acquiring corporation.

A different rule obtains if a redemption of *common* stock preceding a reorganization is desired. In such a case, the Internal Revenue Service has indicated that the "step transaction" doctrine will be invoked and the receipt of cash or property in redemption of common stock will be treated as a part of the plan of reorganization.

The liberal policy on preferred stock redemptions recognizes that preferred stock is usually callable by its terms, is usually held by persons having no substantial common stock equity and no close connection to management, is only a step removed from debt and that its existence often frustrates reorganizations. Accordingly, the Internal Revenue Service has indicated that it will permit redemption at capital gain rates without upsetting the subsequent reorganization plan.

On the other hand, a common stockholder is an equity owner. The redemption of common stock (noncallable) requires personal negotiation. It is so closely related to the reorganization that the Reorganization Branch has indicated it will not view it as a separate transaction.

Where a redemption of *common* stock precedes a "C" reorganization, the Service has indicated that:

1. The redemption distribution must be taken into account to determine whether "substantially all" of the assets of the transferor have been acquired. If the distribution exceeds 10 per cent of the value of the net assets before the redemption, the test will not be held to be satisfied.
2. If less than all of the stock of a shareholder is redeemed, and he thereafter exchanges the balance of his shares in the reorganization, he will be considered to have received "boot" taxable as a dividend under Section 356(a)(2) to the extent of his ratable share of the transferor's earnings and profits.
3. If *all* of the stock of a shareholder is redeemed, the tax effect will be determined under Section 302 of the Revenue Code.

Requirements in Connection With Section 302(b)(3) Redemptions

Forewarned is to be forearmed.

Discussions with the Reorganization and Dividend Branch of the Tax Rulings Division indicate that the Service has adopted certain requirements in connection with Section 302(b)(3) redemptions involving payouts over a number of years, which may not be apparent in the regulations. The following are some of the more important requirements:

1. There must be a contract, note or other evidence of indebtedness to the retiring shareholders. A simple account payable is not sufficient.
2. The retiring shareholders must surrender all of their shares at the time of the redemption. If they hold their shares as collateral, the Service will not treat the transaction as a termination of interest under Section 302(b)(3).
3. If the transaction is arranged in such a way that the retiring shareholders will be permitted to recover their stock upon a default of the redemption payments, this again will prevent the transaction from qualifying as a Section 302(b)(3) redemption. The debt to the retiring shareholders may be secured, however, by a mortgage on the property of the corporation.
4. After a Section 302(b)(3) redemption, the retiring share-

Sec. 302 holders may be creditors of the corporation only as a consequence of the redemption. If they loan money to the corporation or become creditors of the corporation for any other reason, this will also disqualify the redemption.

The above requirements are apparently designed to insure that the relationship between the corporation and retiring shareholders is completely severed as a result of the redemption.

Using Corporate Funds To Finance Sale of Stock

A practical method of disposing of stock of a closely held corporation via the capital gain route. Beware, however, of imposition of Section 531 surtax on improper accumulations.

The use of a close corporation's assets to help its stockholders finance the sale of their stock is made much safer taxwise as the result of the Treasury's acquiescence in the *Zenz* decision (*Zenz* v. *Quinlivan*, 213 F. 2d 914).

In the *Zenz* case, the sole stockholder of a close corporation sold part of her stock to a third party and immediately thereafter caused the corporation to redeem the balance. She treated her aggregate profit as a capital gain.

However, the Treasury asserted an ordinary dividend tax on the proceeds of the stock redeemed on the ground that the redemption was "essentially equivalent to the distribution of a taxable dividend" under 1939 Code Section 115(g)(1).

The taxpayer was sustained on appeal because, as the result of the two related transactions, she "ceased to be interested in the affairs of the corporation."

The Treasury acquiescence in *Zenz* has been ruled to be equally applicable to transactions under 1954 Code Section 302 (Rev. Rul. 55-745, 1955-2 Cum. Bull. 223). That section provides *inter alia* that if a distribution is in complete redemption of all of the stock of a corporation owned by the particular shareholder, it shall not be treated as a dividend.

Thus, a sole stockholder may dispose of his stock in a combination transaction, i.e., sale of part and redemption of the balance, without the hazard of a dividend tax on any part of the proceeds. Indeed, the issuance of notes payable by the corporation as part of the proceeds of redemption is permissible. What is more, if the redeeming stockholder receives such notes or other obligations of his corporation as part of the proceeds of redemption, it is possible that he may elect to defer his gain, reporting it on the installment basis as the obligations are redeemed. *Sec. 302*

However, whatever the circumstances, it is a good idea to obtain an advance ruling before undertaking a *Zenz*-type transaction.

Substantially Disproportionate Redemption of Voting Preferred Stock

Examine the stockholder's entire holdings!

To qualify as a substantially disproportionate redemption under Section 302(b)(2), the ratio of voting stock owned by the shareholder after the redemption to all of the voting stock then outstanding must be less than 80 per cent of the ratio which the shareholder's voting stock immediately before the redemption bore to the outstanding voting stock at that time. In addition, the shareholder's ownership of *common* stock, both before and after redemption, must meet the same 80 per cent requirement.

If a stockholder owns only voting preferred stock, both before and after the redemption, and no common stock is attributable to the shareholder, there will be no change in the percentage of common owned, or considered to be owned, by the shareholder. It will be zero both before and after the redemption. In such a case, the IRS has indicated that Section 302(b)(2) applies to the redemption of the voting preferred stock despite the unchanged zero percentage of ownership of common stock.

Gifts May Adversely Affect Section 303 Redemptions

Sec. 303

Consider estate and income tax saving vs. qualification under Section 303.

One of the most valuable provisions in the Code for stockholders in closely held companies is Section 303. It permits an estate and its beneficiaries to get money out of the corporation

Sec. 303

equal to the estate taxes and funeral and administration expenses. This can be done through stock redemption on a capital gain basis, rather than through tax consuming dividends.

However, to qualify for this, 50 per cent of the value of the net estate or 35 per cent of the value of the gross estate must be in stock of the company. That's the thing to watch at all times. Fathers have a way of making gifts of stock to members of the family. This may stem from natural affection, as well as love of income and estate tax saving. But if the love goes to the extent of having the father part with so much stock that what he has left no longer meets the 35 per cent or 50 per cent requirements, his estate can find itself in a financial and tax squeeze.

The moral of the story is: gifts are fine, but Section 303 may be finer.

Practical Problems in Applying Section 303

A discussion of the consequences of change in valuation of closely held stock.

Section 303 permits a corporation to redeem shares held by the estate of a deceased shareholder, without danger of ordinary dividend consequences, up to the estate's total Federal and state death taxes, plus its funeral and administration expenses. Such a redemption must occur no later than ninety days after the Statute of Limitations expires for assessing additional Federal estate tax. If questions of valuation are being argued with the Internal Revenue Service, the normal three-year statute may well be extended for a considerably longer period by filing a petition in the Tax Court. In such case the application of Section 303 may give rise to interesting accounting as well as tax problems.

Assume a father owns 200 shares, one-half of a corporation's stock. His two sons, active in the business and in high personal tax brackets, own the other half. The father dies in 1955. His stock is the major asset in his estate and qualifies percentage-wise for Section 303 treatment. It is reported for estate tax purposes at $1,000 per share. In 1956, the two sons acting as executors have the corporation redeem, for taxes and expenses, thirty shares at the reported $1,000.

Thereafter an estate tax agent proposes a substantially higher fair market value for the stock. In due course a Tax Court petition is filed. Five years after filing the return, the argument is ended by a compromise agreeing to a $1,200 date of death value. Thus the gross estate is increased by $40,000 (200 shares times $200) on which the additional tax is, say, $12,000. The executors naturally want to turn in more shares so as to raise the needed $12,000.

However, during the five years since the father's death the company has been prospering. The book value of its stock has increased $300 per share. Assuming no other evidence of fair market value, if the company was worth $1,200 per share five years ago, it is likely worth $1,500 per share today.

Two problems present themselves. First, the 1956 redemption was made at $1,000 per share on the assumption that the estate would thereby incur no gain or loss. However, now that a $1,200 per share fair market value at date of death has been conceded, thus establishing $1,200 as the correct tax basis, did the estate have a $6,000 (thirty shares times $200) capital loss? And if so, what can be done about it now that the Statute of Limitations on the fiduciary income tax return has expired?

Second, how many shares should the estate turn in today as consideration for the additional $12,000 being paid out by the corporation? Can the estate simply turn in ten shares at the new established basis of $1,200 each and thereby incur no capital gain tax?

The answers to these problems seem to be as follows:

1. The corporation may properly pay $6,000 to the estate as additional purchase price of the shares acquired in 1956. Assuming it was always intended that the 1956 redemption be at the estate tax basis, the theory has to be that for five years the estate has been carrying a $6,000 account receivable from the corporation. On this assumption, the company should consider this payment as additional cost of its thirty shares of treasury stock purchased in 1956. This approach would eliminate the estate's "lost" 1956 capital loss. In this connection, it appears to be both desirable and practical, when the sale is made in the first instance by the estate to the corporation, for the selling price to be named and agreed upon with an open-end provision that any adjustment upwards or downwards by the Internal Revenue Service is to result in a corresponding adjustment of the selling price. This eliminates the need for assuming the intention that the redemption should be at the estate tax basis by spelling it out in clear-cut

Sec. 303 terms. A reasonable period after the final determination either by the Internal Revenue Service or, if appealed, by the courts, is allowed for the payment of the adjustment in price.

2. The 1961 redemption must take into account the present fair market value of the shares. Since it is assumed that a total of $42,000 can be paid within Section 303 limits, and $36,000 has already been received ($30,000 in 1956 plus the additional $6,000 in 1961), only $6,000 more in fair market value of the shares can now be surrendered. At $1,500 fair market value per share, this means four shares. Four shares have a basis of only $4,800, so the estate realizes a $1,200 capital gain. The estate should not elect to turn in five shares and thus argue that $6,000 of basis should be offset against the redemption price, thereby resulting in no taxable gain.

Compare the last paragraph of Revenue Ruling 57-334 discussing partial liquidations under Section 346(a). It holds that regardless of the actual number of shares surrendered for redemption, the number "deemed" to have been surrendered is a percentage of total shares outstanding before redemption equal to the fair market value of assets distributed, divided by the fair market value of the entire corporation immediately before the redemption.

Incidentally, why not consider redeeming *more* than the Section 303 limits? Even if Section 318 attribution of ownership rules apply so that Section 302 treats the excess redemption as an ordinary dividend, the estate's income tax brackets may well be much lower than those of its beneficiaries who will receive the stock or cash in the estate when it is terminated.

Let us assume ten more shares are redeemed from the estate at $1,500 each. True, since the Section 303 limitation has been exceeded, Sections 302 and 318 come into play. The entire $15,000 will likely be taxed to the estate as an ordinary dividend. However, if termination of the estate can be delayed till a later year, this $15,000, less the estate's income tax thereon, can be distributed to the two beneficiaries tax free.

Paying this "dividend" in the form of a stock redemption makes it unnecessary to pay a similar amount on the corporation's other shares, which in our example are held by the high-bracket sons. The estate loses no tax basis from having surrendered fifteen shares of its stock. Regulations Section 1.302-2(c) calls for transferring the $12,000 basis of the stock surrendered to the estate's remaining shares.

Redemption of Stock Held by An Estate in Related Corporations

Sec. 303

Interactions of Sections 303 and 304.

The Internal Revenue Code contains a number of tests for the determination of the effect of a redemption of stock, i.e., whether the redemption will be treated as a sale or exchange with capital gain treatment or as the equivalent of a dividend with ordinary income treatment.

When the redemption is of stock held by a decedent under Section 303, capital gain treatment is permitted if the proceeds do not exceed the estate taxes and funeral and administration expenses of the estate and if the stock represents 35 per cent of the gross estate or 50 per cent of the taxable estate. The interrelationship of this rule with Section 304 relating to redemptions through use of related corporations poses a problem.

A decedent owned 50 per cent of Corporation A and all the stock of Corporation B. On the basis of estate tax valuation, the stock of Corporation A qualifies for Section 303 treatment but the stock of Corporation B does not. Pursuant to a contract, Corporation A purchases the stock of Corporation B. Under Section 304 the decedent and the estate are considered to be in control of both corporations and, accordingly, the purchase by Corporation A of the stock in Corporation B is considered to be a redemption of Corporation A stock.

The question is whether under these circumstances capital gain treatment would be allowed since, even though Corporation B does not meet the percentage tests of Section 303, the transaction is treated as a redemption of Corporation A stock and that stock does meet the requirements. It is understood that private rulings have been obtained in similar situations from the Service holding that Section 303 does apply. It is sufficient that the stock which is considered to have been redeemed be qualified under Section 303. This interpretation seems consistent with the purpose of these provisions.

Section 306 and Identification of Stock Certificates

Sec. 306

Preferred stock is tainted Section 306 stock, if received as a dividend on common stock. The taint can be washed away, if before or at the time the preferred stock is disposed of, the underlying common stock likewise goes. This makes it important to relate particular common stock certificates to particular certificates of preferred stock received as a dividend on the common stock.

The taxpayer has the right to make the certificate identification in any way he pleases at the time the dividend is received. However, unless there is an identification or disposition of all preferred and related common stocks, the taxpayer will be hard put to establish that the taint was removed from particular certificates of preferred stock. The Government's position could easily be that the common stock sold was related to preferred stock certificates still in hand, or that the common stock sale released merely an aliquot percentage of preferred stock holdings from the taint. Earmarking of certificates at the time of the preferred stock dividend will avoid all these headaches.

Reminder Regarding Use of Section 306 Stock

Disposition of Section 306, but no ordinary income.

The ordinary income treatment likely for gain realized upon redemption, sale, or other disposition of Section 306 stock too often seems to preclude consideration of the possibility of advantageous tax use of such stock.

For example, donation to tax-exempt charitable foundations does not constitute a disposition generating ordinary or dividend income to the donor. As pointed out in Rev. Rul. 57-328, 1957-2 C.B. 229, the taint of Section 306 passes to the donee. The donee, however, being tax exempt, will not be taxed upon subsequent sale or redemption. The donor's charitable deduction will be equal to the fair market value of the stock contributed.

Section 306 stock should also be considered as a means of giving away value in a closely held corporation without relinquishing control, while at the same time retaining greater flexibility for qualifying the remaining stock in the donor's estate for Section 303 treatment. It may also be used where a possibility exists that a major stockholder's interest will be completely terminated by redemption or liquidation.

Redemption of Stock With Appreciated Securities

A ruling should be requested in situations such as this.

A corporation plans on redeeming its preferred stock at a stated dollar amount by distributing appreciated securities to its shareholders. Would the corporation have income to the extent of the difference between its basis for the appreciated securities used in redemption of its stock and the fair market value thereof?

One view expressed was that the redemption would not result in any tax to the corporation under Section 311 of the Code because the corporation is making a distribution with respect to its stock. Section 311 provides that "no gain or loss shall be recognized to a corporation on a distribution, with respect to its stock, of its stock or property."

Another view, with respect to a somewhat analogous situation, is that a distribution of appreciated securities by a corporation in payment of a dividend of a stated dollar amount (e.g., a dividend of 10 cents a share) would be taxable to the corporation to the extent of the appreciation, because the corporation would be satisfying a liability when it pays the dividend with appreciated securities.

Under the second view it is reasoned that after the dividend is declared (and the ex-dividend date has passed) the payment of the dividend is in satisfaction of a liability of the corporation rather than a distribution to shareholders by the corporation with respect to its stock. Thus, the position is taken that the corporation is dealing with the recipient of the distribution as a creditor, not as a shareholder. The proponents of the second view distinguish between a distribution in which the corporation resolves to distribute 20,000 shares of appreciated securities (in which situation they agree that no tax would be payable by the corporation) and a distribution in which the corporation resolves to pay a dividend of 10 cents a share with the same appreciated securities.

Clarification of this point was asked of the Reorganization Branch of the Internal Revenue Service. A reviewer in the Branch stated that he was quite certain that no tax would be payable by the corporation on the redemption of its stock with appreciated securities. He expressed the view that the corporation was making a distribution with respect to its stock and was

Sec. 311 dealing with its shareholders as shareholders and not as creditors. He also thought a distribution of appreciated securities in satisfaction of a dividend of a dollar amount would not be taxable to the corporation because it would be a distribution with respect to its stock.

Sec. 312 Effect of Redemption of Stock On Earnings and Profits

Payment to a withdrawing stockholder for unrealized appreciation created a capital deficit.

Company X was owned 50-50 by two stockholders, A and B, and its balance sheet was as follows:

Assets	
Cash	$ 150,000
Land and apartment building at cost, less depreciation on building	3,000,000
	$3,150,000
Liabilities and Capital	
Accounts payable	$ 50,000
Mortgage liability	1,000,000
Capital stock	100,000
Accumulated earnings	2,000,000
	$3,150,000

The land and apartment building, while carried on the books at $3 million, had appreciated considerably in value and were worth approximately $6 million.

The two stockholders had a basic disagreement, and it was agreed that B should be paid out and should receive $2,500,000 from the corporation for his stock. This was done.

The Internal Revenue Service has stated informally that the redemption of 50 per cent of the stock for $2,500,000 in this case does not create a deficit in accumulated earnings. The position of the Revenue Service is that a distribution to stockholders in redemption of stock may not reduce earnings and profits below zero. This is in accord with the Tax Court decision in *Meyer*, 7 T.C. 1381, and other cases.

It therefore must follow that the redemption in this case creates a capital deficit for tax purposes. The company's tax balance sheet after the redemption would, therefore, be as follows: Sec. 312

Assets	
Cash	$ 150,000
Land and apartment building at cost, less depreciation on building	3,000,000
	$3,150,000
Liabilities and Capital	
Accounts payable	$ 50,000
Mortgage liability	1,000,000
Bank loan (to finance stock redemption)	2,500,000
Capital deficit	(400,000)
	$3,150,000

Taxability of Dividends

Sec. 316

This is a nice thing to know.

A listed client having a large deficit in accumulated earnings wishes to adopt a method of paying dividends in alternate years in order to have a portion of the dividends tax free since the dividends would be in excess of the earnings for the year. However, the client desires to continue to declare a dividend in each year to avoid a possible deleterious effect on the price of the stock which may be caused by an omission of the declaration.

In Rev. Rul. 62-131, the Internal Revenue Service indicated that the payment date was to be used for purposes of determining the source from which dividends were paid and that the declaration date was of no consequence. This means that the client may declare dividends on the usual or historic declaration days but the dividends themselves will be paid in alternate years. This will achieve the desired objective.

Tax-Free Corporation Distributions

Timing is all important.

Proper timing of corporate distributions to stockholders during operating loss years may result in significant tax savings.

Normally, a distribution is charged against total earnings for the year without regard to the amount of income earned at the time the distribution is made. But in a loss year, net income or loss from the beginning of the year up to the time of distribution is added to or subtracted from the earnings and profits accumulated as of the beginning of the year. Thus, a substantial loss incurred during the early part of a loss year may completely wipe out any earnings and profits accumulation. A tax-free distribution to stockholders may then be made despite substantial earnings during the remainder of the year, provided that the corporation has a net loss for the year.

Example: The Upright Corporation is a seasonal business on a September 30 fiscal year. As of September 30, 1964, the company had an earnings and profits accumulation since February 28, 1913, of $50,000. Due to unfavorable business and climate conditions, the company anticipates at least a $10,000 loss for the fiscal year ending September 30, 1965. Since its business season begins in April and lasts through August, Upright Corporation had a six months' operating deficit of $100,000 on March 31, 1965. A $40,000 dividend was paid to stockholders on March 31, 1965.

The taxability of the distribution is determined after the close of the company's year on September 30, 1965. Let us assume that the company did, in fact, lose $10,000 for the year ($100,000 loss during the first half year and $90,000 profit during the second half).

Since there were no current earnings and profits, the earnings and profits accumulated as of March 31, 1965, would have been the only source of a taxable distribution. However, as noted above, in a loss year the accumulated earnings and profits must be adjusted to the date of distribution. On March 31, 1965, the adjusted figure was a $50,000 deficit—the $50,000 beginning balance less the $100,000 net loss for the six months ended March 31, 1965. Since there were no current or accumulated earnings and profits on March 31, 1965, the $40,000 distribution is treated as a return of capital to stockholders, tax-free to the extent of basis in the stock.

What happens to Upright Corporation's earnings and profits balance as a result of the distribution? The $40,000 distribution does not reduce earnings and profits since a distribution out of capital can't create or increase a deficit in earnings and profits. Therefore, Upright's September 30, 1965, earnings and profits balance is $40,000 (September 30, 1964, balance of $50,000 less $10,000 operating loss for the fiscal year).

If the $40,000 had been distributed on September 30, 1965, instead of March 31, 1965, it would have been fully taxable. *Sec. 316*

It is important that the net loss for the year up to the distribution date be accurately determinable. Otherwise, the net loss for the entire year will be prorated (on a daily basis) to the date of distribution and the corporation will lose the tax benefit of substantial losses in the early part of its year.

CORPORATE DISTRIBUTIONS AND ADJUSTMENTS (Subchapter C)—*continued*

LIQUIDATIONS

Character of Assets Change in Liquidation *Sec. 332*

Inventory may be capital asset in hands of parent corporation.

The rationale of the decision in *Acro Mfg. Co.* (39 T.C. 377 aff'd. 334 F. 2d 40 cert. den.) drives home the point that even though the cost bases are unchanged, the character of assets received by the parent corporation in the liquidation of a subsidiary under Section 332 may undergo a change. The taxpayer owned 100 per cent control of Button Corporation which had been acquired in a Section 368(a)(1)(B) transaction. It accepted an offer for the assets of Button but first it liquidated the subsidiary under Section 332. On the same date it sold the assets acquired in the liquidation to the third party. The assets consisted of trade accounts receivable, inventory, and fixed assets. The parent and subsidiary corporations were in unrelated businesses. Taxpayer claimed an ordinary loss on the sale on the ground that the assets were not capital assets under Section 1221. The holding period would encompass the subsidiary's holding period because this was not a liquidation covered by Section 334(b)(2). The court held that the assets were capital in the hands of the transferee because they were not held by it in the ordinary course of taxpayer's trade or business primarily for sale to

Sec. 332 customers. If the subsidiary had been in the same business as the parent, the taxpayer's case would have been stronger.

Presumably, the possible advantages, if any, in approaching the problem through the process of having the subsidiary sell the assets before liquidation and the potential use of the loss by the transferee under Section 381 had been considered and deemed less desirable than the plan as consummated.

Sec. 333

The Court Holding Company Rule and Section 333

The rule laid down in the Court Holding Company *case can still be troublesome.*

Where property is distributed in a one-month liquidation under Code Section 333 and thereafter sold by the stockholder pursuant to negotiations previously entered into by the corporation, the *Court Holding Company* rule may apply and any profit realized may be attributed and taxed to the corporation. The profit thus realized would also create earnings for the corporation which would be taxed to the stockholder as a dividend upon distribution in liquidation under Section 333.

Liquidating Personal Holding Companies

A primer on "would have been" corporations.

The 1964 Revenue Act tightened considerably the definition of personal holding companies. However, it also provided certain avenues for getting out from under.

A new concept is introduced, namely, corporations that "would have been" personal holding companies. This means a corporation which was not a personal holding company in one of the years 1962 or 1963, but "would have been" if the 1964 Act had been in effect for those years. Corporations which were personal holding companies in both of those years do not qualify. Neither does the corporation which would not have been a personal holding company in both 1962 and 1963 even if the 1964 Act had been in effect then.

"Would have been" corporations which liquidate prior to January 1, 1967, are entitled to use a new one-month liquidation mechanism under Section 333(g) of the Code. The recognized gains of those shareholders who have held their shares more than six months will constitute long-term capital gain. The recognition is limited to the greater of their pro rata share of the accumulated earnings and profits or the pro rata share of cash and stock and securities acquired after 1962. *Sec. 333*

"Would have been" corporations which stay in existence after 1966 for the purpose of paying off debt also are entitled to use the one-month liquidation under Section 333(g). For such corporations, payments on account of the principal of qualifying debt reduce the amount otherwise subject to personal holding company tax.

"Would have been" corporations which liquidate prior to January 1, 1966, have their personal holding company tax liability under the law as it existed prior to the enactment of the 1964 Act.

Liquidation of "Would Have Been" Personal Holding Companies

Some basic problems.

"Would have been" personal holding companies are entitled to use the one-month liquidation under Section 333(g). Such a liquidation can result in the cost basis of the personal holding company assets being substantially different in the hands of the stockholders.

For example, assume that an individual in a prior year transferred dividend-paying corporate stock – with a low cost basis and a high fair market value – to a newly formed corporation in a Section 351 incorporation. The corporation then purchased income-producing real estate and therefore did not constitute a personal holding company in prior years for the reason that rental income was sufficient to avoid the personal holding company classification. Assume further that the company is now a "would have been" personal holding company and desires to liquidate under Section 333(g).

Under Regulations Section 1.334-2 the basis of the assets received by the stockholder in the liquidation is the same as the basis of his stock in the company decreased by the amount of

Sec. 334 sible to arrange an asset purchase. Y, therefore, plans to acquire 100 per cent of the stock of Z, by buying X's 50 per cent and the 50 per cent owned by outsiders. The idea would then be for Y to cause Z to be liquidated and get the advantage of Section 334(b)(2), since the net book value of Z's assets is considerably below their fair market value.

Upon initial consideration, this liquidation appears to qualify for Section 334(b)(2) treatment. However, this view fails to take into account the requirement of Section 334(b)(3), specifying that to qualify under Section 334(b)(2), 80 per cent of the stock of the liquidated corporation must have been acquired by "purchase." Section 334(b)(3)(c) provides that a purchase means any acquisition of stock, but only if "the stock is not acquired from a person the ownership of whose stock would, under Section 318(a), be attributed to the person acquiring such stock." Section 318(a)(2)(c) provides that "if 50 per cent or more in value of the stock in a corporation is owned, directly . . . by . . . any person, then (ii) such corporation shall be considered as owning the stock owned directly . . . by . . . that person."

Section 318 accordingly attributes X's 50 per cent ownership interest in Z to Y. The transaction therefore fails to meet Section 334(b)(3), since Y is acquiring 50 per cent of Z stock from X, but under Section 318 was deemed to own that stock all along.

When Must Section 334(b) (2) Liquidations Be Completed?

The two-year rule of Section 334(b)(2) is often misunderstood.

Where one corporation purchases all the stock of another corporation at a premium, it may obtain a stepped-up basis for the acquired corporation's assets by liquidating it under Section 334(b)(2). This section gave statutory authority to the principle earlier enunciated in *Kimbell-Diamond Milling Co.,* 14 T.C. 74, affirmed 187 F.2d 718. Thus, if the requirements of that section are met, the assets take the same basis as the cost of the stock to the purchasing corporation.

Section 334(b)(2) requires that the plan of liquidation of the newly acquired company be adopted within not more than two years after control is acquired. It should be emphasized that there is no requirement that the liquidation be *completed* within two years, merely that the plan of liquidation be *adopted* within two years. *Sec. 334*

If a plan of liquidation need only be adopted, when must the liquidation be completed?

The cited section refers back to the meaning of the term "complete liquidation" as used in Code Section 332(b) relating to the complete liquidation of subsidiaries. The latter defines a complete liquidation to include a plan under which the transfer of all the property is to be completed within three years from the close of the taxable year during which is made the *first* of the series of distributions under the plan.

There is no requirement in Section 332(b) that the first distribution be made within the year in which the plan of liquidation is adopted. Accordingly, it appears that the liquidation of a subsidiary may come within the exception provided for in Section 334(b)(2), even though the liquidation is completed within a period of five or more years after control was acquired. Of course, the status of liquidation must continue after the plan of liquidation is adopted.

Stepped-up Basis on Liquidation of Subsubsidiary

The sequence of events is important here. Also beware of Section 1245.

Corporation A buys all the stock of Corporation B for cash of, say, $1 million. The basis of B's assets is $600,000. By promptly liquidating Corporation B, A can obtain B's assets at a stepped-up basis of $1 million (Code Sec. 334(b)(2)).

However, suppose that Corporation B has a 100 per cent owned subsidiary, Corporation C. Part of the premium of $400,000 paid by A for B's stock is attributable to C's asset values and thus to its stock value.

Query: Can the basis of C's assets be stepped up to Corporation A if C is promptly liquidated after the liquidation of B?

No, according to Service personnel. The applicable Code section provides that the assets of the corporation whose stock is purchased shall take the same basis to the purchaser-distributee as the consideration paid for such stock; that is, the purchase price of $1 million in the above example is to be spread over B's assets. The stock of C is among B's assets. Therefore, part of the premium would be allocated to C's stock—*but not to its assets.*

Paragraph (1) of Code Section 334(b) would apply to the subsequent liquidation of C. Therefore, the basis of its assets in C's hands would carry over to A. The step-up in basis which is attributable to C's assets would presumably be lost to A under the Service's interpretation. If Corporation A, after purchasing the stock of Corporation B, caused C to be liquidated into B before B were liquidated into A, the desired result would be accomplished.

As in so many technical matters, a simple change in mechanics can alter the result. The loss of stepped-up basis can be avoided in such cases if the purchaser arranges for the subsidiary of the purchased company to be liquidated before it liquidates the purchased company.

Thus, in the foregoing example, if Corporation C were liquidated into Corporation B before B were liquidated into Corporation A, C's assets rather than its stock would be among B's assets at the time of liquidation of B. Therefore, their basis unquestionably would qualify for "stepping up" when B is liquidated into A.

Liquidating Corporation Stock Under Section 334(b)(2)

It appears unlikely that the Kimbell-Diamond *rule could be applied where Section 334*(b)(*2*) *did not apply.*

In the cases of *Estate of Suter,* 29 T.C. 244, and *Orr Mills,* 30 T.C. 150, decided under the 1939 Code, the Tax Court applied the principle of the *Kimbell-Diamond* case and permitted the purchaser of the liquidated corporation's stock to use the cost basis of that corporation's stock in computing the basis of the assets received in liquidation. In each of those cases, the Court pointed out that the purchasers of the stock desired to purchase only assets, but because they were prevented from doing so, they had to purchase the stock and then to liquidate the corporation. The Court gave effect to their intent to purchase assets.

An interesting question is whether the principle of these cases can be applied by the Commissioner to current similar transactions falling *outside* the technical provisions of Section 334(b)(2) which statutorily extends the *Kimbell-Diamond* principle to 1954 Code years. Although the point has not been considered to date by a court or the Revenue Service, it would seem that the statutory provision of Section 334(b)(2) is controlling. If so, assuming that less has been paid for the stock than the tax basis of the assets in the acquired company, it appears that by deferring commencement of liquidation proceedings for more than two years after acquisition of the stock, a step-down in basis of assets could be avoided and/or an operating loss carryover under Code Section 381 could be obtained by reason of the liquidation falling outside of Section 334(b)(2).

Application of Section 334(b)(2) By Revenue Agent

The taxpayer here wished to avoid application of the section.

A corporation purchased all the stock of a company for about $500,000 less than the book value (tax basis) of the underlying assets. In order to avoid the application of Section 334(b)(2), the client did not formally resolve to liquidate the purchased company until one and one-half months after the two-year period of Section 334(b)(2)(A)(ii). Within the two-year period, the corporation leased most of the purchased company's fixed assets, and fair rental was paid. At the time of liquidation, the purchased company had a net worth of about $1,600,000, mostly in current assets. After liquidation, the acquiring company sold various fixed assets received from the purchased company at a $500,000 loss computed by using the transferor's basis.

A Revenue Agent has asserted that Section 334(b)(2) applies to the purchase and liquidation of the stock. If this were so, the corporation would not obtain the benefit of the $500,000 deduction. It is the agent's contention that the date of the adoption of a plan of liquidation is determined by all the facts and circumstances and is not controlled by the specific date of the formal resolution. The agent asserted that a plan of liquidation must have been informally adopted in the present case within the two-year period because of the proximity of the adoption of the plan to the end of the two-year period. The agent also maintains that the corporation appeared to be in a state of

Sec. 334 liquidation since the parent was using its fixed assets. The retention of substantial current assets by the purchased company did not alter the agent's position.

Wherever possible, if the objective is to avoid application of Section 334(b)(2), it seems desirable to delay adoption of the formal resolution until a reasonable period of time after expiration of the two-year period following the acquisition of the stock.

Sec. 337

Court Holding Principle Is Not Entirely Dead

Double tax may still obtain in partial liquidations and in liquidations under Code Section 333. *(See page 50.)*

Comm'r v. *Court Holding Company*, 324 U.S. 331, held that a "double tax"—a tax both on the corporation (upon sale of assets) and on the stockholders (upon liquidation) – obtained in certain sales of corporate assets which were negotiated before liquidation.

Code Section 337 was intended to jettison the *Court Holding Company* principle. It provides that gain or loss will not be recognized to a corporation upon the sale of its assets (except certain inventory and installment items) after a resolution to liquidate, if forthwith fully liquidated.

However, the *Court Holding Company* principle may *still* apply in cases of *partial* liquidation or redemption. Thus, where a contract made by a corporation to sell part of its assets at a gain is rescinded, and is followed by the stockholders obtaining the assets by partial liquidation or redemption of shares and completing the sale, the double tax still could apply.

Qualifying Corporate Liquidations Under Technical Limitations of Section 337

Use of a liquidating trustee may enable completion of liquidation within a twelve-month period.

If a corporation distributes all of its assets in complete liquidation within twelve months after the adoption of a plan of liquidation, no gain or loss is recognized from the sale of its property (with certain exceptions) during such twelve-month period. If, after selling off the bulk of its assets, the corporation retains long-term receivables or other properties which cannot be converted into cash except at prohibitive discounts, practical difficulties may preclude the distribution of fractional shares in such unliquidated assets among a relatively large number of stockholders.

Under the circumstances, it should be possible for the corporation to comply with the technical limitations of Section 337 by transferring the assets to a liquidating trustee. In making the transfer, the trustee is specifically empowered by the shareholders to act for them and, in lieu of fractional interests in the properties, the shareholders receive certificates of beneficial interest issued by the trustee. If the sole purpose of the trust is a liquidation of assets through collection and sale and distribution of the proceeds to the shareholders, with no power to engage in any trade or business or to invest or reinvest money, a favorable ruling that the corporation has "completed" its liquidation within the twelve-month period should be obtainable from the Treasury.

Assets Other Than Cash May Be Retained in Section 337 Liquidation

However, it would seem that gain or loss on sale thereof would be recognized if sold after the twelve-month period.

The nonrecognition provisions of Section 337 will not be denied where assets other than cash are retained to meet claims, as long as the amounts are reasonable.

Code Section 337 requires the distribution in liquidation of all assets, less assets retained to meet claims. Regulations Section 1.337-2(b) contains the statement that "a corporation will be considered to have distributed all of its property other than assets retained to meet claims even though it has retained an amount of cash equal to its known liabilities . . . plus an amount of cash set aside under arrangements for the payment after the close of the twelve-month period of unascertained or contingent liabilities and contingent expenses."

Suppose a corporation liquidating under the provisions of Section 337 possessed certain noncash assets which it wished to

Sec. 337 retain to meet certain claims since the assets would be converted into cash before or at the time payment of the claims was required. Under the wording of the regulation cited above, must the retained assets be in the form of cash?

A representative of the Revenue Service has indicated that *any* assets owned by the corporation may be retained for the payment of claims as long as the amount retained is reasonable.

Beware Tax Refunds in One-Year Liquidations

If practicable, use refunds to pay claims.

There can be an embarrassment of riches and a disturbing boomerang in liquidations under Section 337 of the Code. That section permits a corporation to dispose of all of its assets without gain or loss, if it does so within twelve months after adopting a plan of liquidation, and everything goes to the stockholders within that time except amounts reasonably needed to make good on claims against the company.

Suppose after the one-year period the Federal Government comes around and unexpectedly determines that the company is entitled to a tax refund. Where does that leave things in terms of compliance with the twelve-month cleanout? Obviously, there is trouble. The Government can say that all assets have not been distributed within the twelve-month period since the refund was an asset, and hence gain or loss is to be recognized to the corporation on the disposition of its assets. The irony of it is that, even if the refund were expected, the problem would still be acute because refund claims against the Government are not assignable.

One possible solution is to make all refund claims or possibilities part of the pot reserved to meet claims against the company. That at least preserves Section 337, and limits the argument to the factual area as to whether the amounts so reserved are reasonable in relation to the possible claims against the company.

The January 1961 issue of the *Bulletin of the Tax Section* of the American Bar Association reports a ruling that if a liquidating corporation files a refund claim within the twelve-month period and distributes it to a trustee for the stockholder, the requirements of Section 337 for this purpose are met.

Abandonment of Assets Produces Net Cash Profit

A case where an abandonment is better than a sale.

Code Section 337 provides that no gain or loss will be recognized to a corporation on the sale or exchange of its assets within a twelve-month period following the adoption of a plan of complete liquidation if the corporation distributes all its assets within that period. If, however, a corporation owns fixed assets with a tax basis greatly in excess of salable value, it is in a position to secure a tax benefit from any recognized losses. Section 337 would not appear to apply to losses incurred upon abandonment. It would, therefore, be advisable to consider an abandonment of these assets (say, by hauling them to the city dump) and thus obtain an abandonment loss. The corporation could wind up with a net cash saving. For example, fixed assets with an adjusted basis of $50,000 which could be sold for no more than $5,000 would produce a tax saving of $25,000 through an abandonment loss and a net saving in cash of $20,000.

Completeness of Section 337 Liquidation Questioned

Reincorporating part of the assets can cause trouble.

Corporation P had been engaged in two principal businesses and one minor business. Irreconcilable differences arose among three brothers who, together with their respective families, owned all the stock of the corporation. One brother, seeing potential earning capacity in the small business, the net assets of which were less than 6 per cent of the company's total assets, agreed with the other shareholders to take as a portion of his share in the corporate assets those assets attributable to the minor business. Prior to the effectuation of liquidating distributions, a transfer of these assets to a newly organized corporation (S) became advisable for good business reasons and Corporation P transferred them in exchange for the stock of such corporation. The Internal Revenue Service was apprised of the fact that after the disposition of Corporation P's remaining assets and the payment of all of its liabilities, distributions in cash and in kind, including the stock of Corporation S, would occur. The brother who owned directly less than 25 per cent (and indirectly another 5 per cent) of the stock of Corporation P would receive the stock of Corporation S and, in addition, a substantial amount of cash.

Corporation P has been informed informally by representatives of the National Office of the Revenue Service that the distributions to the shareholders followed by the cancellation of surrendered stock and the dissolution of the corporation would not constitute a complete liquidation in this case. Hence, in the Service's view, the provisions of Section 337 would be inapplicable to the sale of assets occurring after the adoption of the plan of liquidation, which adoption had already taken place. The Service says that in "substance" the transaction will amount to a "partial" liquidation. Thus Corporation S would be regarded as the same taxable entity as Corporation P despite separate and simultaneous existence of the two corporations for several months and the surrender by one, Corporation P, of its charter without any action having been taken to merge the one into and with the other.

The position of the Revenue Service in this instance is somewhat similar to that taken in Revenue Ruling 61-156 (revoking Rev. Rul. 56-541). In Revenue Ruling 61-156, it was held that a transaction cast in the form of a sale by one corporation of its assets to a newly organized corporation (in which the shareholders of the "selling" corporation will own 45 per cent of the outstanding stock) and a subsequent liquidation of the "selling" corporation may be considered, in substance, a reorganization under Code Section 368, rather than a transaction covered by Sections 337 and 331. For a recent case on this point, see *James Armour, Inc.*, 43 T.C. No. 46.

Converting Short-Term Gains Into Long-Term Gains Through the Use of Section 337

One more use for this valuable section.

Is it possible to convert a short-term appreciation in value of securities to a realized long-term gain, as a by-product of a Section 337 liquidation?

Let us assume the following set of facts for a real estate corporation which has sold its property after the resolution to liquidate. It has received a large down payment and a purchase money mortgage for the balance. The gain on the sale is not recognized to the corporation. Prior to the complete liquidation of the corporation, it invests its cash in marketable securities which, after a period of two months, have appreciated in value. If the corporation sells these securities, will this gain be recognized to the corporation? Will the Section 337 benefits of the real estate sale be lost?

If the profit on the sale of the securities will not be taxable to the corporation, then, in effect, the gain is picked up by the stockholders as a long-term gain when the corporation is liquidated within the one-year period, assuming that the stockholders' holding period of the stock of the liquidated corporation is over six months.

In *Frank Verito,* 43 T.C. No. 36, the Tax Court held that profit on the sale of such securities was not taxable to the corporation. The Commissioner has not yet indicated acquiescence to or an appeal from this decision.

Section 337 Pitfall

Problems on liquidating parent and subsidiary.

Here's a pitfall to be avoided in the use of Section 337. Mr. X, your client, owns all the stock of X Corporation, which in turn owns all the stock of S Corporation. Both are manufacturing companies engaged in one integrated business and owning substantial low-basis assets. The business is about to be sold and the buyer wants to buy assets, not stock. Mr. X, who is relatively young, has no desire to keep the companies alive as holding companies after the business assets have been sold. Hence, he is very interested when you tell him of the provisions of Section 337 whereby a double tax can be avoided on a sale of assets and a liquidation. He gives you the go-ahead signal.

Tentative plans are thus made to have S Corporation adopt a plan of liquidation, sell its business assets and liquidate into X Corporation. Then X Corporation would also adopt a plan of liquidation, sell its business assets and liquidate all the proceeds into the hands of Mr. X. But wait a minute—just in time you discover the pitfall you almost fell into. The liquidation of S Corporation is a tax-free liquidation under Section 332 with a substitute basis under Section 334(b)(1). Section 337(c)(2)(A) specifically says that Section 337 does not apply under these circumstances. This would mean that the sale of assets by S

Sec. 337 Corporation would be taxable even though the next sale by X Corporation would escape tax under Section 337.

How can this pitfall be avoided? Two alternatives are devised. One is to have S Corporation liquidate into its parent, X Corporation, first before any sale of assets. This liquidation would be tax-free under Section 332 and the assets would retain in the hands of X Corporation the same bases they had to S Corporation under Section 334(b)(1). X Corporation would then adopt a plan of liquidation, sell all the business assets (i.e., its own and those acquired from S Corporation) and then liquidate. The sale of the assets by X would be tax-free under Section 337.

A second alternative is to have X Corporation adopt a plan of liquidation, sell its business assets (not including its stock in S Corporation), and then liquidate. This sale by X Corporation would be tax-free under Section 337. The liquidation of X Corporation would be taxable and would give to Mr. X a stepped-up basis (fair market value at time of distribution) for the S Corporation stock. S Corporation would then adopt a plan of liquidation, sell its business assets and liquidate. The sale of its business assets by S Corporation would also be tax-free under Section 337, since its liquidation into the hands of Mr. X would be taxable.

Informal discussions with various Internal Revenue Service representatives in Washington disclose that they believe both alternatives are good, because they carry out the intent of Section 337. Section 337(c)(2)(A) was not aimed at denying the benefits of Section 337 to a subsidiary liquidated tax-free under Section 332 where the parent was liquidated in a taxable liquidation. It was aimed at a denial of the benefits of Section 337 to a subsidiary liquidated tax-free under Section 332 where the parent was not liquidated at all.

Sec. 341

Collapsible Corporations—Caveat Emptor

Another problem for buyers of corporate stock.

Shareholders can now sell stock in a corporation with the assurance that the collapsible provisions will not apply to their gain. All that is necessary is that their corporation file a consent in accordance with the provision of new Subsection 341(f). The sale of stock must take place within a six-month period after the consent is filed. *Sec. 341*

The buyer, however, may be less than happy with the effect of the consent on his newly acquired company. By filing the consent, a new category of assets is created called "Subsection (f) assets." In general, this includes all noncapital assets, land and any interest in real estate. Gain is to be recognized upon any disposition of these assets, except in certain tax-free transactions where basis carries over. This recognition-of-gain rule can have substantial adverse effects. If the buyer liquidates the company in order to step up the basis of the assets under Section 334(b)(2), gain is recognized on the Subsection (f) assets. If Subsection (f) assets are distributed as a dividend or in partial liquidation, gain is recognized. This taint exists as long as the assets are owned by the company or a tax-free transferee. Proving that the company was not a collapsible corporation at the time of the sale of its stock doesn't help; the taint exists by virtue of the consent.

It would seem provident for a prospective buyer of stock in a corporation which may qualify as a collapsible corporation to determine whether a consent is in force and, if appropriate, to obtain specific agreement that a consent will not be filed prior to the purchase.

Disposal of Collapsible Corporation Stock

The tests of "business purpose" and "continuity of business enterprise" would have to be met in this case.

Can a nontaxable merger of a collapsible corporation with a publicly held corporation be effected which would give the shareholders in the collapsible corporation a marketable security, with the possibility of capital gain upon a subsequent disposition thereof?

A representative of the Reorganization and Dividend Branch of the Internal Revenue Service was of the opinion that a merger of a collapsible corporation with a larger company or publicly held investment company may be accomplished without tax consequences to the shareholders of the collapsible corporation. His thought was that Section 341 applies only when the shareholders

Sec. 341 have a recognized gain on their stock and since gain is not recognized in a reorganization, the section should not be applicable. Of course, the reorganization must have a valid business purpose.

From an economic standpoint the shareholders in the collapsible corporation and the acquiring corporation may, in determining the value of the stock to be issued to the transferring shareholders, take into account the tax that will have to be paid by the acquiring corporation when the collapsible assets are disposed of, thereby minimizing the benefit of the suggested merger. However, if the acquiring corporation has expiring loss carryovers, this transaction may be beneficial to both parties.

Sec. 346 Distributions in Partial Liquidation

These can be combined with disproportionate redemptions and terminations under Section 302(b).

The X Company, a closely held corporation, has been in business since 1900. Until 1950 it operated two plants, one in C city and one in M city. Its business has been declining, and since 1950 it has realized $1,400,000 from the disposition of assets. This amount includes proceeds of the sale of its plant in M city. Further, it has reduced its inventories, and has funds available from this source of $3,475,000. Working capital needs have also decreased, and $3,720,000 is available in cash from this decrease. The directors of the company have projected the cash and other requirements for the conduct of the company's business, and have concluded that $7,700,000 should be distributed.

The stock of X has been held by three family groups, the A's, the B's, and the C's. Each family group consists of a father and two sons. The directors propose the distribution as follows:

1. $2 million to C for a part of the stock of C in a redemption which qualifies under the disproportionate redemption provisions of Section 302(b)(2).
2. $500,000 to one of C's sons for all of the son's stock in a redemption which qualifies as a termination under Section 302 (b)(3).
3. $5,200,000 pro rata to all remaining shareholders to redeem at book value 69 per cent of the stock outstanding after the redemptions in (1) and (2).

On the basis of the foregoing facts, the Revenue Service ruled that the redemptions would qualify for capital gain treatment. *Sec. 346*

Other interesting aspects of this ruling are:

1. A holding that in determining how much can be distributed in partial liquidation under Section 346, no reduction need be made for distributions which qualify as disproportionate redemptions or terminations under Section 302(b).

2. A statement that only the amount received by each shareholder which is not in excess of the fair market value of his stock redeemed will be entitled to capital gain treatment.

3. A reference to Section 531, the accumulated earnings tax, and a statement that the possible application of this section has not been considered.

CORPORATE DISTRIBUTIONS AND ADJUSTMENTS (Subchapter C)—*continued*

CORPORATE ORGANIZATIONS AND REORGANIZATIONS

One Way for Young Partners To Buy Out a Business

Sec. 351

Formation of a corporation and issuance of preferred stock with terminal voting rights to elders furnishes a probation period. But existence of two classes of stock precludes an election under Subchapter S.

The Federal tax law is often censured for the manner in which it renders substantial savings almost impossible. It can seriously handicap a young man of limited means who wishes to acquire a business, because the accumulation of the capital necessary to accomplish this purpose, after the impact of the Federal taxes, may constitute an almost insuperable obstacle.

The following plan dealing with this problem arose incident to the acquisition of a thriving business by two young businessmen:

The enterprise has been operated as a partnership by a man and his son, both of whom wish to withdraw from the business.

Sec. 351 Two young men, very competent and thoroughly experienced in this line of endeavor, desire an opportunity to acquire the business. Their reputation is excellent, but, since they have only $50,000 in cash between them, their funds are limited. The present capital of the partnership is $150,000 and it is considered highly desirable to increase this to a total capital investment of about $200,000.

Another difficulty presents itself – the partners, having only limited knowledge of the newcomers, do not wish to take them into the partnership and possibly become liable for acts performed by the newcomers. The old partners prefer the protection afforded by the corporate form and wish to remain in control for a reasonable period of time.

THE PROBLEMS ARISING:

Assuming that a corporation is formed, several questions then present themselves.

How can the partners protect themselves by retaining actual control of the corporation until the quality of the new men has been proven, and how can the newcomers be assured that they will some day have control of the corporation?

DISTRIBUTION OF THE STOCK:

First, the newcomers will join with the old partners in the formation of a new corporation, paying into it their $50,000 in cash, while the partners transfer assets valued at $150,000. (This will be done under Code Section 351.) The stock issued in the exchange will be $100 par value, and that which is distributed to the newcomers will be common in its entirety. The partners will receive a small amount of common but a considerably greater proportion of 5 per cent cumulative preferred stock, and, to enable them to retain control until the new additions to the firm have proven themselves, their preferred stock will provide that they hold voting rights for the next four years, thus keeping them in control.

At the end of this time, the voting rights in the preferred stock will expire, except in the case of arrearage in preferred stock dividends. This automatically disposes of the question of insuring control to the partners until they are satisfied of the integrity and the adequacy of the new additions to the firm, while on the other hand it provides the newcomers an opportunity to acquire control once they have demonstrated their abilities.

Then how can the new men hope eventually to acquire the entire business, considering their limited capital and the impact tax rates will have upon their income; and how may the retiring partners be assured eventually of withdrawing their money without confiscatory taxation? Sec. 351

FUNDS PROVIDED OUT OF EARNINGS:

Assuming the young enterprisers will not be able to acquire enough income free of Federal tax to purchase $150,000 in capital stock, the preferred stock indenture could provide that the stock be callable after a certain number of years with a reasonable call premium. Then, pursuant to the indenture, the preferred stock can be retired after a period of several years, the old partners picking up an excess over their cost basis as capital gain. But see the possible problems of Section 302. In retirement of the stock, a series of debenture bonds may be issued at the call date and these debentures eventually retired. Thus the necessary funds required by the younger members of the firm to obtain control will be provided out of the earnings of the business.

How will the young men live in the meantime? A reasonable salary with a flexible percentage bonus arrangement should provide the necessary funds.

Transferor's Basis for Exchanging Stock

This is a point not spelled out in the Code or regulations.

Company P organized a new subsidiary, Company S, and issued some Company P voting stock in exchange for all of the stock of Company S. Company S then took the Company P stock and exchanged it for all the net assets of Company X in a C-type reorganization. What is the basis of Company S stock in the hands of Company P?

In the opinion of the Reorganization Branch of the Tax Rulings Division, the basis of the Company S stock in the hands of Company P is the transferor's basis of the assets which came over to Company S. The Revenue Service feels that it is reasonable to assume that the X Company assets flowed up to the parent Company P in exchange for its stock and down to Company S in exchange for that company's stock or as a contribution to capital of Company S. Therefore, the position of the Revenue

Sec. 351 Service is that in a situation of this kind the basis of the stock of Company S is equivalent to the basis of the net assets which came over from Company X.

Tax-Free Incorporation

Scrutinize the balance sheet for liabilities.

Where a cash basis proprietorship or partnership is converted into a corporation under Section 351 there are various traps which may cause the loss of tax-free treatment. Under Section 357(c) of the Code, income results when the liabilities assumed by the new corporation are in excess of the cost basis of the assets transferred. Accounts receivable and possibly other assets of the cash basis transferor do not have a cost basis; so the taxpayer may have an accrual basis net worth but a cash basis deficit. Hence, a statement of assets and liabilities on a cash basis as of a date immediately before the transfer should be prepared to determine whether the total cost bases of the assets transferred to the new corporation exceed the liabilities assumed by it. For example, the omission of a certain asset from the transfer or the inclusion of a liability might make the difference between a taxable and a nontaxable transaction.

Incorporation of Cash-Basis Taxpayer

The transfer of accounts receivable creates a problem.

In the past when a cash-basis taxpayer wanted to transfer assets (including accounts receivable) to a controlled corporation under the provisions of Section 351, the Internal Revenue Service would issue a ruling that the transfer was nontaxable provided the transferee-corporation agreed that the receivables would have a zero basis. The Service required the execution of a closing agreement to such treatment by the corporation which then would report collections of such receivables as income when received.

Some time ago, the Service stopped the issuance of rulings involving transactions of this type. It was understood the Service was giving consideration to the possibility of taxing to the transferor the income represented by the receivables being transferred. Apparently the conclusion was reached that such a position could not be successfully sustained because now the Service has reverted to its former stand and has resumed the issuance of Section 351 rulings in these circumstances. As before, the corporation is being required to execute a closing agreement whereby the receivables are placed on the books with a zero basis as a condition to the issuance of a favorable ruling. *Sec. 351*

Taxability of Bad Debts Reserve On Incorporation of Partnership

The lurking danger in Section 351.

Rev. Rul. 62-128, 1962-33 IRB 8, holds that a proprietor who turns over his business assets and liabilities to a corporation under Section 351 is taxable to the extent of the reserve for bad debts existing at that time since, with his accounts receivable gone, ". . . his need for the reserve ceased." The ruling stated that this rule would apply where full tax benefits had been secured from deduction, in prior years' returns, of the provisions which had built up the reserve. The ruling went on to say that the same rule would apply to a partnership which, under similar circumstances, would be required to include its reserve for bad debts in income reported on its final return. (See *Est. of Heinz Schmidt,* 42 T.C. No. 90, approving Rev. Rul. 62-128.)

Cases have arisen involving treatment of the reserve for bad debts in liquidation situations where election has been made under Section 337 of the Code to avoid recognition of gain on a sale of the assets including accounts receivable. Rev. Rul. 57-482, 1957-2 C.B. 49, authorizes taxing the reserve balance to the corporation in this case, again because the need for the reserve supposedly ceases when disposition has been made of the receivables.

Corporate Reorganizations

Sec. 354

Summary of Code provisions.

The 1954 Code definitions of tax-free reorganizations are generally similar to those in the 1939 Code. However, the requirements have been liberalized and certainty has been added.

Sec. 354

"COMBINING" REORGANIZATIONS

Under the 1939 Code (Sec. 112(g)(1)(B)) a corporation already owning 20 per cent or less of the stock of another company, could, by issuing its voting stock, acquire the balance of 80 per cent or more in a tax-free exchange. However, if the acquiring corporation already owned *more* than 20 per cent of the other corporation's stock, it was uncertain whether it could acquire the balance (because it was less than 80 per cent) in a tax-free exchange, even though it owned 100 per cent after the exchange! Now it is certain. The 1954 Code merely requires that the acquiring corporation have control (80 per cent) of the other corporation after the acquisition (Sec. 368(a)(1)(B)).

Under the 1939 Code (Sec. 112(g)(1)(C)) a corporation could acquire in a tax-free exchange substantially all the *properties* of another corporation in exchange solely for its own voting stock. This is retained. However, under the 1954 Code, such a transaction (or merger) can qualify as tax free even if the voting stock issued for the assets is that of the acquiring corporation's parent company (Sec. 368(a)(2)(C)). In addition, such an acquisition no longer need be made solely for voting stock. Cash may now be used for up to 20 per cent of the consideration without impugning the nontaxability of the exchange (Sec. 368 (a)(2)(B)), except that for this purpose any liabilities of the transferor assumed by the transferee must be taken into account together with the cash in computing the 20 per cent limitation.

"DIVISIVE" REORGANIZATIONS

Divisive transactions are still tax free but there are some modifications. A divisive reorganization is a transfer by a corporation of all or part of its assets to another corporation followed by control in the transferor corporation or its shareholders or both. A "split-up" is a divisive reorganization. The 1954 Code permits the transferor corporation to distribute stock of the transferee to its shareholders without such stockholders continuing to own any stock in the transferor. Thus, if to satisfy an antitrust decree, Corporation T transfers a liquor business to Corporation L and a perfume business to Corporation P and distributes all the stock of L to its stockholder A and all the stock of P to stockholder B, the transaction nevertheless can qualify as a reorganization, i.e., a proportionate or prorata distribution of the transferee corporation's stock is not required (Sec. 368(a)(1)(D)). It was required under the 1939 Code.

Spin-offs also were liberalized by the 1954 Code. As under the 1939 Code Section 112(b)(11) no "exchange" is required. However, under the 1954 Code, a spin-off is classified as a distribution (Sec. 355). A corporation now may distribute stock of a previously owned controlled corporation to its shareholders tax free. No new corporation or new holding company is required to be created as it was under prior law. Nor need the distribution be pro rata or proportionate among its stockholders. However, it *is* required that both the distributing corporation and the corporation whose stock is distributed must be "engaged in the active conduct of a trade or business" immediately after the distribution, and each such business must have been conducted at least five years before the distribution. Note, however, the decision in the *Coady* case wherein the Sixth Circuit, in 1961, affirmed the Tax Court in holding that a single business could be split up and a part distributed in a spin-off transaction. The Commissioner has announced that it has acquiesced in the *Coady* decision (IRB 1965-6). *Sec. 354*

THE NONRECOGNITION PROVISIONS

The nonrecognition provisions — the nontaxability of reorganization exchanges to corporations and stockholders (1939 Code Sec. 112(b)(3) and (4)) — were only slightly modified. Securities, i.e., obligations, may be received tax free by stockholders or security holders but only to the extent that their principal amount does not exceed the principal amount of securities surrendered (Sec. 354). Otherwise, gain is deemed realized to the extent of the fair market value of such excess. The "boot" provisions (1939 Code Sec. 112(c)(1) and (2)), in the same manner as before, call for capital gain treatment or, in certain cases, for dividend treatment of "other property" or money received in reorganization exchanges (Sec. 356).

When Is Operation of Real Estate An Active Separate Trade or Business?

Sec. 355

A pertinent discussion of real estate spin-offs.

Frequently corporate taxpayers which own real estate used in their operations may wish to "spin off" such real estate under Section 355. In order that this be possible, it is necessary that the ownership and operation of the real estate constitute a separate trade or business which had been actively conducted throughout the five-year period preceding its distribution.

The Regulations (Sec. 1.355-1(c)(2)) take the view that the ownership and operation of land or buildings substantially all of which are used and occupied by the owner in a trade or business does not qualify as a separate active business. The two examples given in the regulations suggest that only a one-eleventh occupancy by the owner will not disqualify the real estate operation as a separate business, whereas a three-fourths occupancy will disqualify it.

Faced with these two fairly extreme examples in the regulations, coupled with an understandable desire on the part of taxpayers to secure advance rulings where real estate which has been partially occupied by the owner is desired to be spun off, the Internal Revenue Service has had to adopt a criterion to be used as a guide in issuing rulings. The Service apparently has adopted the view that if the owner or its subsidiary has occupied more than 50 per cent of the floor space or paid more than 50 per cent of the rental income during the five-year period, the active business test is not met. Under these circumstances an adverse ruling would ordinarily be issued.

Where these conditions are *not* met, requests for rulings may require certain additional information to permit the Service to make its decision regarding whether the real estate operation is a separate business. For this purpose the Service may require the following types of information:

1. Income statements for the owner and for any subsidiaries which may have occupied the property during the past five years.
2. Complete description of the property showing dates of acquisition, manner of acquisition, location, tax basis, square footage of rental space and the square footage of space occupied by the owner or its subsidiaries.
3. For each of the preceding five years the total rental value of the property and the rental value of the space occupied by the owner and/or its subsidiaries.
4. Balance sheets for each business at the beginning and end of the five-year period. (These are used in determining whether the earnings of one business have been used to finance the operations of the other business. If that is found to be case, the ruling may be denied.)
5. A business purpose for the proposed spin-off.

Apparently the Service might still rule favorably even though the admittedly arbitrary percentage requirements are not met, particularly if special extenuating circumstances are shown to exist. However, where a request for a ruling presents a borderline case it is likely that the Tax Rulings Division will decline to rule.

Also it seems that this view applies to ruling requests only. The mere fact that these tests are met does not mean that the taxpayer may proceed with assurance without the protection of an advance ruling.

The decision in *Appleby,* 35 T.C. No. 86, aff'd C.A.-3, throws further light on the tax effects of this type of transaction. A corporate real estate and insurance brokerage agency owned a building and occupied 50 per cent of the space (70 per cent of the rental value) and rented out the remainder. This continued for over five years. It then transferred the building to a separate corporation and distributed the stock to its stockholders. The Tax Court ruled that this did not qualify as a spin-off but was a dividend distribution.

For a more recent case on this point, see *Bonsall, Jr.,* 62, 151 T.C. memo, aff'd C.A.-2.

Obtaining a Ruling With Respect to a Spin-off

The Revenue Service has advised that the following information is required:

1. A brief history of the company or companies involved in the spin-off.
2. A copy of the latest available balance sheet before the spin-off.
3. Copies of pro forma balance sheets as they would exist after the spin-off.
4. A summary of the earnings of the company or companies for each of the past five years.
5. A statement of the business reasons for the spin-off.
6. A statement from the stockholders that they have no present intention of selling any of the stock of either company (i.e., either the principal company or the spun-off company).
7. A statement that there is no present intention of liquidating either company involved in the spin-off.

Sec. 362 Subsidiary May Realize Income Through Contributions to Its Capital

This fact is not widely known, but it could be important.

Corporation X acquired all of the stock and a debt of Corporation Y at a nominal cost which was far below the par value of the stock and principal amount of the debt. Corporation Y was insolvent at that time. X desired to contribute to the capital of X the evidence of the indebtedness to improve the financial position of Y. A ruling was received holding that under Section 362(a) of the Code the basis of the debt in the subsidiary's hands would be the same as it was in the hands of the parent and that the difference between the face amount of the debt and its basis would constitute income to the subsidiary from the discharge of indebtedness to be recognized only to the extent that such forgiveness resulted in the subsidiary's becoming solvent. Of course, such income, which would otherwise be recognized, may be excluded under the elective provisions of Section 108 of the Code.

Sec. 367 Section 367 Not Insurmountable

Where there is no over-all tax saving.

Section 367 of the Code provides that for purposes of recognition of gain under most of the key reorganization sections of Subchapter C, a foreign corporation shall not be considered as a corporation unless in advance of the transaction the Treasury has been satisfied that the avoidance of Federal income taxes is not one of the principal purposes of the transaction.

Recently, the Internal Revenue Service ruled favorably under this section on the following facts: X Corporation, a United States manufacturing company, had a wholly owned Canadian manufacturing subsidiary, Y Corporation. When the Y Corporation was formed, incorporation under Canadian law was decided upon in order to compete effectively with Canadian manufacturers of similar products. Substantial dividends were paid by Y in at least one recent year. The taxpayers were able to show that if Y Corporation had been a United States corporation, it would have qualified as a Western Hemisphere Trade Corporation. Furthermore, no United States income taxes would have been due from Y under such circumstances after credit for Canadian taxes actually paid by it. In 1962, both X and Y sold their assets to outsiders and, hence, ceased to be manufacturing companies. Y's assets were sold at book value. Y planned to become an investment company. Y has been inactive since the sale of its assets. Because of these facts, there was no longer any need for the continued existence of Y. However, its liquidation would have produced a substantial taxable capital gain to X if the transaction could not be tax-free under Section 332. Hence, a ruling under Section 367 was sought.

A favorable ruling was granted. It was based "solely on the information submitted" and the representation that Y "would have qualified as a Western Hemisphere Trade Corporation if it had been incorporated as a United States subsidiary." Even though United States taxes were avoided by the use of the Canadian subsidiary, the total of taxes of all types (i.e., Canadian) were increased by such use. Hence, since one would not deliberately pay more Canadian taxes in order to avoid a smaller amount of United States taxes, the avoidance of Federal income taxes could not have been a principal purpose.

Contribution to Capital of a Controlled Foreign Corporation

An apparent loophole in the law may not be a loophole.

A transfer of property to a controlled foreign corporation in exchange for stock or securities does not qualify as a tax-free transaction under Section 351 unless the taxpayer has secured advance clearance in the form of a ruling from the Revenue Service as required under Section 367 that the transaction does not have as one of its principal purposes the avoidance of Federal income tax. If such ruling is not obtained, a transfer of property in exchange for stock or securities of a controlled foreign corporation will be a taxable transaction giving rise to gain equal to the difference between the basis of the property transferred and the fair market value of the stock or securities received in exchange. If a loss is incurred on the exchange, Section 351 is applicable; thus the loss is not recognized.

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It is occasionally suggested that a transfer of property to a controlled foreign corporation as a contribution to capital or paid-in surplus, rather than in exchange for stock or securities, does not produce gain to the transferor because nothing is received in exchange. In the case of a wholly owned foreign corporation, of course, it is immaterial to the taxpayer under normal circumstances whether additional stock is or is not received.

The Treasury's view on this suggestion was made clear by John F. Bogaard, of the Reorganization Branch, Tax Rulings Division, Internal Revenue Service, in a talk before a tax briefing session conducted by the American Management Association. Mr. Bogaard indicated that the Service will take the position that a transfer of property to capital or paid-in surplus of a wholly owned foreign corporation is in substance a transfer "in exchange for stock or securities" and is a taxable transaction if gain results, unless advance clearance under Section 367 has been obtained. In the case of a transfer to a less than wholly owned foreign corporation the Service will examine all of the facts, including the percentage of ownership, possible similar or reciprocal contributions by minority groups, etc., in determining whether the transfer is in substance in exchange for stock or securities. Mr. Bogaard stated that a genuine transfer as a contribution to capital or paid-in surplus might occur in the case of a less than wholly owned foreign corporation.

Even if the transfer is a tax-free transaction, Section 1491 imposes a 27½ per cent excise tax on the transfer of appreciated stock or securities to the extent of the appreciation.

Effect of Failure to Obtain Ruling

Tax consequences if a foreign corporation is disregarded.

Should advance rulings be obtained in all of the types of transactions involving exchanges between a domestic and foreign corporation listed in Section 367? The section states that an advance ruling is a condition precedent only in respect of gains in what purportedly are transactions in which gain or loss is not recognized. In the absence of considerations outside of Section 367, it would appear that a ruling request should be made only where there will be a gain or where what appears to be a loss transaction has the potentiality for turning into a gain. Nevertheless, many practitioners apply for a ruling under Section 367 in all transactions of the type listed there.

There is a dearth of information about the means by which Section 367 penalizes those who neglect to obtain an advance ruling. The regulations leave much to be desired, which is unfortunate, because the section is a trap for the unwary. What it appears to do is disenfranchise the foreign corporation for the limited purpose of barring the types of tax-free exchanges listed in Section 367. That is, under Section 367 the foreign corporation is not a corporation. Not having corporate status, the transaction to which it is a party cannot have the benefit of nonrecognition of gain. It will be observed that each of the transactions covered by Sections 332, 354, 355, 356, or 361 requires at least two corporations and Section 351 requires at least one corporation.

If failure to comply with Section 367 nullifies a tax-free transaction, how is it to be dealt with as a taxable transaction? For example, in a split-off by a foreign corporation which would have been tax free if an advance ruling had been obtained under Section 367, it would appear that the distribution received by a U.S. shareholder would be treated either as a distribution under Section 301 or as a partial liquidation under Section 346, but not as boot under Section 356. The reasoning is that the latter applies only where the transaction is partially of a tax-free character. Section 367 of the Internal Revenue Code contains no mention of Sections 301 and 346.

Failure to Obtain a Ruling Under Section 367

This section cannot be used as a shield by taxpayers.

Section 367 of the Internal Revenue Code of 1954 provides among other things that gain will be recognized to a domestic parent upon the exchange of stock for assets of a foreign subsidiary under a Section 332 type exchange unless the parent corporation receives an advance ruling from the Commissioner. However, a new Revenue Ruling (Rev. Rul. 64-177, 1964 I.R.B. 24, June 15, 1964) states the Treasury's position to be that a taxpayer may not use its failure to obtain a Section 367 ruling

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to defeat the nonrecognition provision of Section 332 and the basis provision of Section 334(b)(1).

A, a domestic corporation, owned all of the stock of B, a foreign corporation. B's assets had a fair market value of 11 X dollars and an adjusted basis of 4 X dollars. B's stock in the hands of A had an adjusted basis of 10 X dollars. Without first securing an advance ruling under 367, A acquired the assets of B in a 332 liquidation. A included in its income gain of 1 X dollars realized from the exchange, and sought a ruling that would permit it to assign a basis of 11 X dollars to the assets obtained from B.

The request for a ruling raised the question as to whether A could obtain a stepped-up basis, for depreciation and other purposes, for B's assets because of its failure to secure a Section 367 ruling. The Treasury ruled that Section 367 and its predecessors were enacted to close "a serious loophole for avoidance of taxes" through the use of foreign corporations, *not* to afford taxpayers an option to escape the tax consequences which would follow but for that Section. "Statutory requirements intended solely for the protection of the Government may be invoked only at the instance of the Government." Thus A was not entitled to utilize to its advantage its failure to secure an advance ruling under Section 367. The transaction was held to be a tax-free liquidation under 332 and by virtue of 334(b)(1), A must carry over B's basis for its assets.

This is an intriguing concept on the part of the Treasury and seems contrary to the spirit of Section 367. It will be strange for taxpayers to request rulings that transactions are taxable.

Transfer of Foreign Tax Credits in Merger of Foreign Subsidiaries

In connection with a Section 367 ruling permitting a tax-free merger of several foreign wholly owned subsidiaries within one of them, a further ruling was requested that in computing the foreign tax credit under Section 902 taxes paid by the companies which were merged out of existence would be deemed to have been paid by the surviving subsidiary. Nothing in Section 381 specifically covers this.

The Revenue Service ruled that such foreign taxes are inherited by the survivor. The ruling implies that the earnings and profits and foreign taxes of a predecessor would be paired with the earnings and profits and taxes of the successor corporation for each year. *Sec. 367*

Comments on Reorganizations

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Based on understanding of informal Service policy.

1. In an A-type reorganization, it is the Revenue Service position that the reorganization will lose its tax-free status for lack of sufficient continuity of proprietary interest unless there is at least a 50 per cent carryover of the equity ownership of the merged or consolidated corporation(s).
2. In a B-type reorganization, the acquiring corporation may use voting callable preferred stock, provided the voting right is absolute, and the stock cannot be called for at least a three-year period. The Internal Revenue Service will issue advance rulings on this point.
3. The Service has ruled informally that the acquiring corporation in a B-type reorganization may pay stock-transfer taxes on the acquired stock and the expenses of an agent for handling the scrip. The amounts so paid will not be considered "boot."
4. It is the Service's policy not to issue rulings in a C-type reorganization where retained operating and nonoperating assets (other than nonoperating assets retained to pay liabilities) exceed 10 per cent.

Effect of Boot in Tax-Free Acquisitions and Distributions

This analysis also points out pitfalls in corporate reorganizations.

This concise but complete analysis of the complicated boot provisions of the 1954 Internal Revenue Code should prove helpful.

A new type of boot was created by the 1954 Code. If in a reorganization or spin-off type of transaction a stockholder receives securities, and the principal amount of the securities received exceeds the principal amount of the securities surrendered, the

Sec. 368 excess is treated as boot to the extent of the fair market value. For example:

Suppose that, pursuant to a plan of reorganization, A, an individual, exchanges 100 shares of stock of Company X which had cost him $5,000 for 200 shares of stock of Company Y which had a fair market value of $4,000, plus $2,000 of 4 per cent bonds of Company Y worth their face value. In this case, since no securities were surrendered, the $2,000 of bonds received would be treated as boot, but since the gain on the exchange amounts to only $1,000, only this amount would be taxed.

If this transaction were a recapitalization of one company rather than a reorganization involving two companies, the result might be different—stockholder A would probably be taxed on $2,000 (the value of the bonds), this representing a distribution of property to which Section 301 would apply.

An interesting provision is Section 357(C), which provides that in the case of a transfer to a controlled corporation, if the liabilities assumed by the transferee as part of the consideration, or the liabilities to which the property is subject, exceed the total of the adjusted basis of the property transferred in the exchange, the excess will be taxed as gain (capital or ordinary, as the facts warrant). In this situation the statute makes no exception, as it does in the somewhat related Section 311 situation, for a case where the property transferred is worth less than the amount of debt to which it is subject.

At the corporate level there are several points to keep in mind:

In a C-type of reorganization (i.e., the acquisition of substantially all the properties of a corporation in exchange for voting stock), the transferee corporation can give boot up to an amount not in excess of 20 per cent of the value of the total assets of the transferor corporation, provided it acquires at least 80 per cent of all the assets solely for stock. The trap for the unwary here is a special rule which requires that for this purpose a liability assumed, or to which the property is subject, be treated as boot, i.e., the assumption of liabilities is the same as giving boot, which forms part of the 20 per cent referred to above.

There is danger in an excessive amount of boot being received in a transaction which purports to be nontaxable. If the value of the boot is too greatly disproportionate to the value of the stock received, the transaction may lose its tax-free character. Thus, in the *Southwest Natural Gas Company* case (189 F.2d 332) the absorbed company in a statutory merger transferred its net assets valued at $568,000 for 16 per cent of the stock of the surviving company worth $5,600, plus bonds of the surviving company and cash to cover the balance. Thus, the stock received was worth only about 1 per cent of the assets transferred. In view of this, it was held that the "continuity of interest" test was not met, and that the transaction was a taxable exchange. *Sec. 368*

An Example of a B-Type Reorganization

It would seem that one can have an open-end reorganization.

Company A wished to acquire all of the outstanding stock of Company B in exchange for the issuance of a number of shares of its own voting stock. The number of shares to be issued was to be based, to a large extent, on the operating results of Company B during the subsequent five years.

Company A inquired whether it could issue a relatively small number of shares of its voting stock initially, and issue further shares each year over the next five years as part of the plan and in consideration for the stock acquired.

The view was expressed, based on prior discussions with the Revenue Service, that a transaction of this kind would constitute a B-type reorganization even though the total number of shares to be issued was contingent and might not be known definitely until several years hence. The important points are that all of the shares being issued will fall within one plan and that the entire plan will come within the definition of a B-type reorganization.

Merger — Common Exchanged for Sinking Fund Preferred Stock

A liberal, but an appropriate ruling.

A company received a ruling from the Internal Revenue Service which approved a Section 368(a)(1)(A) merger where the sole consideration for the common stock of the merged company was the issuance of sinking fund preferred stock of the survivor. The terms of issuance provide that 10 per cent of the net profit

Sec. 368 (after taxes) of the surviving company shall be set aside each year into a sinking fund for the purpose of redeeming said preferred stock. Furthermore, each year within twelve months after such sum is set aside, it must be used for redemption of the preferred stock which is then to be retired. The corporation also may redeem or buy additional amounts of preferred stock, which is traded on an exchange, at its option. It seems likely that even if only the sinking fund is used, all the shares will be redeemed in a period of less than ten years.

An interesting point is that the company is treating the preferred stock very much like bonds inasmuch as there is a sinking fund provided for the retirement of it. Note also that no serious question was raised by the Revenue Service on the issue of continuity of interest. It was necessary for the company to state affirmatively that neither corporation had any net operating loss carryovers at the time of the merger.

It might be mentioned that the stock was ruled not to be Section 306 stock.

Recapitalization Followed by Sale of Part of Stock

This is supported by a private revenue ruling.

The M Corporation is the successful operator of a television station. All the stock of M was owned by Mr. X, who wanted to sell 50 per cent of his interest. However, in order to make the public offering attractive, it was necessary to devise a means whereby greater dividends could be paid on the publicly held shares than on Mr. X's retained shares.

One method of handling the matter would have been to have the corporation issue preferred stock which Mr. X would receive as a stock dividend and which he would sell to the public. Such preferred stock, however, would be "Section 306 stock," and its later sale by X would give rise to ordinary income instead of capital gain. Therefore, to avoid this undesirable tax effect, it was necessary that the stock to be sold be common, since a stock distribution of common on common does not result in Section 306 stock. (Likewise, a recapitalization which results in an exchange of common for only common does not result in Section 306 stock.)

The solution developed was to recapitalize the corporation, so that it would have two classes of common stock outstanding–A and B. Both classes were entitled to equal voting rights, but the B stock was limited for three years to dividends of 50 cents per share. In making the offering the underwriters stated that it was contemplated that dividends of $2 per share would be paid on the A stock. The B stock was convertible, after three years, into A stock. *Sec. 368*

From these facts it appeared that Mr. X would realize capital gain on the sale of the A stock (received in recapitalization). At the same time his long-term position was protected by the conversion privilege, and the A stock was rendered attractive to the public and enhanced in value by the dividend limitation on the B stock.

The Revenue Service ruled that the recapitalization did not give rise to gain or loss, and that neither Class A nor Class B stock was Section 306 stock.

Increasing Common Stock Interest of Corporate Officers

Reshuffling may be accomplished as tax-free recapitalization.

Under proper circumstances, a recapitalization may be used as a tax-free method of increasing the common stock interest of corporate employees active in company management. The plan may be best described by use of an example:

X Corporation has outstanding 1,000 shares of no-par common stock. A owns 300 shares, B owns 560 shares, and C, who is not active in the management of the company, owns 140 shares. A, the most active corporate officer, is dissatisfied with his proportionate interest and B agrees that he should have an approximate 40 per cent common stock interest. Accordingly, the charter is amended to permit the issuance of $100 par, 4 per cent preferred stock. A sufficient number of B's and C's shares of common stock are then exchanged for the new preferred stock to give A the desired 40 per cent common stock interest.

In 1954 the Revenue Service ruled (Rev. Rul. 54-13) that this exchange was tax free under the 1939 Code. However, the Service expressly refrained from ruling on side issues, such as whether the exchange resulted in payment of compensation or the making of a gift.

Under the 1954 Code the exchange would appear to be likewise tax free. However, an advance ruling should be obtained from the Revenue Service confirming that the preferred stock issued in the recapitalization would not be "Section 306 stock."

The same possibility of treatment as a gift or compensation apparently exists under the 1954 Code as before.

Reorganization to Provide Different Classes of Stock

Presumably, this could also have been accomplished by a recapitalization.

The T Corporation is owned by approximately twenty-five stockholders. Forty-nine per cent of the stock is owned by a management group, and 51 per cent by persons not presently connected with management.

The corporation has arrived at what may prove to be a turning point in its history. There has been a substantial decline in two lines of the corporation's business. The management shareholders believe that under these circumstances the corporation should venture into new fields, and they are willing to face the risks incident to such action. On the other hand, the nonmanagement shareholders are interested primarily in steady income, and are reluctant to have their investment endangered by any change in the operations of the corporation.

To resolve this conflict of interests, a new corporation is to be organized, after which the old corporation will merge into the new. Shareholders will be able to exchange their present common stock for either common stock or preferred stock of the new corporation, subject only to the requirement that each shareholder must take either all common or all preferred. It is further provided that, subject to the maximum amount of preferred authorized, at any time after one year from the date of issue the common may be converted into preferred stock.

On the basis of these facts the Revenue Service ruled that the reorganization will be tax-free. Further, the Service held that the preferred stock issued at the time of the exchange would not be Section 306 stock. The Service reserved opinion as to whether preferred stock resulting from a conversion of common stock will be Section 306 stock.

Preferred Stock to Discharge Bond Interest Arrearages

Accomplish this by a recapitalization.

A company wished to clear a default in interest payable on its bonds, such interest being approximately 40 per cent of the face amount of the bonds. The company had leased its properties, which provided cash for current payment of investment return to the bondholders. The plan selected involved an exchange of old bonds for new bonds in the same principal amount, but with a lower coupon rate of interest, and the issuance of 5 per cent cumulative convertible preferred stock for the bond interest arrearage.

It was considered that this rearrangement qualified as a tax-free recapitalization under Section 368(a)(1)(E). The Internal Revenue Service had previously conceded, in I.T. 4081, that the exchange of bonds as such involved a sufficient "continuity of interest." *William Bernstein Estate,* 22 T.C. 1364, acq. 1955-1 Cum. Bull. 3, is authority for the proposition that the bondholder's claim for accrued interest is not severable from his claim for the principal amount due on the bond, and where other securities are received no interest income is realized by the recipient. Section 354(a)(2) does not apply, since there is no increase in principal amount of the bonds. Section 305(b) does not apply, since no accumulation of preferred dividends is being satisfied. Section 306 should not apply, since there is no "receipt by a shareholder" of preferred stock.

Statutory Merger of Less Than Eighty Per Cent Owned Subsidiary

Obtain a ruling.

The Internal Revenue Service has indicated that no gain or loss is recognized by a parent corporation upon receipt of all the assets and liabilities of a less than 80 per cent owned sub-

Sec. 368 sidiary in a statutory merger under the provisions of Section 368(a)((1)(A). Section 332(a) of the Code provides specifically for nonrecognition of gain or loss upon liquidation of an 80 per cent owned subsidiary.

In view of the policy of the Service, it would seem prudent to secure an advance ruling in every instance of the statutory merger of a less than 80 per cent owned subsidiary into its parent since there is case authority for holding gain on such a transaction to be taxable.

Cash in a Statutory Merger

In a proposed statutory merger, one shareholder (unrelated to any other shareholder) was to receive solely cash in exchange for his stock and the other shareholders were to receive solely stock of the surviving corporation. The National Office of the Internal Revenue Service indicated that the transaction would be a nontaxable reorganization with respect to those shareholders receiving stock, and that the shareholder receiving only cash would realize a long-term capital gain.

CORPORATE DISTRIBUTIONS AND ADJUSTMENTS (Subchapter C)—*concluded*

CARRYOVERS OF TAX ATTRIBUTES IN CORPORATE ACQUISITIONS

Sec. 381 Don't Lose a Subsidiary's Operating Loss Carryover

The tax-free liquidation of a subsidiary may preserve its expiring loss carryover.

Parent corporations with subsidiaries which have a continuing record of operating deficits and which are not likely to have earnings in the near future should consider a tax-free liquidation or merger of the subsidiaries in order to utilize the subsidiaries' unused operating losses against the parent's current taxable income. This is especially important where a large portion of a subsidiary's unused operating loss is about to lapse due to the five-year carryforward limitation.

Timing of the liquidation or merger is important because the transaction must be consummated not later than at the end of the fourth taxable year after the year in which the loss arose in order to utilize fully the unused carryforward under Section 381.

For example, assume the following taxable income or losses for B Company, a subsidiary of A Company, since its organization on July 1, 1952:

Fiscal year ended June 30	*Income (Loss)*
1953	($100,000)
1954	10,000
1955	5,000
1956	(5,000)

Assume further that it was near the end of the company's 1957 fiscal year and management knew that the result of operations for 1957 would be a loss. The company was not expected to do much better in the 1958 fiscal year.

It was quite evident, then, that a large portion of B Company's 1953 loss would never be used to offset taxable income since it could not be carried beyond 1958, and B would not have sufficient earnings to utilize it by that time. In this situation, the parent, A Company, should consider liquidating or merging the subsidiary (tax-free) in order to utilize the subsidiary's loss.

The latest date on which the transaction could have been consummated without losing any portion of B's 1953 loss was June 30, 1957. Consummated on that date, B's unabsorbed 1953 loss could be utilized (to the extent of A's taxable income) for A's fiscal year ended June 30, 1958.

Note, however, that if the liquidation occurred on June 29, 1957 (or any other date in the year ended June 30, 1957, other than June 30) the period from the liquidation to the end of A's current taxable year (June 30, 1957) would be counted as a full year for loss carryover purposes and B's losses could be utilized only to the extent of A's income for such period.

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Unprofitable Subsidiaries

Review balance sheet for most effective utilization of loss.

In *Marwais Steel Company,* 38 T.C. 633, the taxpayer lost in an attempt to obtain two deductions in respect of the same loss. It had deducted in prior years provisions for bad debts in respect of the uncollectibility of loans and advances made to the subsidiary and had claimed a loss for worthlessness of the subsidiary's stock under Section 165(g)(3). In the year at issue, the parent restored equity to its investment in the capital stock of the subsidiary by the expedient of making a contribution to the subsidiary's capital through forgiving the same debts against which the bad debt provision had been made. The subsidiary was merged into the parent and the subsidiary's net operating loss carryovers, then remaining open, were claimed as deductions by the parent under Section 381(c)(1). The Tax Court disallowed the loss on the ground that Congress did not intend to grant double deductions. Apparently, it likened this set of facts to the situation of losses of an affiliated corporation on a consolidated return which must be applied in reduction of the cost bases of amounts due from, and investment in, the subsidiary (*Ilfeld Company* v. *Hernandez* 292 U.S. 62).

The case serves to point up some important fundamentals in this area:

1. Net operating loss carryovers are available under Section 381(c)(1) only if the distribution qualifies under Section 381 (a); however, the distribution cannot qualify under the latter unless the parent's investment in the subsidiary's capital stock had some value on the date of the liquidation. Hence, the parent forgave the debt to eliminate the subsidiary's deficit in the *Marwais Steel* case. As an aside, it does not appear that the *Marwais Steel* case holds that the forgiveness of debt by the parent would be ineffective as a contribution to capital for the purpose of establishing an equity where the case does not involve a double deduction.

2. The value of the investment should be watched carefully so that liquidation occurs while the subsidiary's balance sheet still shows some remaining equity for the owner of its common stock. This is particularly important where the parent owns between 80 per cent and 95 per cent of the subsidiary's stock and for that reason an ordinary deduction is not available under Sec-

tion 165(g)(3)(A), or, if for another reason the loss would be a capital rather than an ordinary loss under Section 165. *Sec. 381*

3. Where the subsidiary's stock hovers on the brink of worthlessness and, in a sense, there is a choice between a Section 381 (c)(1) loss carryover or a worthless stock loss, a study should be made to determine which is preferable. Usually, the total of the bad debt and worthless stock deductions will exceed the net operating loss carryover in amount and will be the route selected.

4. A bad debt deduction should be claimed for amounts which are uncollectible from the subsidiary, where the latter's capital stock retains some equity and it is proposed to claim operating loss carryovers under Section 381(c)(1) after the subsidiary is liquidated. The Government may seek to scale down the net operating loss inherited from the subsidiary loss carryover to the extent that the bad debt produces a double deduction as under the *Marwais Steel* case; but, since the bad debt comes first, it should be allowed if uncollectibility is established.

Investment Credit Carryover

Keep a close tab on this item.

Follow-up records should be established to insure that carryovers are utilized in respect of unused investment credits. Section 381(c)(23) makes possible the transfer of this tax attribute in a corporate acquisition which qualifies under Section 381(a). It is conceivable, for example, that in future years action will be taken to liquidate a controlled subsidiary into its parent corporation under Section 332 primarily because the subsidiary cannot make effective use of its own investment credits.

Availability of Loss Carryovers of Acquired Companies

A useful tabulation as to the effects of various methods of acquisition.

The high rate at which smaller companies are being acquired by larger, well-established companies does not seem to abate. Good business reasons undoubtedly motivate most of these trans-

Sec. 381 actions and thus the possible applicability of Section 269, relating to Acquisitions Made to Evade or Avoid Income Tax, is obviated. Nevertheless, the presence of an operating loss carryover in the acquired company often furnishes some inducement to the acquiring company.

Assuming that the acquiring company has no desire to forsake its own corporate existence, the following tabulation summarizes the availability of the operating loss carryovers of the acquired company under the most common types of current acquisitions:

1. Purchase of the acquired company's assets by the acquiring company in a *taxable* transaction: The operating loss carryovers are forfeited.

2. Purchase of the acquired company's stock by the acquiring company in a *taxable* transaction:

   a. Continuation of acquired company –

      (1) The acquired company's operating loss carryovers may be applied to reduce its own future profits in separate returns if the acquired company continues to carry on its same trade or business (see Sec. 382(a)).

      (2) Consolidated return – The acquired company's separate-return operating loss carryovers may be carried forward against consolidated income only to the extent the acquired company contributes current income to the consolidated return (Reg. Sec. 1.1502-31(b)(3)). Thus, the effect is virtually the same as in (1) above.

   b. Immediate liquidation of acquired company – The acquired company's operating loss carryovers are forfeited. However, the basis of the acquired company's assets may be "stepped up" in the hands of the acquiring corporation under Section 334(b)(2). On the other hand, the continuation of the acquired company for at least two years for adequate business reasons, and its subsequent liquidation, will preserve the remaining operating loss carryovers for use by the acquiring company.

3. Acquisition of stock or assets for stock in *non*taxable transactions:

   a. Continuation of acquired company –

      (1) The acquired company's loss carryovers are fully available against its own future profits. (Same as 2a(1) above, except the requirement that the acquired com-

pany may not change the nature of its trade or business is absent in this case.) Sec. 381

(2) Consolidated return — same as 2a(2) above.

b. Tax-free merger, consolidation, or acquisition of "substantially all the assets" of the acquired company, etc. The operating loss carryovers of the acquired company may be used against the continuing company's earnings, except that the amount of the loss carryovers must be reduced if less than 20 per cent of the acquiring company's stock is issued to the acquired company's stockholders. The acquired company's carryover is first used in the first taxable year of the acquiring corporation which ends after the date of the transaction, but only to a limited extent. The unused balance may be used in subsequent years so long as it does not expire under the five-year carryover rule (Sec. 381 and 382(b)).

In all of the above situations the provisions of Code Section 269 should be given consideration.

Effect on Net Operating Loss Carryover of a Statutory Merger

A helpful ruling.

A parent corporation planning to combine two subsidiaries may choose to merge one into the other by means of a statutory merger under Section 368(a)(1)(A). One benefit of this route is that the documentary stamp tax may be avoided since it is not necessary to exchange stock. The stock of the merged company can be cancelled.

When this route is followed, a question may arise as to the applicability of the carryover provisions of Section 381. Section 381 applies to a statutory merger only if Section 361 applies. Section 361 is applicable to exchanges of property for stock. In the contemplated statutory merger there is, in fact, no stock issued; thus a question arises as to whether Section 361 is applicable.

It is understood that the Internal Revenue Service has ruled privately that there is a constructive issue of stock in this situation to make Section 361 and Section 381 applicable.

Sec. 381

Earnings and Profits Under Code Section 381

A logical explanation of a puzzling provision.

Code Section 381(c) provides that a transferor's earnings and profits (or deficit) are deemed to have been acquired by the successor as of the close of the date of the transfer, but a deficit of the transferor or predecessor may offset only earnings and profits accumulated after the date of the transfer.

The subsection also provides that a deficit of the successor cannot be used to reduce earnings and profits acquired from the transferor or predecessor, but can be used only to reduce earnings and profits of the successor accumulated after the transfer.

Inquiry was made of the Revenue Service as to why the provision had been worded this way. The Service advised that in drafting this provision in the 1954 Code, it was felt that the tax treatment should be the same no matter whether a company with accumulated earnings acquired a deficit company in a Section 381 transaction or the deficit company acquired the company with accumulated earnings. This seems a logical explanation of why the law was worded as explained above.

Designation of Surviving Corporation

Bury the right corporation.

In planning for the preservation of net losses in corporate acquisitions under Section 381(a), the general rule is that it is immaterial which of the corporations is the surviving entity; however, there are at least three situations affecting reorganizations of the types described in Section 368(a)(1)(A) and (C) in which the designation of the surviving corporation can make a real difference.

1. As the taxable year of the transferor corporation ends on the day of the transfer, a foreshortening of the five-year carryover period will result unless that date coincides with the close of the taxable year of both the transferor and the acquiring corporation. This follows because a part-taxable year is the same as a full year in checking out the five years over which the carryover may be spread. For example, a calendar year transferor's loss in 1962 may be spread over only four years if it is merged into a calendar year acquiring corporation on any day

in 1963 other than December 31. The span would be two part-taxable years in 1963 and full years in 1964, 1965, and 1966. The best approach is to merge on December 31, 1963, but if that cannot be managed, consideration should be given to designation of the profitable corporation as the transferor and having the loss corporation as the surviving corporate entity, since only the transferor's year ends as on the date of the transfer.

2. Where both parties to the reorganization have had earnings in the years prior to acquisition and the preservation of a loss carryover is not a consideration, the corporation with the larger earnings in the years immediately preceding the reorganization should be the surviving corporation.

3. Merger is preferable to consolidation if there is a possibility of a net operating loss carryback from the combined operation. A loss suffered after the date of the transfer may be carried back to a preacquisition period only against taxable income of the acquiring corporation, and, in a consolidation, a new corporation emerges as the survivor. Consequently, there is no preacquisition taxable income against which to carry back the loss.

Date of Distribution for Carryovers Under Section 381

A suggestion for accelerating the carryover of losses.

Under Section 381 of the Code, the time when carryover items are first taken into account by a successor corporation is referred to as the "date of distribution or transfer." Section 381(b)(2) provides an option as to the date of distribution or transfer when all of the property in a transaction subject to the carryover provisions is not transferred on one day. Normally, this date is the date on which distribution or transfer is completed. However, under regulations, the date when substantially all of the property has been distributed or transferred may be used if the distributor ceases all operations, other than liquidating activities, after that date.

This option may present an opportunity for constructive tax planning. For example, assume a distribution to a calendar-year corporation which is substantially complete in October 1963 but which will not be fully completed until February 1964. If the option is exercised and the earlier date is deemed to be the date

Sec. 381

of distribution or transfer, any available net operating loss carryovers from the distributor might be usable by the distributee in 1963, instead of in the year 1964, which would be the year if the earlier date were used.

Reg. Sec. 1.381(b)-1(b) provides that in order to use the optional date certain statements are to be filed with the returns of both the transferor and the acquiring corporation for the year of distribution.

Sec. 382

Inequity in Rules Governing Loss Carryovers in Mergers

This type of inequity should be corrected by legislative action.

The 1954 Code permits the carryover of net operating losses to a successor corporation in a reorganization, subject to certain limitations. These comments concern the almost complete loss of carryover which seems to follow from the limitations where a majority-owned company merges with its much larger parent.

The report of the Senate Finance Committee stated that it was considered appropriate to allow full carryover of losses in reorganizations only where the shareholders of the loss corporation had a substantial continuing interest in the successor corporation. If they received 20 per cent of the stock of the successor corporation, their interest was considered substantial. If they received less than 20 per cent, the portion of the loss carryover available to the successor corporation would be in the ratio of the percentage of stock received to 20. For example, if they received 10 per cent of the stock, the successor corporation would be entitled to 50 per cent of the loss carryover.

A special rule is applicable where the surviving corporation in a merger owned, before the merger, stock of a merged loss corporation (Sec. 382(b)(5)). This rule provides a formula for determining the percentage of its own stock which the survivor is considered to have received for its interest in the loss corporation, for the purpose of applying the limitation on loss carryovers. It is the operation of this rule that produces a result seemingly inequitable.

Assume that Corporation P owns 75 per cent of the stock (there is only one class) of Corporation S. Corporation S has had several years of operating losses which are available for carryover. As a result of these losses, the fair market value of the total outstanding stock of S is only about 1 per cent of the fair market value of the total outstanding stock of P after the merger. Under the formula in the special rule, P is treated as owning .75 of 1 per cent (1 per cent of 75 per cent) of its own stock as a result of its ownership of S stock before the merger. The 25 per cent minority interest in S presumably would receive .25 of 1 per cent of the stock of P for their S stock, and the total interest in P stock accruing to S stockholders is therefore considered to be 1 per cent. As previously mentioned, where stockholders of the merged company receive for their interest less than 20 per cent of the stock of the survivor, the loss carryover to the survivor is scaled down proportionately. In this example, apparently only 5 per cent ($1/20 \times 100$) of the loss carryover of S is available to P. *Sec. 382*

Contrast this with the possibility that P might have owned 80 per cent of S rather than 75 per cent. A liquidation under Section 332 then would have entitled P to 100 per cent of the loss carryover as compared with 5 per cent computed under the special rule where there was 75 per cent ownership.

Redemption May Affect Net Operating Loss Carryovers

The following problem is another worry which must be added to the corporate buy-out headache.

The limitation on loss carryovers under Section 382(a) is not confined to situations where the stock is sold to new interests. There may be a forfeiture of loss carryovers where there has been a redemption of all the shares of a holder of 50 per cent or more of a company's stock if the corporation has not continued to carry on the same trade or business carried on before the redemption. This does not apply to a redemption to pay estate taxes and funeral expenses.

Operating Loss Carryovers

Under the rules of Code Section 382(a), where there is a change in 50 per cent or more of stock ownership during a two-

Sec. 382 year period, as a result of a purchase or redemption of stock, coupled with a change in the trade or business, a net operating loss carryover will not be allowed to a corporation.

A careful study of Section 382(a) and Regulations Section 1.382(a)-1(d) reveals that it is possible to have a change in 50 per cent or more of stock ownership without affecting the use of the operating loss carryover. This result may be achieved where some of the stock before the change is attributed to another stockholder as provided in Section 382(a)(3).

Let us assume that before the change the stock is owned as shown in Table I, below.

Because of substantial losses, A and D, the elder stockholders, wish to dispose of their interests and agree to sell their stock to A's sons, B and C. It is contemplated that after the sale several changes in the operation of the business will be made to eliminate losses.

The stock ownership would be as shown in Table II, page 99.

Inasmuch as the total increase, due to the purchase or redemption of stock, is only 40 per cent (even though there was actually an 80 per cent change in stock ownership, including 60 per cent from an unrelated party), Section 382(a) would not be applicable even though the nature of the business is changed. However, a careful study of Regulations Section 1.269-6 should be made to ascertain that Section 269 is not applicable.

TABLE I

Stockholder	*Percentage of Stock Actually Owned*	*Percentage of Stock Owned Actually and Constructively*	
A	20%	40%	(His own plus that of his two sons)
B (A's son)	10%	*30%	(His own plus that of his father)
C (A's son)	10%	*30%	(His own plus that of his father)
D (Unrelated party)	60%	60%	
Total	100%		

*Under the rules of Section 318(a)(1)(A), stock owned by B would not be attributable to his brother C.

TABLE II

Stockholder	Percentage of Stock Actually Owned	Percentage of Stock Owned Actually and Constructively	Percentage Point Increase	Percentage Point Increase Attributable to Purchase
A	–0–	100%	60%	–0–
B	50%	50%	20%	20%
C	50%	50%	20%	20%
D	–0–	–0–	–0–	–0–

Possible Avoidance of Limitation On Loss Carryovers

Acquisition of small companies and utilization of their operating loss carryover by large companies may be possible by formation of a subsidiary for "acquisition" purposes, thus avoiding the 20 per cent rule of Section 382(b).

The provisions of Section 382(b) of the 1954 Code were designed to limit the availability of net operating loss carryovers where, as the result of a reorganization transaction, the stockholders of the loss company retain a continuing ownership of less than 20 per cent of the stock in the surviving company. In part this rule may have been prompted by a desire to discourage the take over of small companies by large companies which would be able to utilize net operating losses.

However, under Section 382(b)(6), stock of an acquiring company's parent will be treated as stock of the acquiring company in determining whether the special limitation on net operating loss carryovers applies. This rule appears to make possible the acquisition of the assets of a small loss company by a large company without the forfeiture of loss carryovers through the use of a wholly owned subsidiary under circumstances where a substantial portion of the loss carryovers would be forfeited if the assets were acquired directly by the large company for its stock.

Suppose, for example, that X Corporation wishes to acquire all of the assets of the Y Corporation, which has loss carryovers. Because of the relative sizes of the companies, if the assets of Y were acquired by X for X voting stock, Y stockholders would own only 5 per cent of the resulting outstanding X stock. Ac-

Sec. 382 cordingly, 75 per cent of Y's loss carryovers would be forfeited.

However, it apparently would be possible for X to form a wholly owned subsidiary, transferring to that subsidiary operating assets able to produce a profit large enough to absorb Y's loss carryovers. In addition X would transfer to the new subsidiary a sufficient number of shares of X voting stock to be used by the Section 382 subsidiary in acquiring Y's assets.

Example: Corporation P owns all the stock of Corporation S. Corporation S acquires all the assets of Corporation W for stock of Corporation P in a C-type reorganization. Immediately, thereafter the stock of P is worth $1 million and the stock of S is worth $200,000. If the stockholders of W acquire, as a result of the reorganization, 4 per cent of the stock of P, this will be equivalent in value of 20 per cent of the stock of S and the 20 per cent requirement of Section 382(b) will have been met.

It should be noted that the regulations under Section 382(b)(6) provide that this subsection shall apply only if, at the time of the reorganization (the acquisition of the assets of W in the above example), it is intended that the acquiring corporation itself (S above), and not the corporation which controls the acquiring corporation, shall make use of the net operating loss carryovers from the loss corporation.

Furthermore, Section 269 should be examined for possible application.

DEFERRED COMPENSATION (Subchapter D)

Sec. 401

Profit-Sharing Plan Trust Purchase of Employer's Stock

Employee approval must be obtained.

The National Office of the Revenue Service is reported to have issued a Technical Advice Memorandum in which profit-sharing plan trustees were allowed to purchase stock of a closely held corporate employer even though the stock had no history of dividend payments and little prospect of dividend payments in the foreseeable future. The stock was not listed on an exchange and did not have a readily ascertainable fair market value.

The Service approval was based upon a provision that the trustees would purchase stock only upon the absolute direction given them by each of the participants involved. Accordingly, only the electing participants would benefit from an increase in the stock's value or sustain loss for a decrease. The memorandum stated that where earmarked investments are made at the absolute direction of the individual employees the "exclusive benefit" requirement is presumed to be met.

Deferred Compensation Plans—A New Arrangement

Clearance by the Service might be desirable to assure tax deferral under this type of arrangement.

From time to time, directors of small companies consider deferred compensation plans for executives to provide income after retirement. Ideally, the plan should provide the retired executive with adequate security to assure payment but should not create a nonforfeitable right to any sums of money. It has been suggested that the following method *may* achieve the desired result.

Suppose Mr. B, employed by a small company he does not control, is being paid a salary of $25,000 plus a bonus which averages $15,000. He is fifty-five years old. He now enters into a ten-year employment contract which provides that his annual salary shall remain at $25,000 but that the bonus will be payable in monthly installments for ten years beginning at age sixty-five when he plans to retire. This would mean that at his retirement the company could owe him $150,000.

At the time of the employment contract, the company would enter into a trust agreement with a trust company. This agreement would cause the company each year to deposit with the trust company a sum equal to the amount of the bonus payable

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to B. All income from the funds in the trust would be payable to the company in annual (or more often) payments. On the date when B becomes sixty-six, one-tenth of the total principal sum will be repaid to the company, this to continue annually until the fund is exhausted. The company, in turn, is to disburse such payments to B, at which time it would be entitled to deduct the payments annually.

It is believed that this arrangement may give B adequate protection without causing him to be taxed at the time the trust deposits are made. B would seem to have no rights in the trust, present or future—since it merely provides a collateral fund to assure performance of the contract. Under similar circumstances (except that the trustee made payments directly to the employee) the Sixth Circuit, in *Drysdale* v. *Comm'r* (April 20, 1960), reversed the Tax Court and held that the amounts paid to the trustee were not taxable to the employee until received by him.

Appreciation in Value of Assets Of Profit-Sharing Trusts

The Service's attitude on problems created by increasing portfolio values in employee's trusts is quite reasonable.

Many employee's profit-sharing trusts, qualified under Section 401, have invested a portion of their funds in listed common stocks. Such investment may be only from the employer's contributions, or employees who contribute may have requested similar investment for their own payments. The comments herein are directed at problems related to the employer's contribution.

It is common to find that the rise in stock market prices in recent years has led to a substantial appreciation in the value of trust assets. The Internal Revenue Service has recognized this by insisting that there be a revaluation of assets at least annually, with appropriate adjustment of the employee's individual accounts. The Service raises this issue when new trusts are created or older trusts are brought in for amendment. However, older trusts are still turning up where accounts are kept and pay-outs are made on a cost basis, with appreciation recognized only when stocks are sold. Eventually the trustees decided that a change is in order. The questions they must then face include the following:

1. What should be done about retroactive adjustments for employees whose service was terminated in prior years?
2. How do additional payments to terminated employees affect capital gain treatment under Section 402(a)(2)?
3. How would future depreciation affect employee relations?

Retroactive Adjustments. The Internal Revenue Service appears to have a hands-off attitude toward retroactive adjustments, so long as the rule against discrimination in favor of highly placed employees is not violated. It follows that the trustees may decide on a policy which is reasonable under the circumstances, without exposing themselves to criticism by the Internal Revenue Service.

It is likely that appreciation was not material before 1950, when a bull market began to develop, so that any adjustment of pay-outs before 1950 might well be disregarded. For later years, the starting time for adjusting pay-outs can be selected by taking into account the number and size of adjustments which would be required and any other factors which are considered material.

Presumably, the trustees will take into account the possibility that they may have no right to make retroactive adjustments, or even to base future pay-outs on present values, without first obtaining an amendment to the trust agreement.

Effect on Capital Gain Treatment. Section 402(a)(2) provides for capital gain treatment of distributions where the total amount payable with respect to any employee is paid within one taxable year of the distributee on account of the employee's death or other separation from service, or on account of the employee's death after his separation from service. How will a second payment affect the capital gain treatment of the first payment which was thought at the time to be the total amount payable, and what treatment will be accorded to the second payment?

Revenue Ruling 56-558 (1956-2 Cum. Bull. 290), indicates that capital gain treatment of the first "total" payment will not be disturbed, but an adjustment paid in a later year will be treated as ordinary income.

The ruling relates to a stock bonus or profit-sharing plan but there is no reason why it should not be applied also to other types of plans. In the example given, the employee participated in the profits of the year during which he retired, which of course were not determinable until after he had retired and which were paid to him in the subsequent taxable year. The ruling states that in this situation the payment in the second year will not vitiate the capital gain treatment of the amount received in the first year. In effect it adds the words "as at the date of retirement" after the words "total distributions payable" in Section 402(a)(2). Since the amount distributable to the employee in respect of the year of his retirement was not determinable until after he had retired, the Service ruled that the first payment did constitute "the total distribution payable."

Care should be taken to apply this rule only where there is an after-developed type of adjustment. The rationale of the ruling will not support giving capital gain treatment to the first distribution where the second distribution represents merely an accounting change or a correction of some error inherent in the first distribution. Past experience indicates that even where the equities are entirely with the taxpayer, the Service will insist on treating both payments as ordinary income when the second one is the result of such an error or accounting change.

In this connection the Revenue Ruling implies, without stating in so many words, that where an after-developed type of adjustment is made and the payment is received in the same taxable year of the beneficiary as the original total lump-sum payment, the second payment also would qualify for capital gain treatment. This result seems contrary to the logic used in giving capital gain treatment to the first of two payments which are made in different taxable years, but it is not likely that any taxpayer will be found who will complain of this treatment.

Employee Relations. Profit-sharing trusts are ordinarily set up in the hope that employee relations will thereby be improved. What happens to employee relations when the employee learns that there is $500 less to his credit than there was a year ago, because of a decline in market prices? Will there be employees who conclude that the market is at a peak and is due for a decline, and therefore they should resign and take out their profit-sharing credit from the fund immediately?

These are problems to be considered by the employer's labor relations department.

Benefits of Pension and Profit-Sharing Plans

Here is a summary of the tax benefits accruing to the employee from qualified pension and profit-sharing plans, as compared with ordinary compensation:

1. No tax until received, when presumably lower surtax rates will apply.
2. No tax on earnings of the fund, permitting a faster accumulation.
3. No estate tax on the value of annuities or "other payments" payable to beneficiaries and attributable to the employer's contribution.
4. Capital gain treatment where an employee's full share is paid out in one year because of death or separation from the service.
5. Provision for deferment of tax on the unrealized appreciation of employer securities distributed from the trust until the appreciation is realized.

Profit-Sharing Plans: A Capsule Review

A detailed and useful "primer."

More and more profit-sharing plans are being adopted by American industry in preference to conventional pension plans.

Under a profit-sharing plan, the annual cost varies with profits, and when there are no profits, no expense is incurred. Likewise, the amount of benefits distributable to the beneficiaries cannot be fixed but will vary according to the amount of funds accumulated in the trust through company contributions and trust income. On the other hand, under a formal pension plan, the annual expense is relatively fixed, and although such a plan may be sufficiently flexible to permit the employer to pay past service costs at such time as he elects, nevertheless the cost for current service is a continuing expense at fixed amounts or at such amounts as are necessary to pay the benefits specified in the plan, although payments may not be required in years of hardship. (See Rev. Rul. 56-596.)

In considering the possible adoption of a profit-sharing plan, it should be borne in mind that as long as the plan is formally adopted on or before the last day of a fiscal year, it is effective

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for that entire year. Also, the establishment of a profit-sharing plan does not preclude the subsequent adoption of a formal pension plan, if that should be decided upon.

A summary of the particular features of and basic provisions relating to profit-sharing retirement plans is given in the following paragraphs:

Definition. As defined by Regulations Section 1.401-1(b), a profit-sharing plan is "a plan established and maintained by an employer to provide for the participation in his profits by his employees or their beneficiaries. The plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants and for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as lay-off, illness, disability, retirement, death, or severance of employment."

Requirements in General. A plan must be a permanent as distinguished from a temporary program. The employer may reserve the right to change or terminate a plan, but if abandoned for any cause other than business necessity within a few years after it has taken effect, the Treasury Department may disallow, as tax deductions, contributions to the plan prior to its termination for the years not outlawed by the Statute of Limitations.

The plan must be for the exclusive benefit of employees, although it need not provide benefits for all of the employees. Among the employees to be benefited may be persons who are officers and shareholders. However, a plan is not for the exclusive benefit of employees in general, if, by any device whatever, it discriminates in eligibility requirements, contributions, or benefits in favor of employees who are officers, shareholders, supervisors, or highly compensated employees.

It must be impossible for any portion of the funds accumulated under a plan to revert to the employer or otherwise be used for any purposes other than the exclusive benefit of the employees or their beneficiaries.

A comprehensive description of the plan must be made available to the employees.

Formal Written Instruments. A profit-sharing plan must be set forth in a formal written instrument, such document to embody the formula (if any) for determining the employer's contributions, the eligibility requirements for participation, the formula for allocating contributions among participants, the vesting conditions, procedures for allocating income and credits forfeited by former participants, provisions for distribution of benefits, provision for amendment of the plan, and miscellaneous administrative provisions. Most of these provisions are discussed below. *Sec. 401*

A profit-sharing plan must also embody a trust. Usually a trust agreement is included as part of the plan itself, or it may be set forth in a separate agreement under the plan. The trustee may be a trust company or an individual (frequently, three employees serve as cotrustees).

Formula for Employer's Contributions. While a fixed formula for the amount to be contributed is no longer necessary, there is a limitation on the amount allowable as a deduction under the Internal Revenue Code, which limits such deduction to:

1. Fifteen per cent of the compensation otherwise paid or accrued during the taxable year to the participants under the plan, plus
2. An additional amount payable under certain carryover provisions of the Internal Revenue Code to compensate for any years when the employer's contribution is less than the 15 per cent of compensation referred to above. Such additional amounts are intended to permit the employer's contribution to average approximately 15 per cent of the compensation otherwise paid or accrued to participants after the adoption of a plan.

If the employer pays more than 15 per cent in one year, the excess may be carried forward as part of the contributions of succeeding years to the extent needed to bring the deduction up to the 15 per cent limit.

Eligibility Requirements. Eligibility for participation in a plan can be limited to a designated class of employees (including officers and shareholders), providing the eligibility requirements do not discriminate in favor of the officers, shareholders, supervisors, or highly compensated employees. For example, participation may be limited to employees who:

1. Are employed on a salary basis
2. Have been in the continuous service of the company for a minimum period, such as five years
3. Have attained a stated age, such as twenty-five years
4. Who are not older than a stated age, such as sixty-five years

Sec. 401 Continuous years of service, as defined for determining eligibility, may include periods interrupted solely by military service or by authorized leave of absence.

Formula for Allocating Contributions. The employer's contributions to the trust must be allocated to the accounts of the participating employees on a specific basis as set forth in the plan.

Frequently, the contribution is allocated in the proportion that the compensation of each participant for the applicable year bears to the total compensation of all participants. In other cases the formula for allocation includes a factor which gives weight to years of service.

Vesting Conditions and Forfeitures. The phrase "vesting conditions" refers to the requirements of a plan whereby a participant's interest in the trust becomes nonforfeitable.

Usually, an employee's interest is payable in full if termination of employment is attributable to normal retirement, disability or death. However, if employment is terminated for other reasons, the plan may limit the benefits payable to the former employee, such as a provision that the employee's interest shall vest at the rate of 10 per cent of the balance standing to his credit, multiplied by the number of years of service (up to ten years) after the effective date of the plan, or 50 per cent of the balance, whichever is greater. Amounts forfeited by former participants are usually reallocated among the remaining participants.

Allocation of Income, and Net Gain or Loss on Investments. The income of the trust, net of expenses, if any, and the net gain or loss on investments are allocated at least annually to the account of each participant, on a pro rata basis. For example, such allocation may be made in the proportion that the balance held for each participant bears to the total held for all participants. The allocation of gain or loss on investments may include the increase or decrease during the year in the market value of securities held in trust.

Distribution of Benefits. Benefits may be paid to an employee in a lump sum or in installments over a stated period of years or in such manner as may be mutually agreed upon. The payment of benefits to an individual or his beneficiaries generally is not made until after the occurrence of one of several specified events such as retirement, death, permanent disability, or termination of employment.

Administrative Committee. The board of directors of the employer generally appoints a committee for administration of the plan. Usually such administrative committees consist of three employees (including officers) who are participants in the plan and whose powers and duties may include the following:

1. Maintenance of (or control of) accounting records which will show the allocation and distribution of the trust among its participants
2. Adoption of such rules as may be necessary for the proper administration of the plan
3. The direction of the trustee in the investments of the trust fund and in all distributions to be made from the trust

The Trustee. The trustee acts as a custodian of the trust investments and cash, collects the income thereon, pays expenses, if any, and remits the amounts payable to participants or their beneficiaries, upon the direction of the administrative committee.

The trustee may have the power and duty of making investments on his own initiative, or he may be restricted to act only upon the direction of the administrative committee.

The trustee is expected to maintain records showing all cash receipts and disbursements. However, he is not expected to maintain records showing the allocation of the trust among the participants as such records are generally maintained by or under the supervision of the administrative committee.

Expenses. The expenses of the trustee and of the administrative committee may be borne by the trust or the employer, in which latter case they are deductible for income tax purposes.

Income Tax Considerations. The employer's annual contribution is deductible in the year of accrual, provided it is paid prior to the time prescribed for filing the Federal income tax return (including extensions) for such year.

The trust is exempt from income taxes. Accordingly, the increment of the trust fund (arising from income on investments, capital gains, if any, and the employer's contributions) accumulates free of Federal taxes.

The employer's contributions to the trust are not taxable as income to the employee until distributed or made available to

Sec. 401 him after retirement, death, disability or termination of employment.

Amounts paid from the trust to participants also receive favorable tax treatment if distribution of the entire amount of benefits due on account of separation from service is paid within one taxable year. Under such circumstances the amount distributed is taxable to the individual as a gain from the sale or exchange of a capital asset held for more than six months. However, if benefits due to a former employee are paid during periods of more than one taxable year of the employee, each distribution will be included in the gross income of the individual in the year received; the tax effect, therefore, is to treat such distributions as ordinary income.

Approval of Plan by Treasury Department. In order that an employer may establish in advance that a plan qualifies under the Internal Revenue Code, an application for a ruling thereon may be submitted to the Service prior to the actual execution and adoption of a plan. Because the amounts to be contributed are necessarily substantial sums of money, it is recommended that a ruling be obtained from the IRS prior to the formal adoption of any profit-sharing plan.

The type of plan and trust outlined herein is intended to meet the requirements for qualification under Section 401(a) of the Code. The formulas and provisions described herein have in most cases been found to be acceptable to the Treasury, but it should be borne in mind that some of the provisions which are of general application might not be acceptable to the IRS under the specific circumstances of a particular employer.

The drafting of a profit-sharing plan and trust agreement is necessarily a legal matter, and accordingly these instruments should be prepared by counsel.

Buy-Out Agreements at Book Value

Many buy-out agreements of stockholders, partners, etc., refer to book value. One of the things frequently not considered in that respect is the unfunded portion of past service costs of a pension trust. It is important to bring this to the attention of clients when such an agreement is under way, in order to make sure that adjustment is, or is not, to be made for this factor.

Employer's Stock as Investment For a Profit-Sharing Plan

An attractive means of deferring income taxes.

An investment by a qualified profit-sharing plan in the employer's stock may be an attractive means of deferring income taxes on distributions in kind from such profit-sharing plan. A drawback to the adoption of such an investment policy is the added complexity affecting all concerned, particularly the trustee. Two methods of handling such investment are as follows:

1. The corpus of a profit-sharing plan may be divided into two trusts with the principal of one invested primarily in the employer's stock and that of the other in diversified investments, both being common funds. Members of the plan are given a choice as to the funds in which their credits from the employer's contribution are to be placed.
2. Where only a few members of the plan decide to have part of their credit invested in the employer's stock, it would appear that only one trust is needed, with the amount invested in the shares of the employer segregated, using specific identification of the employer's shares in the individual account.

Either arrangement may prove attractive to closely held companies where the market value of the stock is not susceptible to measurement and, accordingly, restricted stock option plans are not feasible. Upon a severance distribution to the employee from the plan, tax is deferred on the appreciation on the employer's securities which are distributed in kind. The unrealized appreciation will not be taxed until the employee sells the securities. This advantage extends not only to employer's securities purchased with contributions to the fund but also to employer's securities purchased with income earned by the fund. Accordingly, it is important that provision be made for distributions in kind of the employer's stock as a mode of distribution. There is no deferment of tax on unrealized appreciation where outside investments are distributed.

If the employer's stock is included in the investment portfolio, the requirements of Regulations Section 1.401-1(b)(5)(ii) must be met.

Integrating Profit-Sharing Plans Under Special Rulings

Integration provides a relatively large advantage with respect to a comparatively small contribution.

Many profit-sharing plans have as their principal objective the funding of retirement allowances. This vehicle is preferred over the pension plan by most smaller companies because of their desire to avoid the fixed commitments incident to pension plans. Having a common objective, there are certain similarities in the rules for the two. Both may be tailored so as to exclude the amount of compensation covered by social security, only if they are integrated therewith under the special rules set forth in the regulations. For profit-sharing plans, management has flexibility in that it may select either of two approaches depending upon whether it is (a) economy minded, or (b) desires to make the maximum contribution but wishes to slant the allocation of benefits in the direction of its highly paid employees and officers. For profit-sharing plans, integration is accomplished by excluding the first $4,800 of compensation in allocating the employer's contribution among the plan members. This is subject to a number of conditions such as the 9⅜ per cent limitation factor applied to the compensation in excess of $4,800. Integration often is ignored in the profit-sharing field, possibly because its impact is either misunderstood or underestimated. Since a definite formula no longer is required for such plans, an employer can compute in advance the contribution it should make each year in order to carry out its particular objective, always provided that the result is not discriminatory.

The economy-minded company can confine its total contribution to 9⅜ per cent of compensation in excess of $4,800. To test the impact on the personnel, a calculation could be made for each individual excluding the first $4,800 of compensation. The excess would be used for the purpose of allocating to him his share of the employer's contribution, subject to the restriction that the amount so allocated may not be greater than 9⅜ per cent of such excess. The contribution would coincide with the total of the amounts so determined. Assuming that in 1962 a company pays $500,000 total compensation to eighty employees none of whom receives less than $4,800, the contribution which would yield the maximum advantage to the highly paid follows:

Total compensation	$500,000
Exclusion $4,800 × 80	384,000
Total excess	$116,000
Contribution, 9⅜% of total excess	$ 10,875

While the total contribution appears almost niggardly, the formula gives considerable leverage to the highly paid. An employee receiving a salary of $20,000 would have a credit of $1,425 (15,200/116,000 × 10,875). Under a nonintegrated plan, a company contribution of $35,625 would have been needed in order to extend that same credit to him. If the company had contributed only $10,875 to a nonintegrated plan, his credit would have been $435 (20,000/500,000 × 10,875) or $990 less than in the integrated plan.

Companies which want to contribute the statutory maximum of 15 per cent of the total compensation may do so under an integrated plan. The only difference in mechanics is that there are two steps rather than one. Using the same assumptions as above, except for an increase of the employer's contribution to 15 per cent, the amount of $64,125 (being the excess of $75,000 over $10,875) would be allocated among all plan members without reference to the $4,800 social security exclusion. As the aforementioned officer received 4 per cent of the total compensation paid by the company, he would be credited with an additional $2,565 (4 per cent of $64,125), making his total credit $3,990, or $990 more than would have been his due in a nonintegrated plan. Employees whose compensation did not exceed $4,800 would receive a pro rata share of the second-step distribution of credits. For instance, an individual with exactly $4,800 compensation would be credited with $615.60 (4,800/500,000 × 64,125) under the second step, but would not be entitled to anything under the first step.

The Revenue Service specifies in Revenue Ruling 61-75 certain requirements to be met before it will approve an integrated profit-sharing plan, as follows: (a) The plan may provide benefits only upon retirement or other separation from employment; (b) there may not be any other qualified plan containing the integration element; (c) forfeitures during the year must be added to the employer's contribution in applying the 9⅜ per cent factor in allocations among plan members, but a minimum allocation per participant not in excess of $60 may be specified; and (d) allocations must be made on a nondiscriminatory basis.

Regulations Section 1.401-3 published January 21, 1960, raised the maximum exclusion from $4,200 to $4,800 in line with the increase in the social security base. The 9⅜ per cent factor stems from the limitation provided for money purchase plans set forth in Mim. 6641, Cum. Bull. 1951-1. The factor was computed in 1951 when the exclusion was $3,000 but in Revenue Ruling 61-75 it was adopted for the $4,800 exclusion.

Flexibility of Nonqualified Deferred Compensation Contracts

A case for proper training.

X, an executive with A Corporation, has a base salary of $200,000 per year. In addition, he is a participant in a nonqualified cash incentive plan from which he has been receiving approximately $100,000 per year. Finally, he is a participant in a qualified deferred profit-sharing plan. His employer's payments for him into the latter plan are related both to his base salary and to the amounts received by him from the cash incentive plan.

X consults you as to how the payments from the cash incentive plan can be deferred until after his retirement without having A Corporation's payments for him into the qualified profit-sharing plan correspondingly reduced. A Corporation is aware of his desires and is willing to be co-operative. Deferring the payments under the cash incentive plan is easy, you tell him. The cash incentive plan is so drawn that the directors of A Corporation can at any time drop from the plan one or more of the plan participants without cause. Hence, he should be dropped from this plan and in lieu thereof be given an individual nonqualified deferred compensation contract providing for the payment to him in each year after retirement of the amount he would have received in the corresponding year of employment under the cash incentive plan.

Thus, if X will retire on December 31, 1969, he should receive in 1970 under the nonqualified deferred compensation contract what he would have received in 1964 under the cash incentive plan, and in 1971 what he would have received in 1965, etc. To forestall any constructive receipt arguments (in spite of Rev. Rul. 60-31, C.B. 1960-1, p. 174), the nonqualified deferred compensation contract should have appropriate forfeitability clauses.

You then tell him that avoidance of reductions in A's contributions for him to the qualified deferred profit-sharing plan can only be done by an amendment to that plan which would include future deferred compensation as part of the measure of current contributions. He tells you that, although A Corporation is cooperative, it is reluctant to amend that plan. In the first place, A just doesn't want to disturb that plan and secondly, such a provision might cause the qualified plan to be discriminatory and to lose its qualification.

Thereupon, you point out to him a method of accomplishing the same practical result by indirect means. This is because nonqualified individual deferred compensation contracts offer great flexibility. X's contract can be drawn so that in 1970 he would be paid not only what the cash incentive plan would have paid him in 1964, but also what the qualified deferred profit-sharing plan would have paid him in 1970 if A Corporation's 1964 contribution for him had been determined by both the 1964 cash incentive payment and the 1964 base salary.

Correspondingly, similar payments would be called for in later years, i.e., in 1971, X would receive under the contract what the cash incentive plan would have paid him in 1965 plus what the qualified deferred profit-sharing plan would have paid him in 1971, if A's 1965 contribution for him had been determined by both his 1965 cash incentive payment and his 1965 base salary.

Profit-Sharing Plan Amendment Under Unusual Circumstances

Reasons why it was inadvisable to terminate the plan.

A favorable determination letter was obtained approving an amended profit-sharing plan under rather unusual circumstances. The employer had made two annual contributions to the plan trust and then sold practically all of its business assets, remaining alive as an investment company with two employees.

Amendment, rather than termination of the plan, was selected for the following reasons:

1. The premature termination problem was probably avoided.
2. Any possible controversy as to whether distributions to the other participants withdrawing from the plan were caused by their separation rather than termination of the plan was avoided.
3. All the tax advantages of a profit-sharing plan continued for the two remaining stockholder participants. The original group had over fifty participants.

Conversion of a Pension Plan To a Profit-Sharing Plan

An explanation of how this was accomplished.

A company became dissatisfied with the operation of its pension plan which it had installed during the year 1955. Among other things, the company found after four years of operation that for the last two years it was scarcely able to make a contribution covering past services.

At the time the company's Federal income tax returns were being examined for the years 1956, 1957 and 1958, a problem arose upon review by the local pension section of the Revenue Service with respect to the plan's termination. If the plan's termination provisions were literally followed, the distributions to employees would be discriminatory. Consequently, the Service would not permit the termination without disqualifying the plan in its entirety for all the years under review.

It was suggested to the company that, rather than terminate the plan, it be converted to a profit-sharing plan. The changeover was allowed by the pension section for the following reasons:

1. The company's principal customer, the source of over two-thirds of the company's sales, would not allow any portion of the pension plan contribution covering past service liabilities as a cost under a cost-plus contract, whereas this customer would allow as a cost its pro rata share of the profit-sharing contribution.
2. Relatively poor profit had resulted from operations in recent years.

3. The company was of the opinion that a contribution to a plan based on operating profits would serve as an incentive to employees to improve their efficiency and thereby help to increase not only the profit-sharing contribution, but also net profits of the company.

4. Barring an unforeseen sharp economic recession, the prospects from future operations appeared to indicate that sufficient earnings would be realized so that the company would be able to make a contribution to the amended plan substantially in the amount as under the pension plan.

The Service felt that the aforementioned factors constituted valid business reasons for the termination of the existing pension plan and substitution of a profit-sharing plan. The substitution of the profit-sharing plan in any event has the advantage for future years that if the company experiences small or no profits, its expense for a profit-sharing contribution will likewise be small or nothing at all.

The conversion of the pension plan to a profit-sharing plan was technically accomplished by terminating the old plan and establishing a new plan. Before the pension plan could be terminated, amendments were made to it to eliminate any of the discriminatory features which would have tended to favor highly compensated employees if the plan had been terminated without amendment.

This type of conversion could also be accomplished where it is desirable to convert a profit-sharing plan to a pension plan. In such cases, problems of discrimination are not likely to arise since a qualified profit-sharing plan usually provides for roughly proportionate credits for all participants.

Profit-Sharing Plan Forfeiture Reallocations

It is understood that one District Director's Office, as a matter of policy, will approve no further profit-sharing plans which reallocate forfeited accounts of withdrawing participants over the accounts of the remaining participants in the ratio of those account balances. The region will approve reallocations which are based on the ratio of the remaining participants' compensation for the current year, i.e., the forfeitures can be added to the current year contribution, and the total allocated in the ratio of

Sec. 401 the participants' compensation. It is understood that the region feels that reallocation on account balances results in a discriminatory "ballooning" effect.

Consulting Contracts Versus Retirement Pay

A means of preserving social security benefits.

A company had an employee who had reached sixty-five, but who did not qualify under the company's pension plan because of having joined the company after he was forty-five. The company felt some obligation to this employee and proposed giving him a contract as a consultant for several years after retirement. The draft contract required him to furnish such advisory and consulting services as would be required of him and not to compete with the company.

Examination of the draft contract indicated that if the retired employee entered into such a contract with the company, he would be deemed to be receiving compensation for services and so might not qualify for social security benefits until he reached seventy-two, which meant that between himself and his wife he would lose some $2,000 a year tax-free income. The company was surprised to learn this and asked for suggestions. It was suggested that since this employee had rendered valuable services to the company for many years, it would be justified in giving him retirement pay without requiring any services from him. The agreement with this employee was therefore revised so that it now provides that he will receive the same amount per year as retirement pay which the company was planning to pay him for consulting services. All the contract now requires is that he shall not compete with the company in the United States.

Sec. 402 Retired Employees and Consulting Contracts

It could be important to obtain a ruling.

The Pension Trust Branch of the Revenue Service has issued a number of advance rulings on whether employees who retire and immediately enter into consulting contracts with their employer will be considered to have separated from service for purposes of the capital gain treatment on lump-sum distributions under Section 402(a)(2). Before ruling, the Pension Trust Branch requires the employee to submit a copy of the consulting contract and a detailed statement of the duties and circumstances of the individual's employment so that a comparison can be made between the employee's relationship with his employer both before and after his retirement. In ruling on this question the Pension Trust Branch follows the rulings issued by the Employment Tax Branch on the employer-employee relationship. Rulings on the employer-employee relationship have been published including Revenue Ruling 55-695, Revenue Ruling 55-466, Revenue Ruling 56-528 and Revenue Ruling 54-586. The capital gain treatment apparently depends upon whether the subsequent services are rendered as an independent contractor. *Sec. 402*

A taxpayer received a favorable ruling allowing capital gain treatment on distributions received from the employees' profit-sharing trust within one year of termination of services as an officer-employee (treasurer) of a closely held company. The taxpayer remained on the board of directors and was retained on a consulting contract at $15,000 per annum.

The Service ruled that there was a separation from the service of the employer because the employer-employee relationship did not exist as defined for employment tax purposes. Specifically the ruling stated that "where the employer-employee relationship does not exist for Federal employment tax purposes it will be considered that such relationship does not exist for purposes of Section 402(a) of the Code." The ruling also made note of the fact that the taxpayer was on boards of directors of several other companies.

Capital Gain on Admission to Partnership

Employee who is made a partner will be deemed to have terminated his employment for the purpose of qualifying for capital gain treatment on lump-sum distribution under the pension plan.

An interesting tax planning opportunity exists for partnerships where new partners are generally elevated from the ranks of employees of the partnership. This possibility arises through the use of a qualified pension, profit-sharing or annuity plan.

The beneficiary of a qualified employees' trust or annuity plan may obtain long-term capital gain treatment for certain lump-sum distributions on account of the employee's death or other separation from the service. If a partnership has such a plan, it is clear that participation is restricted to "employees," and partners themselves are not allowed to participate since the partners would not be employees. This raises the interesting question of what happens when an employee of a partnership is admitted to the partnership and ceases to be an employee.

Specifically the question arises whether admission of an employee of a partnership to membership in the firm would constitute a separation from service in order to permit the employee who becomes a partner to receive a lump-sum distribution of the amount standing to his credit in the employee plan as a long-term capital gain.

It is understood that the Internal Revenue Service has issued unpublished rulings to the effect that an employee does become separated from service when he becomes a partner. Apparently, the Internal Revenue Service has no choice but to rule in this manner, since only an employee may be covered under a qualified plan. However, since the Service has not published its position in this matter, partnerships or employees of partnerships which may be affected might consider requesting a specific ruling covering this point.

Revenue Ruling Will Announce Change In IRS Position

It was good while it lasted.

On December 11, 1950, the Internal Revenue Service in a special ruling held that a distribution in cash, and an annuity contract to a participant under an exempt employees' trust in the year of termination of services, entitled the participant to long-term capital gains treatment with respect to the cash received. It was held that payment in a later year under the annuity contract would be taxable as ordinary income.

Subsequently the Pension Trust Branch changed its position and in a number of private rulings denied capital gains treatment under Section 402(a)(2) where it was proposed to distribute an annuity contract with respect to a portion of the employees' interest in a trust exempt under Section 401(a), with the balance of the interest being distributed in cash in the year employment terminated. Capital gains treatment was approved as to both the cash and the annuity contract proceeds in cases when the annuity contract was surrendered for its cash value in the same year the contract and cash were received and employment terminated. *Sec. 402*

It is now learned that a Revenue Ruling which has been under consideration will soon be issued specifically overruling the aforesaid special ruling of December 11, 1950. No capital gains treatment will be recognized in any case where the distributee can receive any amount in a year subsequent to the year of termination of employment. Ordinary income will be held to have been received as to the cash in the year of distribution as well as to the subsequent annuity payments.

Pension Trust Past-Service Contributions

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The question presented here would appear to have not yet been finally resolved.

The following question was submitted to the Internal Revenue Service:

In 1955, calendar-year Company A set up a trusteed pension plan and paid in $100,000 to completely fund past services. It also made a contribution for the year 1955 at the time it set up the plan. It took as a deduction in 1955 $12,000 in respect of current costs, plus one-tenth of the amount paid in to fund past services, or $10,000, making a total deduction for 1955 of $22,000. In 1956, 1957, and 1958, it also contributed an amount to cover current costs and claimed this as a deduction, in addition to one-tenth, or $10,000, in respect of past services.

In 1959, the company incurs a loss or is short of cash and so does not pay anything into the pension fund. It can, of course, claim as a deduction in 1959 one-tenth of $100,000, or $10,000, in respect of past services. However, can it take part of the $100,000 which it paid in 1955 to fund past services and treat this as a payment of current service cost in 1959? In other words, can it

Sec. 404 borrow from the amount it paid in to fund past services in the prior year (1955) and use this as a current service payment?

The Revenue Service representative referred to Section 404(a)(1)(C) of the Code which he said limits the deduction for past services to 10 per cent of the $100,000 of the total past service costs. He stated that this limitation cannot be exceeded simply by designating the amount in excess of $10,000 as a deduction for current service costs. In other words, the maximum limitation under Section 404(a)(1)(C) is $10,000 in the example and this amount cannot be increased to $25,000, for example, through the expedient of designating the additional $15,000 as a current service cost.

In the situation described in the example he stated that the $100,000 payment in 1955, even though voluntary, is nevertheless a payment in respect of past services. Unless the company is permitted to withdraw this amount at will, which he said he assumed is not the case, he does not see how the Service can allow a deduction for current service costs. To treat a designation of a portion of the amount paid in 1955 as a payment for current service costs would, he said, require the Service to view the transaction as one in which the company first "borrowed" or withdrew from the trust an amount equal to the current payment from the trust and then paid this amount back to the trust. He does not believe the company under these circumstances has any right to make such a withdrawal.

The Service representative was unable to refer to any specific authority on this matter. However, he stated there is no doubt that this is the way the Service would rule on the question if it were submitted in a formal ruling request.

Pension Plan Data to Be Filed With Returns

Remember to file Form 2950.

Regulation Section 1.404(a)-2 which was amended by T.D. 6599 adopted May 9, 1962, not only made the filing of Form 2950 mandatory for years ending on or after December 31, 1961, but made two other significant changes as follows:

1. In addition to the information required by Form 2950, the following information must be furnished each year in the case

of a pension or annuity plan: A summary of the costs or liabilities and adjustments for the year under the plan based on the application of the methods, factors, and assumptions used under the plan in sufficient detail to permit ready verification of the reasonableness thereof. Heretofore, this information was required only in the first year of the plan.

2. For years ended after December 31, 1961, only the Commissioner has authority to waive the filing of information. Previously, such authority rested in the District Director.

Determination of Profit-Sharing Contribution Simplified

A simple solution is to provide that the profit-sharing contribution be computed on net income before deducting any taxes based on income. The rate of profit-sharing can be decreased to compensate for the larger base.

There are many profit-sharing plans which, at least potentially, confront management and accountants with very difficult algebraic calculations. For instance, in a situation where the profit-sharing contribution is to be determined on net income after Federal income tax, and the company does business in a number of states which impose taxes measured by income, there will be numerous unknowns with which to cope. One plan amendment which has received the approval of the Service provides that wherever highly complex mathematical calculations are necessitated in respect of relatively insignificant amounts the treasurer of the company has the power to take whatever short cuts he deems fit. Another means of avoiding this situation is to provide for discretionary payments to the profit-sharing plan insofar as they are permitted by the present regulations. However, this does not help the company which is already committed to a formula-type plan, unless the plan may be amended.

Contributions to Qualified Plans

In an address before the Council of Profit-Sharing Industries in San Francisco, Isidore Goodman, Chief of the IRS Pension

Sec. 404 Trust Branch, stated that a plan which had compulsory employee contributions of up to 5 per cent (Treasury will approve up to 6 per cent) could have voluntary contributions in addition of up to 10 per cent, making a total of 15 per cent (actually could be up to 16 per cent). Such contributions by participants can, in some cases, make qualified plans even more attractive.

Paying Pension Trust With Note

What looks smart in taxation can sometimes turn out to be smarty. Suppose an employer pays his obligation to a pension fund with the employer's note. One court has held that the employer can take such a payment as a deduction. But where does that leave the pension trust? Isn't it in effect making an unsecured loan, and therefore indulging in a prohibited transaction? If so, the whole house of tax cards crashes, with the employees up in arms to boot.

If cash can't be used or raised, a safer bet is to pay with preferred stock. One of the ironies of the law is that an unsecured loan is a prohibited transaction, but stock, which is junior to the unsecured loan, is acceptable.

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Employee Stock Plans Requiring No Cash Investment

Be careful that these plans can be sustained as bona fide.

The provisions of Regulations Section 1.61-2(d)(5) dealing with employee's compensation for property received which is subject to restriction, and related Regulations Section 1.421-6 dealing with unrestricted stock options, suggest two methods of giving officers and other key employees an opportunity to benefit from future growth of the company without investing any money. These plans should be particularly useful where for some reason a restricted stock option plan is impracticable. While the tax effects of these plans are somewhat less certain than in the case of a restricted stock option, the results of underestimating the fair market value of closely held stock are less disastrous.

Under the first plan, stock is purchased by the employee for nonrecourse notes. An outright purchase is made from the corporation at the fair market value of the stock, for which the employee gives in payment notes with the stock pledged as collateral. At no time would the employee be liable on the notes for an amount greater than the value of the stock. The employee has all the rights of a shareholder, including the right to receive dividends or to have them credited against his indebtedness.

The desired tax result is that if the employee sells the stock more than six months after he purchased it, the appreciation will be taxed to him as long-term capital gain.

Because of the nonrecourse feature of the plan, it is very possible that the Service will contend that in substance the transaction amounts to an option rather than a purchase, with the result that, under the regulations, the profit referred to above would be ordinary income. However, the fact that the employee had all of the attributes of ownership may more than offset any option elements that are present. In addition, the plan may be subject to attack in individual situations on the ground that the purchase is not bona fide. Therefore, precautions should be taken to establish the good faith of the plan. For example, it would be well to have the notes bear interest at the going rate and to have the interest paid promptly when due.

Furthermore, the Treasury might contend in some instances that the fair market value of the stock when acquired was higher than the agreed sales price. If such a contention prevailed, the employee would be taxed on such excess as ordinary income in the year of purchase. The amount on which he was taxed would be added to the basis of the stock for purposes of computing gain or loss on its subsequent sale.

The second plan is one where stock is given to the employee outright, but he is required to return it to the corporation if his employment is terminated for any cause within a reasonable fixed period, say, three years. As soon as the required time has elapsed, the employee is free to sell the stock.

According to the Regulations (Sec. 1.421-6(d)(2)) the lower of the fair market value of the stock when he acquired it, computed without regard to the restriction, or the fair market value when the restriction lapsed is taxed to the employee as ordinary income. If the stock has appreciated since he acquired it, the appreciation realized on its sale is taxable as capital gain.

For example, assume that on January 1, 1960, an executive is given 100 shares of his company's stock, which has a fair mar-

Sec. 421 ket value of $10 per share, subject to an obligation on his part to return the shares if his employment terminates in three years. His employment continues and immediately after the restrictions expire in 1963, he sells the stock, realizing $20 per share, or $2,000. For tax purposes in 1963, he has ordinary income of $1,000 and long-term capital gain of $1,000 on account of his stock.

In the above illustration, the employer is entitled to a deduction of $1,000 for compensation paid, subject to the usual requirement that the executive's total compensation is reasonable. It is not clear, however, whether the deduction is allowable in 1960 or in 1963. Regulations Section 1.61-2(d)(5) relates to the time of reporting compensation by an employee for property received which is subject to restriction. While this section does not cover the time for claiming the deduction by the employer, presumably the same rules would apply as in Regulations Section 1.421-6, which indicates that in the case of an unrestricted stock option the deduction is claimed in the same year that the employee reports the income, which in this case is 1963. For a somewhat analogous situation, see *Union Chemical & Materials Corp.*, Ct. Clms., 1961.

Under the second plan, as under the one first described, it is important to be able to prove that the plan is bona fide. The employee must receive all the rights of a shareholder during the period the restrictions are in effect. For example, stock certificates (with the restrictions endorsed thereon) should be issued to him, and he should be entitled to dividends and to full voting rights.

Unrestricted Stock Options for Company Executives

An addition to the yearly audit program?

When a company gives its executives an unrestricted stock option there can be income to the executive and a like amount of deduction to the company at the time of grant, at the time of exercise, or at a later date if the stock is subject to restrictions, depending on the facts. Sometimes, on a Revenue Agent's examination, the amount of income is increased for the executive, based on an increase that the Government makes in the value of the option. It is important under such circumstances to follow through to make sure that the company gets the correlative increased deduction. A systematic program should be followed of checking with the executives, at least one year before the Statute of Limitations runs, to find out whether there have been any changes made by the Government in that respect in their personal returns. *Sec. 421*

Planning for Stock Options

Some interesting considerations.

The granting of restricted stock options to "key" employees after December 31, 1963, must meet the stringent tests of new Code Sections 421 through 425, covering "qualified stock options." With one exception, relating to grants made pursuant to binding agreements, employers who expect to continue to grant employee options must formulate new plans or amend their restricted stock option plans so as to meet the new rules.

Several planning considerations are of interest in implementing the new requirements.

1. *Consider modification of certain 1964 options.* Restricted stock options which have been granted in 1964 (other than those issued pursuant to a binding contract entered into prior to January 1, 1964) can be modified to meet the requirements of qualified stock options using the fair market value at the date of original grant. These options, like all qualified stock options issued in 1964, are not required to have stockholder approval. This provision will be of benefit where the market value of stock subject to options granted in 1964 has increased since the date of grant.

2. *Consider duration of the option.* Qualified stock options can be made exercisable for a period of five years from the date of grant. However, before issuing options with a five-year exercise period, the possibility of a decline in market prices should be considered, since qualified options with a lower option price than qualified or restricted stock options previously granted cannot be exercised until the earlier options are exercised or expire.

Sec. 421 Thus a five-year option period may preclude (for a period of time) new options with lower prices.

3. *Establish a reporting system.* New reporting requirements contained in the 1964 Revenue Act make it necessary for issuing companies to set up systems so that they can obtain the information required for reporting to the Government. These systems should be instituted immediately and should provide means of determining all reportable transfers since January 1, 1964, of stock issued as a result of options exercised on and after January 1, 1964.

Provision must be made so as to accumulate the following information:

(a) Every transfer of stock by a corporation to a person as a result of the exercise of a qualified stock option or a restricted stock option during each calendar year.

(b) The first transfer of such stock by a person who received the stock as a result of the exercise of an 85 per cent to 95 per cent restricted stock option.

(c) The first transfer of stock by a person who received such stock as a result of the exercise of an employee stock purchase plan option at less than 100 per cent of fair market value.

Transfer of stock to a street name is considered a transfer for purposes of items (a) and (b).

"Modifications" of Restricted Stock Option: Tax Status Preserved

This is supported by a private revenue ruling.

A number of listed corporations have adopted restricted stock option plans which provide that at the time of the exercise of an option, the holder (or a person exercising the option after death of the holder) shall represent to the corporation that at the time of exercise it is his present intention to acquire the shares for investment and not with a view to distributing the shares. The purpose of the investment representation was so the person exercising the option would not be deemed to be an "underwriter" for Securities and Exchange Commission purposes and would not have to register the stock.

Because the investment representation requirement is burden-some upon a holder of an option and probably even more so on his heirs (or other person exercising the option after death of the holder), it is sometimes desirable to remove such a requirement from a stock option plan. The Internal Revenue Service has ruled privately on several occasions that deletion of the investment representation requirement in a restricted stock option plan is *not* a "modification" as defined in Section 421(e)(2) of the Internal Revenue Code of 1954. *Sec. 421*

This point is particularly important at this time because a modification of an existing restricted stock option constitutes the granting of a new option which would be governed by the new rules set forth in the 1964 Revenue Act, if the modification occurs after the effective date.

"Disqualifying Dispositions" of Restricted or Qualified Stock Option Stock

A deduction which can easily be overlooked.

Section 421(a) of the Internal Revenue Code provides generally that no deduction is allowable to a corporation with respect to a restricted or qualified stock option which has been granted to an employee.

However, this rule does not apply if the stock acquired pursuant to either type of option is disposed of by the employee within certain periods provided by statute. Such a disposition is called a "disqualifying disposition." In such an event, the general rule, is that the employee thereupon realizes compensation to the extent of the difference between the value of the stock at the time acquired and the option price, and that the corporate employer becomes entitled to a deduction of an equivalent amount.

Employees usually try to avoid a disqualifying disposition because of the additional tax burden which results. However, numerous disqualifying dispositions occur for a number of reasons. For example, the employee may be more concerned about the future market price of the stock than he is about the tax consequences of a disqualifying disposition; he may need the cash to meet personal emergencies or to undertake other ventures; or he may simply be unaware of the meaning and sig-

Sec. 421 nificance of a disqualifying disposition. Whatever the reason, the corporation is entitled to a deduction merely because the disqualifying disposition has been made.

A disqualifying disposition is apt to be overlooked because no immediate business or accounting action is ordinarily necessitated by a transfer of shares from one stockholder to another. In many corporations, the stock transfer functions are conducted by persons, such as the secretary, who do not participate in accounting and tax matters. If an independent stock transfer agent and registrar are used, the corporation will ordinarily not receive this information unless specific arrangements are made. In some cases, the stock acquired may be placed by the employee in a "street name," and the corporation, or its transfer agent and registrar would have no way of ascertaining if the stock had been disposed of.

One method to secure the information would be to send a questionnaire to every employee who has exercised a restricted stock option and who could be affected. Each corporation must determine for itself what method is to be used. Those charged with the responsibility of preparing the corporation's Federal income tax return should seriously consider the possibility of additional deductions.

ACCOUNTING PERIODS AND METHODS OF ACCOUNTING

(Subchapter E)

Sec. 441

Different "Taxable Years" Created by Section 381(b)

Tax advisers should be alert to these provisions.

A strict interpretation of Code Section 381(b) seems to indicate a radical change with respect to the requirements for filing returns for companies which have engaged in certain types of reorganizations. Such change could have a substantial effect upon the determination of refund claims due to carrybacks.

For example, assume that Corporation X acquired substantially all the assets of calendar-year Corporation Y in exchange solely for voting stock in Corporation X (a C-type reorganization) as of September 30, 1958. Assume further that Corporation Y had an operating loss for the period January 1 to September 30, 1958, and taxable income for the period October 1 to December 31, 1958.

Under Code Section 381(b)(1) and the Regulations (Sec. 1.381(b)-1(c)) the taxable year of Corporation Y ended September 30, 1958, despite the fact that it remained in business until the end of the calendar year. A return should be filed for the short period ended September 30 and the loss for such short "taxable year" carried back to the year 1955 of Corporation Y. Moreover, Corporation Y would be required to file another return from October 1 to December 31, 1958 (the date on which Y's taxable year normally would have ended). (Regulations 1.381(b)-1(c).)

If, on the other hand, Corporation Y had taxable income for the period January 1 to September 30, 1958, and a loss from October 1 to December 31, it appears that the loss should be carried back to the year 1956 of Corporation Y. However, note Revenue Ruling 61-191, which is to the effect that losses sustained by a corporation after the date that it is *de facto* dissolved may not be carried back to prior taxable years.

The foregoing represents a substantial change from the procedure which would have been followed under the 1939 Code, since under that law the taxable year would *not* have ended on September 30 and only one return would have been required for the full calendar year. Any net loss falling in that year would be carried back two years.

On the other hand, in a reorganization involving "a mere change in identity, form or place of organization, however effected" (an F-type reorganization), the taxable year of the corporation does not end for Federal purposes on the date of the reorganization. Therefore, if Corporation S changed its state of incorporation, say, from Pennsylvania to Delaware, on September 30, 1958, and is a calendar-year taxpayer, a Federal return need only be filed for the full calendar year. An operating loss for the entire calendar year would be carried back to the calendar year 1955 (of the "Pennsylvania" company). In the case of state returns, states in which the company is doing

Sec. 441 business may require two separate returns for the year of change.

Change of Fiscal Year After Filing Form 2553

The mere filing of this form apparently does not commit the taxpayer.

A corporation was organized in July 1959 and an election to have the income taxed to the shareholders (as permitted by Code Section 1372) was filed within thirty days after incorporation. This form showed that the fiscal year would end November 30, 1959. It subsequently developed that the shareholders would prefer to adopt a June 30 fiscal year. The question arose as to whether the statement in the Form 2553 that the November 30 year would be used amounted to an adoption of a fiscal year. The informal opinion of the Internal Revenue Service is that a fiscal year is adopted by filing a return as prescribed by Section 1.441-1(b)(3) of the regulations and that the error in designating the end of the accounting period on the Form 2553 would not invalidate the election. The conclusion was that the corporation was free to adopt a June 30 fiscal year and that it should merely write a letter to the District Director where the Form 2553 was filed, informing him that a different taxable year would be used than that indicated on the Form 2553.

Change of Taxable Year May Prove Advantageous

A way to accomplish this without permission.

The X Corporation, which is on a calendar-year basis for tax purposes, acquires the assets of another business on September 30. The acquired business is of a seasonal nature. Normally substantial profits are earned during the summer months and losses are incurred during the remainder of the year. It would be advantageous for the X Corporation to change its fiscal year to May 31, the close of the inactive season of the acquired business, in order to take advantage of the seasonal losses of the latter. It is unlikely, however, that permission could be secured to make this change. Sec. 441

It was suggested that X should organize a subsidiary to acquire the new business and should establish a May 31 fiscal year for the subsidiary. After a reasonable time has elapsed X would merge into the subsidiary, thereby accomplishing the desired change of fiscal year (assuming that the problems of a "downstairs merger" may be overcome).

Permanent Deferral of Tax

Sec. 442

Changing a calendar-year personal holding company to a January 31 fiscal year will permit the annual distribution of earnings in January instead of December. Thus, in the year of change, the shareholders might report only one-twelfth of their usual annual income from this source. They have a permanent deferral of tax. If a married shareholder's income was $120,000 a year and was all derived from a personal holding company, such a change could reduce his tax by over $50,000 in the year of change. Such a change in fiscal year can be made without permission if the conditions of Regulations Section 1.442-1(c) are complied with.

Net Losses and Automatic Change of Accounting Year

How to compute taxable income for the purpose of the automatic change rules.

Regulations 1.442-1(c)(2)(iii) requires that the taxable income of the short period resulting from an automatic change in accounting period equal, when annualized, 80 per cent or more of the taxable income for the immediately preceding year. It has not been clear whether the taxable income of the short period and of the preceding year are to be computed before or after any allowable net operating loss deduction.

The position of the Service on this question is now available. Revenue Ruling 65-163 holds that the taxable income for the short period and for the taxable year preceding such period

Sec. 442 means taxable income as defined in Section 63, exclusive of any net operating loss deduction.

Sec. 446

How to Spread Precollected Income

Tailoring the business arrangement to accomplish this objective.

The Supreme Court has declared that income collected in advance is immediately taxable, even to accrual-basis taxpayers (*Schlude* v. *Comm'r,* 63-1 U.S.T.C. Para. 9284). Some service organizations are now following an interesting procedure. When they enter into a long-term service contract with a customer, they ask for payment that covers only that part of the year that expires with the end of their own fiscal year. The contract itself covers a period beyond that, but payment for the extended period is to be made pro rata in each fiscal year of the contractor. This keeps the books and tax returns of the service organization in agreement, and picks up only one year's income at a time. It also averages out the rate bracket. These advantages have been calculated to more than outweigh the easier finances of advance collections.

Hybrid Methods of Accounting

Permission to have hybrid methods affects the problem of change of method vs. correction of error.

The 1954 Code included a new provision (Section 446(c)(4)) authorizing, in addition to the cash receipts and disbursements method of accounting and the accrual method, "any combination of the foregoing methods permitted under regulations." A recent case indicates that this sleeping dog may have sharp teeth with which to bite the taxpayer.

In *Dorr-Oliver, Inc.,* 40 T.C. 50, the taxpayer was generally on the accrual method of accounting and, as of the end of its year, had an accrued liability to certain employees who had vested rights to certain amounts of vacation pay. In 1954, the taxpayer for the first time attempted to deduct its ending vacation pay accrual without the permission of the Commissioner to change accounting methods. The Tax Court in *American Can Co.,* 37 T.C. 198, later reversed (11 AFTR (2d) 63-1555), had allowed such a change without permission in a case arising under the 1939 Code. However in *Dorr-Oliver, Inc.,* the Court held that "the 1954 Code brought about a critical change in respect of the problem before us. Prior to 1954, hybrid methods of accounting were not recognized and a change in the method of treatment of a particular item was not regarded as a change in the 'method of accounting' requiring the prior consent of the Commissioner. . . . But hybrid methods of accounting may now be recognized under the 1954 Code, and consent must be obtained before a change in the method of treating material items is adopted."

Sec. 446

The case does not discuss the provision in the regulation (Section 1.446-1(c)(1)(iv)) that states that a taxpayer using the accrual method for purchases and sales "may use the cash method in computing all other items of income and expenses." It may be that the last word has not been said as to whether use of the cash method for only one expense, as distinguished from "all" expenses, is a combination of methods "permitted under regulations."

It should be noted that the problem of distinguishing between a change in accounting method and a correction of an error has caused a great deal of difficulty. (See, for example, *Fruehauf Trailer Co.* v. *Comm'r,* 42 T.C. 83) Rev. Proc. 64-16 provides a means for resolving many of these problems, including those raised on a tax examination, by permitting taxpayers to request a change in an accounting "practice," subject to a ten-year spread-forward of any resulting adjustment.

Application for Change of Accounting Method

A taxpayer may change his mind after obtaining permission to change his accounting method.

If an application is filed for permission to change the method of accounting and subsequently approval is granted, is it mandatory that the taxpayer then change to the new method of accounting?

Personnel in the Rulings Division of the Service informally indicated that it is its present policy not to consider its approval of the application as an irrevocable election to change; hence, it does not insist that the proposed change be made.

The Rulings Division advised it was not uncommon for a taxpayer, subsequent to the approval, to decide not to make the proposed change. The Service has requested that a taxpayer not electing to make the proposed change should attach to the return, for the taxable year for which the change would have become effective, a copy of the letter in which the permission was granted, and indicate in such return that it has elected not to make the proposed change.

Vacation Pay

Rules for changing from cash to accrual treatment.

Vacation pay accrual has long been an area of contention between taxpayers and the Internal Revenue Service. Recently Congress has again enacted legislation to postpone the effective date of the strict vacation pay accrual rule announced by Revenue Ruling 54-608, 1954-2 C.B. 8. The strict rule will not apply to any taxable year ending before January 1, 1967.

Meanwhile requests have been pouring into the National Office of the Internal Revenue Service for permission to change the treatment of vacation pay—usually from the cash to the accrual method. The ground rules for obtaining favorable consideration of a request for such a change are:

1. The taxpayer must use the accrual method of accounting.
2. The request must apply to vested vacation plans and cover all vested plans which the taxpayer has in existence with any of its employees. No ruling will issue as to any nonvested plans which the taxpayer may have in existence with other employees.
3. Form 3115—Application for Change in Accounting Method —must be completely filled out and filed.
4. The following additional information should be submitted:
   a. The amount of vested vacation pay accrued at the end of the preceding year
   b. The number, if any, of nonvested vacation pay plans in existence

c. Advice as to any vacation pay issues involved in a return under examination or before any court

d. An agreement by the taxpayer to write off the vacation pay adjustment over a period of ten years, including the year of change

In consideration of granting the change, the National Office requires filing of a "terms" letter setting out certain irrevocable agreements on the part of the taxpayer. The letter will usually require the taxpayer to agree:

1. Not to file any refund claims or court proceedings involving vacation pay issues for years prior to the year of change;
2. To deduct the vacation pay accrued at the beginning of the year of change over a period of ten years;
3. Upon future vesting of existing nonvested vacation pay plans, to change to the accrual method for the year in which the plan becomes vested and to allocate the accrual at the beginning of such year over a ten-year period.

The third requirement is the newest wrinkle in connection with vacation pay ruling requests. By putting this condition in the terms letter the Service makes it possible for a taxpayer to change its treatment of vacation pay plans becoming vested in the future without the necessity of another ruling request to the National Office.

Exception to Ten-Year Spread of Change in Accounting Practice

This procedure is experimental, and necessitates consideration of any special circumstances.

Under Rev. Proc. 64-16, a change in "accounting practice" requires that a resulting adjustment be spread ratably over a ten-year period. What if the facts during the ten years depart from the situation which was contemplated?

For example, an accrual-method taxpayer, currently not reporting rents which have accrued but remain uncollected, might agree to report the uncollected rents when accrued. If there were a resulting adjustment of, for example, $30,000, an amount of $3,000 would be taken into income during the year of transition and in each of the succeeding nine years. If in the second year

Sec. 446 the taxpayer charges off as a bad debt $25,000 of the total $30,000 not previously included in income, may he still defer the reporting of the income over the next nine years or must he include in income the portion attributable to the bad debt written off?

The Revenue Service has indicated informally that such a subsequent event would probably serve to accelerate the reporting of the deferred income, so that the balance of unreported income would be taxed in the year of the subsequent event. In order to expedite rulings in this area, a taxpayer might wish to include in an application for change under this procedure a request for consideration of the effect of subsequent events on the contemplated adjustment.

Sec. 451

How Bookkeeping Entries May Create Taxable Income

"Cleaning out" balance sheet accruals or liabilities may be costly taxwise. However, reserves that were not properly deductible to begin with are not taxable when restored to surplus (Greene Motor Co., *5 T.C. 314 and others*).

Can taxable income be created by a bookkeeping entry?

Technically not. The courts generally have followed the principles that bookkeeping "does not create facts, it only records them"; that book entries "may be of value when there is a dispute as to fact, but they cannot work an estoppel as to an undisputed fact"; that books of account "are no more than evidential, being neither indispensable nor conclusive" (*Doyle* v. *Mitchell Bros.*, 235 F.686 (1916); affirmed 247 U.S. 179 (1918); and *Standifer Construction Corporation*, 30 B.T.A. 184; *North American Coal Corporation*, 32 B.T.A. 535; and *Adams*, 5 T.C. 351).

However, where the facts are obscure, a bookkeeping entry *may* become the deciding factor in the absence of contradictory evidence; and where there is a question as to *when* income is taxable, the courts have held the bookkeeping entry to be the controlling event.

The decision in *Lime Cola Co.* (22 T.C. 77) graphically illustrates how a bookkeeping entry can give rise to taxable income. There, an unclaimed account payable, inactive for twelve years, was held to be income in the year an entry was made by the debtor, eliminating the liability and crediting the amount thereof to surplus. The amount represented by the liability had been deducted in the earlier year's return.

The *Lime Cola* case does not stand alone. Salaries credited but not withdrawn became income when the balances were credited to surplus (*Beacon Auto Stores, Inc.*, 42 B.T.A. 703); and uncashed checks were held to be taxable when taken into income on the books (*Chicago, Rock Island and Pacific Railway Co.*, 13 B.T.A. 988).

The foregoing decisions should be kept in mind when the year of "cleaning out" of balance sheet reserves, accruals or other liabilities of a particular client is discretionary. Reversing entries might be made more advantageously in loss years from which no carryover or carryback benefits are expected. It would seem, however, that under the "tax benefit rule," if the deduction never resulted in a tax benefit, the subsequent reversal of the liability on taxpayer's books would not result in taxable income.

Note that one District Court (*Studebaker-Packard Corp.*, 8 AFTR 2d 5058, D.C., Ind.) has held that even where the addition to the reserve resulted in a tax benefit, no taxable income resulted from a transfer of such reserve to surplus in a year subsequent to the year in which it became apparent that the reserve was no longer needed.

No Constructive Receipt of Liquidating Distributions

The availability of such distributions does not govern the year of taxability.

Based on several recent private rulings by the Treasury, it appears that stockholders can choose the year in which income is realized on liquidating dividends.

Where shareholders in a publicly held company had the right to receive liquidating distributions after a certain date by merely turning in the stock of the liquidating company, the Treasury ruled that the date of distribution, for the purpose of determining gain or loss, would be the date of hand delivery or mailing of the distribution or the date when the new certificates were issued in the name of the shareholder. In another case the date of dis-

Sec. 451 tribution was deemed to be the date the shareholders turned in their old certificates.

Since in each situation the shareholders had to turn in their old shares before receiving any distribution, they apparently could control the year of distribution, as well as the six-month period of ownership for long-term capital gain status. Presumably, the same rule would apply to liquidation of a closely held corporation.

Sec. 453 Installment Sale Contemplates More Than One Payment

No election is available if the total price will be paid in a single installment.

It is the position of the Internal Revenue Service that to qualify as an installment sale, the sales price may not be paid in less than two payments. Thus, a sale with the payment of the entire sales price to be made in a single payment in a year subsequent to the year of sale would fail to qualify. The entire amount of gain realized would be recognized in the year of sale although no sales proceeds were received in such year. See Regulations 1.453-2(b) as amended when the new "revolving credit" regulations were adopted.

Installment Sales by Estates and Trusts

The importance of distributing before sale.

Where the property held by an estate or trust has increased in value and it is proposed that a sale be made on the installment basis, attention should be focused on the matter of acceleration of reporting the profit which results where the installment obligation is distributed, such as on the termination of the estate or trust. For example, if the proceeds of the installment sale are to be reported over a ten-year period and administration of the estate terminates one year after the sale, the profit which otherwise would be reportable over the remaining nine years becomes taxable to the estate in the year of termination. Obviously, the consummation of the sale should be deferred until after the asset has been distributed. Transfer of the installment receivable asset from the estate to a testamentary trust also would accelerate taxation of the installment profit, as would distribution of the installment obligation upon termination of the trust. By reason of Section 453(d)(3), no acceleration results from transmission of installment obligations at death of the owner. In that event, the income element becomes an item of income in respect of a decedent and is taxable under Section 691. *Sec. 453*

Installment Reporting on Sale of Corporation

The problem and possible solutions.

A difficult problem is created when a corporation is liquidated under Section 337 and the shareholders receive in liquidation an installment obligation received by the corporation from the purchaser of its property. Under these circumstances installment reporting is lost, since the fair value of the installment obligation must be reported as liquidation proceeds in full. A Section 333 (one-month) liquidation might have been a satisfactory alternative if the accumulated earnings and profits of the corporation were not too large. After liquidation under that section, the stockholders could have sold the property on the installment basis.

It is possible to use, on occasion, a different alternative, which is practical where the purchaser is acquiring the bulk of the corporate assets—typically where incorporated real estate is involved. The shareholders of the selling corporation agree with the purchaser to sell stock, rather than assets, in return for the purchaser's installment obligation. The purchaser immediately pledges the stock as collateral to secure the installment obligation. The parties further agree that at such time as the purchaser liquidates the corporation the sellers will co-operate by releasing the stock from collateral to the purchaser, who will, immediately after liquidation, place a mortgage on the assets received and transfer the mortgage to the sellers as replacement security on the installment obligation.

This procedure allows the sellers to use installment reporting

Sec. 453 on the sale of their stock and ultimately to receive a mortgage on the real estate or other assets to secure the purchaser's installment obligation. Revenue Ruling 55-5 appears to be authority for the proposition that the replacement of the mortgage for the stock as security does not accelerate the profit of the sellers. The purchaser should enjoy a stepped-up basis for the corporate assets if he liquidates soon after the purchase of the stock. On the other hand, the purchaser must be alert for any potential income under Sections 1245 or 1250 (depreciation recapture) or tax increase under Section 47 (early disposition of investment credit property) which might result from liquidating the corporation after he purchased the stock.

How to Adjust Installment Obligations

Problems arising from forgiveness of installment obligations.

Suppose a taxpayer makes an installment sale of property to a member of his family or to a charity and in subsequent years forgives a portion of the indebtedness arising from the sale. How does the cancellation by the seller of one or more of the notes issued to cover the unpaid portion of the sales price affect his Federal income tax liability?

The Internal Revenue Service has generally considered that this forgiveness of an installment obligation constitutes a disposition, giving rise to taxable income to the donor under Section 453(d) of the 1954 Internal Revenue Code. The amount of income is the difference between the basis of the installment obligation in the hands of the donor and its fair market value at the time of the cancellation. This view is expressed in Rev. Rul. 55-157, C.B. 1955-1, p. 293. A different conclusion was reached by a Federal District Court in the case of *Miller* v. *Usry* (D.C., La., 1958) 1 AFTR 2d 1295, when a taxpayer cancelled his son's installment notes. The Court said the cancellation constituted a "satisfaction" at other than face value, rather than a "disposition" of installment obligations. If an obligation is "satisfied" at less than its face value, gain is measured by taking into account the amount realized from the satisfaction and in this case the Court considered that nothing was received in satisfaction of the obligations.

Because of the income tax problems arising, an approach worthy of consideration is a modification of the contract of sale rather than the cancellation of installment notes. If it can be demonstrated that for sound and valid reasons the contract is being amended, perhaps because it is now agreed that the original sales price was too high, no disposition of installment obligations will take place. It is then permissible to reduce the taxable gain in the remaining installments, as these are collected, so that the total profit reported will be the amount based on the reduced price in the revised contract. This position was supported in the case of *J. L. Jerpe,* 45 B.T.A. 199 and *Dalriada Realty Co., Inc.,* 5 B.T.A. 905; also by Rev. Rul. 55-429, C.B., 1955-2, p. 252. *Sec. 453*

Manufacturers May Use Installment Reporting

Deferring taxes cuts down borrowing needs and thus reduces interest expense.

A manufacturing client sells to distributors on extensive credit terms. It was suggested that the credit terms could be arranged to fit the installment sale provisions and that an election could then be made to report income on the installment basis. A sale of receivables was effected at the end of the fiscal year preparatory to electing the installment basis for the next fiscal year (because it was feared that the original method of selling might be successfully contended by the Service to be installment selling) and then the revised form of selling was inaugurated.

The Internal Revenue Service has issued a favorable ruling in this matter. As a result of the change, a substantial amount of Federal income tax will be deferred. If the specific installment requirements with respect to Federal excise taxes are complied with, a substantial amount of excise taxes may also be deferred.

Disposition of Installment Obligations

A convenient check list.

Section 453 permits a taxpayer to report gain from sales of property on the installment basis, provided certain conditions are met. Should the obligations received under installment sales

Sec. 453 be transmitted, distributed, sold or otherwise disposed of, recognized gain or loss results in the year of disposition. In dealing with transfers of installment obligations between related taxpayers, Section 453 and regulations issued thereunder have provided several exceptions to this general rule.

The following transfers of installment obligations will generally be deemed to be nontaxable to the transferor:

Transferee	*Transaction*	*Related Section*
Controlled corporation	Tax-free incorporation	351
Parent corporation	Liquidation of subsidiary	332
Surviving or new corporation	Merger or consolidation	381
Partnership	Contribution by a partner	721
Outgoing partner	Withdrawal from partnership	731
All partners	Dissolution of partnership	731
Estate	Upon death of taxpayer	691

The following transfers of installment obligations will be deemed taxable to transferor:

Transferee	*Transaction*	*Related Section*
Donee	Gift	1001
Stockholder	Upon liquidation of corporation	331
Stockholder	Distribution not in liquidation	301

Where a corporation adopts a plan of liquidation under Section 337 and sells its assets, under an installment sale, within one year after adopting the plan, there is no gain to the corporation upon distribution of its installment obligations to the stockholders. This is so, provided the installment obligations were received from sales qualifying for nonrecognition under Section 337. The transferee stockholders, however, must take into consideration the fair market value of the installment obligations in computing the total received on liquidation. Gain or loss on liquidation of the corporation is then measured by the total value of assets received less the basis of the stock of the liquidated corporation.

On the other hand, where stockholders elect to liquidate a corporation within one month under Section 333, the gain to the stockholders is expressly limited by the provisions of that section. But there is no mention of limiting the gain to the transferor corporation. It would appear that if a corporation held installment obligations at the time of its liquidation under Section 333, the deferred gain would become taxable to the liquidating corporation upon distribution of such obligations to its stockholders, with a resultant increase in earned surplus, which in turn would increase the taxable income to the stockholders. *Sec. 453*

Upon a liquidation where Section 334(b)(2) applies, no gain is recognized upon transfer of installment obligations from the acquired subsidiary to the parent company by reason of the liquidation being governed by Code Section 332.

Use of Installment Sale for Stepped-up Basis

A double advantage.

Subject to the limitations found in Sections 707(b) and 1239, it appears feasible to transfer depreciable properties between related entities and obtain a higher depreciable base (assuming that the transfer price is based upon bona fide present fair market value).

A taxpayer has successfully combined this type of transfer with installment sale treatment of the transaction by the transferor. By providing for the payment of most of the principal amount involved in a much later year or years, the offsetting capital gain tax can be postponed for a considerable period of time. Nevertheless, the transferee gets the immediate benefit of higher depreciation deductions.

Tax Saving by Accruing Savings Bond Interest *Sec. 454*

A year-of-death election may prove advantageous.

Rev. Rul. 64-104, IRB 1964-13, 13, dealing with the status of unreported increment in value reflected in the redemption price of Series E United States savings bonds as income in respect of a decedent under Section 691(a), serves as a reminder of the possibility of utilizing the election contained in Section 454 to minimize taxes. Under Section 454, a cash-basis taxpayer (which includes most individuals) can elect to treat the annual increment in Series E bonds as income in the year it accrues. If the election is made, it applies to the entire amount of increment existing

Sec. 454 as of the beginning of the election year in addition to the amount accruing within such year.

Normally, cash-basis taxpayers do not make the election, preferring to await the "cashing" of the bond before incurring tax liability. But suppose in the situation described in Rev. Rul. 64-104 (a decedent had died owning bonds on which the increment had not been reported) the decedent had little or no income in the year of death. This situation might arise because the date of death was early in the decedent's taxable year, because of large medical expenses or for other reasons. The personal representative of the decedent should consider making the Section 454 election so that the entire increment in value of the bonds for all prior years would be taxed on the decedent's final return. Then when the bonds were subsequently cashed in by the estate or by the beneficiaries, no income in respect of a decedent would result.

If the estate was not subject to estate tax, no attributable estate tax deduction would have been available to the recipient of the income in respect of a decedent which would be sacrificed by the election. Assuming, on the other hand, that an estate tax was payable, the final return's tax liability would qualify as a debt of the decedent. If, in addition, the estate or beneficiaries were in substantially higher income tax brackets than was the decedent in the year of death, an over-all tax saving would be accomplished.

Sec. 472 Lifo and Bargain Purchases

How to get the maximum tax advantage of a bargain purchase of inventory.

When there has been a bargain purchase of inventory, the purchaser may realize an extraordinary amount of taxable income in the first year, due to inventory turnover. This realization may in many cases be avoided by the election of Lifo, preferably the dollar-value method using one pool as allowed in the regulations under the natural business unit rule. If Lifo is used, an election should be made to compute inventory increases on the basis of items first acquired during the taxable year, so that the bargain purchase price is built into the base.

For dollar-value Lifo purposes, the best procedure is to effect the purchase at the end of a month and immediately close off the taxable year of the purchaser. A new corporation is frequently used as purchaser. In such case the bargain price becomes the base, and the Lifo election is made for the following year. If it is not feasible to follow the foregoing procedure, and the bargain purchase is effected at some time during the taxable year, the acquisition of the inventory at a bargain price is treated as an inventory increase, and if the use of first acquisitions is elected as suggested above, the Lifo inventory at the end of the year is computed item by item, using the bargain price to the extent of the quantity of the bulk purchase and the costs of additional items in the order of their acquisition. *Sec. 472*

As inventory is zero at the beginning of the year, the year-end inventory consists of new items entering a pool for the first time, and the base-year unit cost of each entering item is the current-year cost of that item, unless the taxpayer is able to reconstruct or otherwise establish a different cost (Reg. 1.472-8(e)(2)(iii)). Therefore base cost and current cost can be treated as the same under Reg. 1.472-8(e)(2)(iv), and the resulting ratio for the first taxable year is 100 per cent. In the second taxable year the comparison of base-year cost and current cost will result in a high ratio, which should hold the Lifo inventory down to the bargain-price level and prevent any large realization of gross profit. The Lifo election in such case should be made for the year in which the inventory is purchased.

Imputed Interest *Sec. 483*

This new law may have surprising applications.

Code Section 483, involving imputed interest, is likely to cause all sorts of surprises. It may crop up in the following examples:

1. In contingent payments received after a year under a contract which in itself is not of the installment type.

2. To disqualify what was thought to be an installment sale. Suppose the sale price is ostensibly $10,000 and the down payment is $3,000. Ordinarily that would qualify. But if the imputed interest is $2,000, the sale price is only $8,000, and $3,000 is more than 30 per cent. Hence there is no installment sale.

3. To necessitate withholding from aliens in respect of payments that purportedly are principal.

Sec. 483 4. To disqualify stock options because the option price, when reduced by the imputed interest, is less than the minimum price required by the Code. This could affect all three types — restricted, qualified and employee stock purchase plans.

5. To cause a corporation to become a personal holding company because of the conversion of what was seemingly principal to interest, the latter being personal holding company income.

6. In the sale of a nonbusiness asset such as personal residence even at a loss.

7. In purchase of a corporation stock or a partnership interest on a stretch-out basis.

The list is not all-inclusive. This ubiquitous section is likely to intrude itself in other strange places.

Installment Sales and Imputed Interest

The imputed interest rule must be carefully observed in connection with installment sale computations.

Sellers seeking to qualify a sale for installment treatment must exercise caution in view of the enactment of new Section 483. In the past, the seller would frequently attempt to take up as much of the price as possible in the year of the sale without violating the 30 per cent test of Section 453(b)(2)(A). With respect to future sales where this objective is sought, the seller must measure qualification for the 30 per cent test in the light of Section 483.

New Section 483 imputes interest to sales or exchanges of property after June 30, 1963, where the contract provides for payments to be made beyond one year after such sale or exchange and there is either no interest or insufficient interest ("unstated interest") on payments deferred beyond six months. The portion of a deferred payment which is to be treated as interest under Section 483 is to be treated as interest for all purposes of the Code (Section 483(a)). The seller, however, need not consider Section 483 where the sale of the property would not be accorded capital gain treatment.

To determine whether the 30 per cent test has been met in an installment sale, the "selling price" must be reduced by the total amount of unstated interest included therein, according to TIR No. 557, March 25, 1964. Therefore, to avoid the danger of having the gain fully realized in the year of sale, the seller should give consideration to the operation of this new section. Note that in turn, payments in the year of sale are also to be reduced by unstated interest if they are due after six months from the date of the sale. These payments must not exceed 30 per cent of the selling price as reduced by the unstated interest if installment sale treatment is to be obtained.

Is It Better to Stipulate or Impute Interest?

Certainty is preferable in this situation.

Interest is imputed at 5 per cent unless the agreement affirmatively provides for at least 4 per cent. This applies to sellers only with respect to installment-type sales of capital assets and Section 1231 assets for a selling price of over $3,000 entered into after June 30, 1963.

Is it better to provide for the interest in the sales agreement or let the Code and regulations take over? The answer is to provide for the interest. One reason is that there can be the 1 per cent differential between 4 per cent and 5 per cent. Another is that by providing for interest, the amount is reportable in the regular accrual pattern. The imputed interest is reportable only in respect of "payments." Proposed Reg. Section 1.483-2(a)(1) stipulating interest makes a record of the interest clause in the event that the contract is assigned to another party. Also, providing for interest and reducing principal avoids excessive sales taxes, transfer taxes, etc.

Deduction of Imputed Interest

A case in which the new law provides for a deduction and no offsetting income.

Section 483 substantially precludes a seller's burying interest income under the rug of capital gain. But in doing this, it opens up – to the purchaser – vistas of interest deductions not seen before. It is now necessary, therefore, to analyze *purchases* of over $3,000, in order not to overlook an imbedded interest deduction.

Sec. 483 Suppose a company sells stock to an employee, payment to be made over a period of years without interest. Is interest imputed to both the company and the employee?

A specific provision makes the seller exempt from imputed interest even though the buyer gets his deduction. The exemption applies if "no part of any gain" from the sale would be a capital gain. The sale by a company of its own stock cannot give rise to gain. It follows that the company is home free of imputed interest.

The buying employee, on the other hand, has himself an interest deduction.

EXEMPT ORGANIZATIONS (Subchapter F)

Sec. 501 Outside Income of Social Clubs

An important warning as to the possible loss of tax exemption by such clubs.

The Internal Revenue Service thinks that too many social clubs are making their facilities available to outside groups — a practice contrary to the intent of the law and regulations granting exemption from taxation. Attention will be paid to situations in which the amount of "outside income" is more than incidental and trivial (i.e., substantial) as well as to the number and frequency of outside activities.

Example: (1) "Outside" income includes income derived from parties, dinners, wedding receptions, etc., held at a golf club and sponsored by a member who is not, in the true sense of the word, host to such entertainment or hospitality. In these instances the member is reimbursed by another or others for the charges made by the club.

(2) A member entertains twenty-five or thirty friends or associates and acts as true host for the particular party, personally bearing the cost thereof. Income of the club from such a function is not considered to represent "outside" income. Sec. 501

The Service has set forth certain guidelines in this area in Rev. Proc. 64-36, IRB 1964-37, 23. Apparently gross receipts from the general public will probably result in a holding that the club is not being operated "exclusively for pleasure, recreation, or other nonprofitable purposes" unless such gross receipts are not more than the higher of $2,500 or 5 per cent of the total gross receipts of the organization. The Rev. Proc. also points out the danger if the club, regardless of the gross receipts test, advertises or otherwise solicits outside business.

Exemption Rulings Are Sometimes Misleading

In the final analysis, it is the actual operation of the charity which determines its status.

The private charitable foundation (organized either as a nonprofit corporation or as a trust) is becoming increasingly popular with many taxpayers. A particular advantage is that through a foundation, contributions can be made to individuals and unorganized groups which, if made directly, would be clearly nondeductible.

To avoid arguments with revenue agents about the deductibility of contributions to foundations, donors find it desirable to have a favorable Treasury ruling in advance. Until late in 1963, the Treasury required a foundation to operate at least one full year, and submit a list of all income and disbursements during that year, before it would consider issuing a ruling. Although this waiting period is no longer required as a matter of course (Rev. Proc. 63-30, IRB 1963-52, 51), the IRS has retained an option to do so. If a ruling follows the waiting period, the last paragraph regularly contains a statement to this effect, "This exemption may be jeopardized by distribution of your funds to. . . ." There follow the names of all who have received the foundation's funds who are not listed in the Treasury's latest "Cumulative List of Organizations Described in Section 170(c) of the Internal Revenue Code of 1954." Such a warning naturally disturbs a

Sec. 501 client. Very logically he asks, "Does this mean my foundation cannot make any more contributions to the donees named?"

The "warning" does not mean this at all!

Section 501(c)(3) of the Internal Revenue Code lists the types of foundations (and other organizations) which are tax-exempt on their own income. To qualify under this section, a foundation must be operated exclusively for charitable, etc., purposes. But there is no requirement that it make contributions only to other organized and approved entities.

Section 642(c) allows a trust an unlimited deduction (as compared to the 20 per cent or 30 per cent contributions limit for individuals) for amounts devoted to charitable, etc., purposes. Again there is no requirement that contributions go only to organized and qualified donees.

These sections must be distinguished from Section 170(c) which defines "charitable contributions" in terms of whether gifts made by *individuals* may be claimed as tax deductions. Under this section, only payments to *organized* charities are deductible. Thus, if an individual, with purely charitable intent, gives $100 to a poor family, even though completely unrelated to himself, he cannot deduct it. But his private charitable trust may give $100 to the same poor family without in any way jeopardizing or impairing its tax-exempt status if such contribution is within the scope of its permissible activities.

The Treasury recognizes this principle. Revenue Ruling 56-304 (1956-2 Cum. Bull. 306) states that private charitable foundations "are not precluded from making distributions of their funds to individuals, provided such distributions are made on a true charitable basis in furtherance of the purposes for which they (the foundations) are organized." In such cases the Treasury reasonably requires that adequate records be maintained to show to whom donations are made and what, if any, their relationship was to the donors or trustees of the foundation.

When the Treasury says a private foundation's status may be "jeopardized" by giving money outside the approved "Cumulative List," this means only that the Treasury will not guarantee *in advance* that grants to a given unlisted recipient fall within the foundation's charitable purposes. But foundations always have the right to show that, in fact, a particular grant was made with a charitable or educational motive, and that such distribution was therefore entirely proper.

Capital Gains and Losses Of Charitable Foundations

What effect do such items have on accumulated income?

Charitable foundations often sell securities which have been contributed to the foundation. A problem arises as to whether the capital gains or losses realized on such transactions should be included in "accumulation of income within the year" on Form 990-A, and if so, whether the donor's basis or the fair market value of the securities at the date of gift should be used to determine the gain. If the capital gains are substantial, the inclusion of such gains in "accumulation of income within the year" may raise the problem of an unreasonable accumulation of income for which the foundation could lose its exemption.

Form 990-A indicates that "accumulation of income within the year" is to be determined by inclusion of gain (or loss) from sale of assets. The instructions to this form do not define "assets" but merely set forth the necessary information which must be disclosed on their sale.

Section 6033(b) prescribes the broad classes of information which an organization exempt under Section 501(c)(3) must furnish in its annual return. Among the required information is "its accumulation of income during the year." Although this term is not defined in the Code, Regulations Section 1.6033-1(a)(v) states that "the aggregate accumulation of income shall be divided between that which is attributable to the gain or loss on the sale of assets (excluding inventory items) and that which is attributable to all other income."

Section 504 provides for the denial of exemption to Section 501(c)(3) organizations for unreasonable accumulations of income. Regulations Section 1.504-1(c) defines income for purposes of Section 504 to be "gains, profits, and income determined under the principles applicable in determining the earnings or profits of a corporation."

Regulations Section 1.504(c)(1) provides that, in determining the reasonableness of an accumulation out of income, "the accumulation of gain upon the sale or exchange of a donated asset to the extent that such gain represents the excess of the fair market value of such asset when acquired by the organization over its substituted basis in the hand of the organization" is disregarded.

This regulation also provides that the accumulation of gain

Sec. 504 upon the sale or exchange of securities where the proceeds are within a reasonable time reinvested in property acquired and held in good faith for the production of investment income is disregarded in determining the reasonableness of an accumulation out of income.

It appears then that a charitable foundation's "aggregate accumulated income during the year" should include the gain or loss on the sale of securities but this gain should be adjusted to reflect the fair market value of the stock when acquired if donated. Appropriate note should be made on the return that proceeds from the security sales have been reinvested, if that is the case.

CORPORATIONS USED TO AVOID INCOME TAX ON SHAREHOLDERS

(Subchapter G)

Sec. 531-37

Section 531 Tax on Wholly Owned Subsidiaries

Nondistribution by the subsidiary may cause a problem for the parent.

An Internal Revenue Agent recently asserted Section 531 tax against the wholly owned subsidiary of a large publicly owned corporation.

The subsidiary had apparently accumulated earnings in excess of its separate business needs. Ultimately it was conceded that there was no authority to support the proposition that Section 531 could be applied to a subsidiary for accumulating earnings to avoid the intercompany dividend tax on distributions to its parent.

The agent insisted, however, that accumulated earnings tax liability existed, since Regulations 1.532-1(a)(1) speak of the avoidance of "the individual income tax on its shareholders, or on the shareholders of any other corporation." That the latter phrase refers to the individual stockholders of the parent corporation is clearly indicated by the example in Regulations 1.532-1(a)(2). When, however, the parent corporation is a large publicly owned corporation with the usual liberal dividend-distribution record of that type of enterprise, it should be very difficult for the Service to establish that earnings were being accumulated in the subsidiary to avoid the individual income tax on the shareholders of the parent. *Sec. 531-37*

Tax-Free Exchanges of Personal Holding Company Assets

Sec. 541

The following suggests a possible solution to the personal holding company problem. However, this is one of the areas in which the IRS will not issue advance rulings (see Rev. Proc. 64-31).

Many personal holding companies are in the position of owning assets which have substantially appreciated in value. Some owners of these companies would like to liquidate them, but find for one reason or another that it is not practicable to do so under Section 333, and hesitate to liquidate because of large inherent capital gain tax which would naturally result in shrinkage of principal. Some open-end investment companies are offering to acquire for their own stock either the stock or assets of personal holding companies resulting in tax-free exchanges qualifying under provisions of Code Sections 368(a)(1)(B), or (C). Of course, the "continuity of business enterprise" requirement of Regulations 1.368-1(b) must be satisfied for the transaction to qualify as a reorganization. But see the liberalized treatment of this requirement in Rev. Rul. 63-29, IRB 1963-10, 9.

Generally, there is no "loading" charge made by the investment company on its shares so issued. However, if there is a substantial difference between the unrealized appreciation of the personal holding company assets and the investment company assets, some adjustment in the number of investment company shares to be issued will be necessary. Any such adjustment normally will be less than the tax liability which would result from the sale of the assets.

Under appropriate circumstances an exchange of this type should be quite attractive to the personal holding company shareholders. There is no diminution of capital invested by reason of capital gain tax paid, shares of an investment company whose earnings and dividends receive favorable tax treatment are received and, of course, the shares are readily marketable.

Note, however, Rev. Proc. 64-31, IRB 1964-30, 14, which states that the IRS will not rule as to whether the tax-free reorganization provisions apply "to the acquisition by an investment company of the stock or assets of another investment company, where, as a result of such acquisition, the shareholders of either company, or both companies, thereby achieve a substantially wider diversification of the investment assets underlying their stock holdings." This presents the question of the definition of "substantially wider diversification," and whether the IRS will rule in the absence thereof. It would appear, furthermore, that shareholders of personal holding companies have been making such exchanges despite the unavailability of IRS rulings.

Thoughts on the Sale of a Business

Perhaps the corporation should be continued as a personal holding company.

The following comments relate to certain aspects of a change in ownership of a business from the viewpoint of the seller.

If the business assets are to be sold at amounts not greatly in excess of book values, the advantages of retaining the selling corporation as a personal holding company should be considered. This would be most appealing if the shareholders' cost basis of the corporate stock were quite low. If the cash realized from the sale were invested in stock of domestic corporations, only 15 per cent of the dividend income would be subject to corporate income taxes, and in many situations this could go on for a long time and the resulting corporate taxes would be relatively small in relation to capital gains taxes that would have resulted from prompt liquidation. The corporation could be continued until the death of the principal shareholders, when the corporation might be liquidated or the decedent's stock retired or, if possible, partially redeemed under Section 303.

In situations in which the corporation sells its business assets and continues in existence, and if there is substantial income in the year of the transaction, the question of applicability of the Section 531 tax on accumulated earnings might be raised. Business needs would hardly be a factor if the assets at year-end consisted of cash or investments. Careful timing of dividend payments may offer some relief. In the year of the transaction it is unlikely that the corporation would be a personal holding company, but it no doubt would be in the following year. Section 563(a) provides that for purposes of the Section 531 tax a dividend paid within two-and-a-half months after the close of the year shall be considered as paid during the prior year. In computing undistributed personal holding company income under Sections 545(a) and 561, credit is given for dividends paid during the year. Thus a dividend paid in the first two-and-a-half months of the year following the sale of the business assets does double duty. *Sec. 541*

Consider a case where the corporation continues in existence, but the assets are sold at an amount that results in a loss in the year of the transaction. This loss may, of course, be carried back against prior years' income and thus there is an advantage in "cleaning up" pending matters so that any resulting cost or expense may be reflected in the carryback loss. It is assumed that the corporation will become a personal holding company and this same operating loss that has already been carried back against prior years' income may, under Section 545(b)(4), be deducted in arriving at undistributed personal holding company income in the following year. In this circumstance, the operating loss does double duty.

Foreign Corporations for Foreigners No Refuge *Sec. 542*

Under certain circumstances, they can be personal holding companies.

Ordinarily a foreigner can, through a foreign corporation not doing business in our country, get immunity from United States income taxes (except for withholdings). There is an important "but." If the income from the corporation is primarily from U.S. investments, there is a chain reaction of taxes.

The company will be a personal holding company. As a personal holding company, it is subject to personal holding company tax, unless a dividend is paid. The dividend, though paid by the foreign company, will be taxed the same as if it were paid by an American company. This is expressly provided for in Section 861. The foreign stockholder is therefore subject to American withholding and tax on the dividend.

Sec. 561 Distribution of Appreciated Securities as a Dividend

This may leave unresolved problems under Sections 531 and 541 of the Internal Revenue Code.

Where a corporation owns appreciated securities which are readily marketable, it often is desirable to pay out a portion thereof as a dividend in kind. The corporation does not have to pay the capital gain tax on the appreciation although the dividend to individual shareholders is taxed on the basis of the market value of the shares so distributed. However, this practice should be avoided both by personal holding companies and by corporations vulnerable to the penalty tax on unreasonable earnings under Section 531. These two penalty taxes are mutually exclusive and cannot be applied to the same corporation in a taxable period. The regulations at Section 1.561-1 state in part that the amount of the dividends-paid deduction with respect to a distribution in property shall be the adjusted basis of the property in the hands of the distributing corporation.

Take the case of a personal holding company or a business type corporation which has a net income after tax of $25,000 and distributes 1,000 shares of stock of a listed company having a market value of $25 a share but a cost basis of $5 a share. The company has paid out only $5,000 in dividends for the year in terms of the dividends-paid deduction and $20,000 of undistributed earnings remain under either Section 541 or 531. The personal holding company provisions would apply automatically, but the tax on unreasonable accumulations does not operate on mechanical principles.

In the assumed situation, since the stockholders have reported total dividend income equal to the net income of the corporation after tax for the year, it is unlikely that the Internal Revenue Service could urge successfully under Section 531 that there has existed in the corporation a purpose of avoiding the income tax with respect to its shareholders. However, if the total of the value of the distributions to stockholders in kind and cash during the year was less than the net income after taxes, Section 531 might apply. Accordingly, in this type of situation, as well as in a personal holding company, it is not advisable to distribute low-cost, high-market-value assets as a dividend. However, see the item which follows for an example of distribution of high-basis-low-value assets.

Property Dividends by Personal Holding Company — *Sec. 562*

In this situation, there is, of course, no effect on the regular corporate taxes.

P Company, a personal holding company, frequently realizes capital losses from the sale of securities. Instead of selling securities which have declined in value, a tax advantage can be obtained by distributing them as a property dividend. The result is that the corporation receives a dividends-paid deduction equal to the basis of the securities so distributed, while the stockholders include only the value thereof in taxable income. Dividend income of the shareholder is thus reduced in the amount of the loss not taken by the corporation. Since the stockholders are in high tax brackets, a sizable over-all tax saving is realized.

The advantage of this technique as compared to selling the stock at a loss and then distributing the proceeds is that the capital loss on a sale is not deductible in determining undistributed personal holding company income while the distribution in kind, in effect, secures the deduction of the loss and enables the corporation to retain earnings at a tax cost not to exceed 25 per cent.

NATURAL RESOURCES (Subchapter I)

Step-up in Basis of Mineral Properties Often Useless — *Sec. 613*

A self-evident type of thing that might easily be overlooked during purchase negotiations.

Where one corporation proposes to acquire with its own stock another corporation at a premium price, there is almost always a conflict of tax interests—the selling stockholders want a tax-free exchange and the buying corporation wants a basis for the acquired assets commensurate with the premium price it pays.

Sometimes the buying corporation might defer to the selling stockholders by passing up its step-up in asset basis and agreeing

Sec. 613 to a tax-free exchange. The buying corporation, in such a case, will forsake future depreciation, depletion, etc.

However, if the premium price is attributable to *mineral properties,* the step-up in basis may not be found to be helpful to the acquiring corporation anyway. The reason therefor is the likelihood that future depletion will take the form of *percentage* depletion, the amount of which does not depend upon the basis of the mineral properties.

Therefore, where mineral properties are to be acquired by a corporation at a premium price, there is often no use insisting upon a taxable transaction simply to accomplish the step-up in basis. Percentage depletion may compensate for the loss in basis. Of course, for purposes of distributions to shareholders, earnings and profits would be reduced by cost depletion, rather than by percentage depletion.

Sec. 632 Current Status of Carved-out Oil Payments

Resolving the loose ends that arose in the wake of the Lake *decision.*

In *Comm'r* v. *P. G. Lake, Inc., et al.,* 356 U.S. 260 (April 14, 1958), the Supreme Court held that proceeds from a carved-out oil payment are taxable as ordinary income, subject to depletion, not as capital gain.

The Treasury attacked only carved-out oil payments (as distinct from various other types of oil payments which exist); and the Supreme Court quoted language from I.T. 4003, 1950-1 Cum. Bull. 10, 11, which limited the Government position to such transactions. However, if proceeds from a carved-out oil-payment are pledged for development, the transaction is considered to be a sharing arrangement under G.C.M. 22730, 1941-1 Cum. Bull. 214. Thus, income does not accrue to the creator of the oil payment.

Following the *Lake, et al.,* cases, the Tax Court in *Flewellen,* 32 T.C. 317, held that income from a donated carved-out oil payment will be taxed to the donor, subject to depletion, as it arises. The Court distinguished the *Nordan* case, 22 T.C. 1132, stating that there, "title to the property itself (subject to a contingent reversion) passed to the donee."

The Supreme Court also held that a carved-out oil payment does not qualify for a tax-free exchange under the like-kind provision (1939 Code Sec. 112(b)(1); 1954 Code Sec. 1031). This follows the Treasury's position, which also was sustained in *Midfield Oil Co.*, 39 B.T.A. 1154(A); but it is uncertain whether the Supreme Court intended to apply this rule to retained oil payments or to the recipient of a carved-out oil payment.

Attention also should be given, in appropriate cases, to *Burke*, 5 T.C. 1167(A), which supports the Treasury position that combination oil payments should be treated as carved-out oil payments.

In the decision of *Estate of O. W. Killam* v. *Comm'r*, 33 T.C. 41, the Tax Court held that the sale of a primary oil payment resulted in ordinary income where the vendor retained a secondary oil payment. A secondary oil payment is occasionally desirable when there is a dispute among the parties as to the quantity of mineral reserves available in a property that is being sold. Payout of the secondary oil payment does not commence until the primary oil payment has been satisfied. The Revenue Service views both oil payments as a single property, with the carve-out and sale of the primary oil payment as an anticipatory assignment of income.

Subsequent to its decision in *Killam* the Tax Court held, in the case of *Jay H. Floyd* v. *Comm'r*, T.C. Memo 1961-56, that, under the rationale of *Lake* and *Killam*, the sale of an oil payment which had previously been retained simultaneously with a royalty interest on the assignment of a lease also constituted an anticipatory assignment of income. This decision was affirmed by the Fifth Circuit, 309 F. 2d 95, which (in 1963) reached a similar result in *Foster* v. *Comm'r*, 324 F. 2d 702.

In *Howard Glenn* v. *Comm'r* 39 T.C. 427, the Government for the first time litigated the position that cash received on the assignment of a working interest with retention of a deferred production payment—i.e., one which would begin to pay out at some time subsequent to the transfer of the operating rights—constituted proceeds of a constructive carve-out of the "front-end" of the production payment. The Tax Court rejected this view, as well as the alternative lease bonus argument advanced by the Government, and held the proceeds taxable at capital gain rates.

In 1963 the assignment of income doctrine of *Lake* was ex-

Sec. 632 tended, in *John A. Matthews* v. *U.S.*, 213 F. Supp. 224, to the sale of 100 per cent of a royalty interest to a charitable organization for a term sufficient to permit recovery of the specified selling price plus interest.

Even though a carved-out oil payment is treated as ordinary income, selling one may be advisable when the taxpayer needs to increase his income in order to avoid wasting deductions. For example, when development and/or lifting costs are heavy, so that depletion is limited to 50 per cent of taxable income from the property instead of 27½ per cent of gross income (1954 Code Sec. 613(a) and (b)(1)), selling an oil payment will increase current income without increasing current costs and thus will increase the depletion deduction, with the result that the oil payment will be taxed at very favorable rates. Similarly, an individual taxpayer who has made charitable contributions in excess of the percentage "ceilings" (1954 Code Sec. 170(b)) may increase his income, and prevent the wasting of the deduction, by selling an oil payment. This may raise the medical expense "floors" (1954 Code Sec. 213(a) and (b)), but the percentages involved are much smaller.

INCOME TAXES OF ESTATES, TRUSTS, BENEFICIARIES AND DECEDENTS

(Subchapter J)

Sec. 642 Tax Planning on Termination of an Estate

A matter of timing.

Proper timing of income and deductions in the final stages of the administration of an estate can produce substantial tax savings. Take, for example, an estate which is in its final year and has realized $50,000 of capital gains attributable to corpus. It has unpaid income commissions of $25,000 and its sole beneficiary is in the 70 per cent income tax bracket. If the commissions are paid in the same year the capital gains are realized, the beneficiary will pick up a long-term gain of $25,000 on which he will pay $6,250 for tax. The estate will have an excess deduction of $12,500, representing the Section 1202 deduction on the portion of the long-term capital gain which is not distributable to the beneficiary. This excess deduction will pass through to the beneficiary pursuant to Section 642(h) (Rev. Rul. 59-392, 1959-2 C.B. 163) and will reduce his tax bill by 70 per cent or $8,750, leaving a net saving of $2,500. However, if the administration of the estate can be properly extended into the year after the capital gains are realized and the income commissions paid in that later year, which would be the final year of the estate, the following would result: The estate would pay a tax on the capital gain of approximately $12,500. In the subsequent year, the beneficiary would be entitled to deduct the estate's net deduction of $25,000 which would produce a tax benefit to him of approximately $17,500, or a net over-all savings of $2,500 *more* than under the first method.

Similar situations may produce tax savings if properly planned.

Effect on Beneficiaries of a Trust's Loss Carryback

This situation may be unusual but the result is quite logical.

Some time ago there were filed refund claims for beneficiaries of a trust on the basis that distributions by the trust were nontaxable because a net operating loss carryback from a later year was sufficient to eliminate the distributable net income of the trust for the year of the distribution. The Revenue Agent who examined the claims took the position that the net operating loss carryback did not change the taxability of the original distributions.

In answer to a request for technical advice, the National Office overruled the agent and allowed the refund. It stated that Section 642(d) allows an estate or trust the benefit of a net operating loss deduction. In addition, it stated that Section 643, which

Sec. 642 defines distributable net income, does not require taxable income to be modified by the elimination of a net operating loss deduction. Therefore, distributable net income is determined by taking into account a net operating loss deduction, even though the loss arose in a year following the year of the distribution.

See also Revenue Ruling 61-20, relating to estates, which is to the same effect.

Sec. 643

Distributable Capital Gain of Estate

An unusual situation in which a capital gain is includable in "distributable net income."

Suppose investment real estate is sold by an estate at a gain, and it constitutes the only taxable income of the estate. Suppose further the proceeds are distributed to one of several residual beneficiaries, in full settlement of his interest in the estate. Is the capital gain part of the distributable net income under Section 643 of the Code? While capital gains are ordinarily excluded from distributable net income, it seems apparent that in this situation the capital gain has actually been distributed to a beneficiary and that, accordingly, it is deductible by the estate and taxable to the beneficiary to whom it is distributed. (See Regs. Section 1.643(a)-3(a)(2).)

Where this type of situation arises the incidence of the capital gains tax should be covered in the agreement between the estate and the beneficiaries in advance of the sale of the property.

Sec. 652-62

Income Tax Planning for Estates and Trusts

Here is an astute use of fiscal years and corpus distributions.

The decedent's estate passes under his will partially to Trust A (a marital deduction trust) and partially to Trust B; the surviving wife being the income beneficiary of each trust. Two plans for tax saving or deferment have been proposed. The beneficiary uses the calendar year. The estate will adopt a fiscal year ending February 28, and the two trusts will adopt a fiscal year ending January 31. The result of this plan will be that the income of the estate for Year 1 (if distributed) will fall into the trusts' returns for Year 2 and from there (if distributable) into the beneficiary's return in Year 3. Thus, a dollar of income derived by the estate for the year ended February 28, 1962, will be includable (if distributed) in the returns of the trusts for the year ending January 31, 1963 and (if distributable) in the beneficiary's return for the year ending December 31, 1963.

Distributions of income of the trusts to the beneficiary are mandatory. On the surface this seems to eliminate the trusts as taxable entities so far as dividing the income in such a manner that it would be isolated in the hands of the trusts and taxed at lower rates. A plan has been evolved, however, whereby distributions of corporate stock owned by the decedent will be made from the estate to the two trusts. The view is that this will constitute a distribution of income to these trusts for Federal income tax purposes but that for trust accounting purposes under state law, such distribution will be considered a distribution of corpus and, therefore, the trustee will not be required to make distributions to the beneficiary. The amount distributed to the trusts will therefore be taxable to them. Cash distributions will be made directly to the widow by the estate pursuant to a paragraph of the will which authorizes such distributions. The overall result will be the division of the income received by the estate into four approximately equal amounts taxable to the estate, each of the two trusts, and to the widow with the resulting minimization of Federal income tax liability. The success of this plan will depend upon local law, although in most states the rules applicable to these exact facts are probably as outlined above.

Example: The estate of O has a corpus of $200,000, and distributable net income for the year ended February 28, 1962 of $20,000. It distributes corporate stock worth $5,000 to each of Trusts A and B, and distributes $5,000 cash to the widow. The four entities will be taxable on the $20,000 of income as illustrated in the following table.

Estate of 0	– year to 2-28-1962	$5,000
Trust A	– year to 1-31-1963	$5,000
Trust B	– year to 1-31-1963	$5,000
The widow	– year to 12-31-1962	$5,000

Sec. 661 Possible Inequitable Effect of Corpus Distribution From Estate

The American Institute of CPAs has recommended to Congress certain changes to remove the inequities referred to herein.

An important tax effect apparently results from a distribution of corpus to one residuary beneficiary if there is an inadequate, or no distribution, to other residuary beneficiaries in the same taxable year of the estate. Under Section 661(a), IRC, provision is made for the deduction of "other amounts" properly paid or credited by an estate or trust. Correspondingly, Section 662(a)(2) provides that any such distribution is includable in the taxable income of the beneficiary with certain exceptions as provided by Section 663.

In the case of a trust, a distribution to a beneficiary without corresponding distributions to other beneficiaries may constitute taxable income to the distributee only to the extent of his proportionate share of the distributable net income of the trust, if the accounting requirements of Section 663(c), IRC, and Section 1.663(c)-1 of the regulations with respect to separate shares being treated as separate trusts are satisfactorily met. This procedure for limiting taxability to a beneficiary where other beneficiaries do not receive distributions is applicable only to trusts.

There is no corresponding specific limitation in the case of a distribution from an estate. Thus, assuming that a corpus distribution to a residuary beneficiary exceeds the amount of the distributable net income, with no distribution to other residuary beneficiaries during the same taxable year of the estate, the distributee will be taxable on the estate's entire distributable net income for such year. Where such effect would be undesirable, there should be sufficient distributions to the other beneficiaries within the taxable year to result in equitable tax consequences.

Trust Distributions of Appreciated Value Property

A means of avoiding a capital gains tax.

If the trustee of a discretionary trust holds property which has appreciated in value, a tax saving would appear to be possible if such property is distributed in kind, in lieu of a cash distribution, to the extent that the fair market value does not exceed the distributable net income of the trust. *Sec. 661*

No gain or loss is realized by the trust if the distribution does not satisfy a right to receive a specific dollar amount or to receive other specific properties (Regulations Section 1.661(a)-2(f)(1)). The trustee may deduct the fair market value of the property distributed (Regulations Section 1.661(a)-2(f)(2)).

The basis of the property to the beneficiary is its fair market value at time of distribution (Regulations Section 1.661(a)-2(f)(3)). Therefore, the beneficiary may sell the property and avoid the gain that would have been realized had the trust sold the property. (See Rev. Rul. 64-314, IRB 1964-50, for the method of determining the basis of assets distributed where the value of such assets exceeds the distributable net income of the trust.)

The above would also apply to estates to the extent of the distributable net income for the current year.

Application of Five-Year Throwback Rule *Sec. 665*

An unintended benefit?

Does the application of the five-year throwback rule to an accumulation distribution of previously taxed capital gains permit the gains to be offset by the beneficiary's capital losses in the years the gain were accumulated, with a current tax credit for tax previously paid by the trust?

It seems questionable whether the throwback rule was intended to provide a current tax credit without an offsetting increase in current tax liability. However, informal discussion with the Chief Counsel's Office indicates that this can be the result, under certain circumstances, when capital gains are accumulated for a number of years and subsequently distributed.

Spouse as Beneficiary of Short-Term Trust *Sec. 673*

An attractive way to divert income into a low tax bracket.

The Code does not attribute to a grantor the income of a ten-year trust where the beneficiary is the grantor's spouse, and the

Sec. 673 Service has issued rulings stating that the grantor of a trust is not taxable on its income merely because his wife is the beneficiary. Of course, if the income should be distributed currently, it would find its way back into the grantor's joint return. However, if the income is accumulated and distributed to the spouse at the end of ten years, the income is taxed to the trust (usually at much lower tax rates). The throw-back rules do not apply because the spouse gets a final distribution more than nine years after the last contribution to the trust (Section 665(b)(4)). This seems to be a very attractive way to divert income into a low tax bracket without really losing the income.

Since income would not be distributed currently, this is not a gift of a present interest and is not entitled to annual gift tax exclusions. However, it can be applied against the lifetime exemption and, even if taxable, the gift tax should be negligible compared to the income tax saving. This tax-saving idea should be useful to anyone in the higher tax brackets who can afford to set aside some income.

Capital Gains of Short-Term Trusts Should Not Be Overlooked

An undecided question with respect to gift taxes on unrealized capital gains.

Much has been written about the advantages of the ten-year reversionary trust. Such a trust is a very effective means of transferring income from a high-bracket taxpayer to one paying lower taxes, while allowing the grantor to regain his principal at the end of the trust term.

In recommending such a trust, the problem of capital gains should not be overlooked. Ordinarily, capital gains are added to the corpus of the trust. If this is done, the gains are taxable to the grantor in the year in which they occur, because they are considered as income being held for future distribution to him (Regulations Sec. 1.677(a)-1(f) and (g), example (2)).

The taxation of such gains to the grantor may be avoided by providing in the trust instrument that they are to be included in the income going to the income beneficiary. If the income is currently distributable, the capital gains will be taxed to the beneficiary. If the trust income is to be accumulated for later distribution to the beneficiary, all of the income including the capital gains will be taxed to the trust.

Another approach is to provide that the current income is to go to one beneficiary and the capital gains to another, either currently or at the end of the trust term. For example, Mr. Smith could set up a trust for ten years and provide for the regular income to be distributed to his mother currently, and the capital gains to be held for distribution to his wife at the end of the term. The gains would be taxable to the trust. They could, of course, be made currently distributable to his wife, in which event they would be taxable to her in the year realized by the trust. However, it might be advantageous to have the gains accumulated and taxed to the trust in a lower bracket than that of the Smiths. Even the long-term gains could be taxed to the trust at a starting rate equal to one-half of the lowest income tax bracket.

What are the gift tax effects of a provision that capital gains are not to be included in the trust principal which returns to the grantor? The gift tax regulations set forth a table which gives the percentages to be applied to the value of trust assets contributed in order to determine the value of a gift of income. Neither the regulations nor any cases shed any light on the question of whether or not the percentage changes if the grantor also disposes of potential capital gains. It would seem that the latter gift occurs in the year of the creation of the trust, just as does the gift of current income. It is difficult to find a theory for a gift in a later year (e.g., the year of termination) if the grantor is not the trustee and has given up control of the corpus in the year the trust is created.

The answer may be in Gift Tax Regulations Section 25.2512-5 (a)(1) which provides that: "Where the donor transfers property in trust or otherwise and retains an interest therein, the value of the gift is the value of the property transferred less the value of the donor's retained interest." If the corpus to be set up in trust has appreciated over basis to the grantor, and if any gains resulting from the realization of such appreciation would not revert to the grantor, the Service might very well say that the value of the retained interest does not include such appreciation because it might not return to the grantor.

On the other hand, if the corpus had not appreciated over

Sec. 673 basis when the trust was created, or if there is an appreciation over basis and such appreciation would not be accumulated for or distributed to a beneficiary, the retained interest should be based upon the full value of the original corpus. If this theory is correct, there should be no gift tax on the beneficiary's capital gains. For income tax purposes, the gains to be distributed to beneficiaries would be only gains realized from appreciation subsequent to the date the trust was created.

It is understood, however, that the Service has held in certain cases that where a ten-year short-term reversionary trust provides that both capital gains and current income will be distributed to the beneficiary, and also provides that the grantor will be trustee, then the value of the gift is the present value of the ordinary income to be received by the trust during the ten-year period (based on the usual actuarial tables). Capital gains will be treated as additional gifts in the year they are realized.

Sec. 677 Minors—Trust or Custodianship?

A custodianship can avoid the throwback problems of Sections 665-668 which apply to trusts.

To the extent that income of a trust is used to discharge or satisfy the obligation of the grantor to support or maintain the beneficiary, it is includable in the taxable income of the grantor. To avoid this, the income should be used only for those items which are clearly beyond the support obligation.

Whether the cost of providing a child with a college education, for example, comes within the definition of legal support would depend on state law. Considering the manner and direction in which our social and economic environment is progressing, it is conceivable that state courts will hold a college education a necessity.

A custodial arrangement is not considered to constitute a trust and therefore is not taxed as a separate entity (Rev. Rul. 56-487, 1956-2 C.B. 23). It follows, therefore, that the throwback rules are not applicable. Accordingly, a parent should not be taxed on income accumulated in prior years which is expended for support of a minor in a subsequent year.

Intermittent accumulation and expenditures of income in a custodial arrangement, therefore, help to avoid the inclusion of income in a parent's return. In many cases the income from gifts made in custodial form will be applied in the future to defray the cost of higher education so that income accumulated over many years will be dispersed over a comparatively short period of time, with minimal, if any, adverse tax effects to the parents. *Sec. 677*

An overriding principle to be borne in mind in considering tax problems involving minors is that for Federal income tax purposes a minor is any person who has not attained his twenty-first birthday. This rule applies in all cases even though under the laws of some states a child reaches his majority when he becomes eighteen (*William E. Borbonus,* 42 T.C. 983 (1964)).

Grantor's Deduction for Capital Losses Of Short-Term Trusts

Don't overlook this benefit.

In a normal short-term trust situation where income is distributable currently for more than ten years and the principal reverts to the grantor, any capital gains added to principal are taxable currently to the grantor under Section 677(a)(2) even though no current distribution is made to him. A frequent oversight, however, is that losses chargeable to principal of such a trust are allowable to the grantor (Example (2) in Regulations 1.677(a)-1(g)).

Under the Internal Revenue Code of 1939, gains in these circumstances were taxable to the grantor, but losses could be used only in computing the fiduciary's tax liability. The difference arises from the clause, "The grantor shall be treated as the owner . . ." which did not appear in Code Section 167.

Income "In Respect of a Decedent" Under Code Section 691

Sec. 691

An excellent primer on a complicated area of the Code.

Many estates have some sort of income rights or debts which qualify as income and expenses "in respect of a decedent" because usually there exist some accrued interest income, fees and

Sec. 691 commissions; or debts such as accrued real estate taxes, accrued interest on loans, and accrued business expenses. Also there exist from time to time unusual income rights such as compensation agreements and damage and infringement cases in progress at death, all of which fall into the complex area of this section.

There are two important aspects concerning these Section 691 items. *First,* no estate tax return basis is attributed to them as is usually attributable to other property of the decedent. *Second,* the estate tax deduction allocable to the net Section 691 items is allowable for income tax purposes in the year the income right ripens and is reported as income.

As to the first aspect, the recognition of the income rights which fall outside the ordinary pattern is important because if an estate basis is erroneously used, a considerable deficiency may be incurred when the basis is disallowed upon examination. The courts have taken a rather broad view of income rights involved under Section 691. They hold that income in respect of a decedent includes:

1. Income rights which are capable of valuation in the gross estate even though not accruable to the decedent under ordinary accrual concepts
2. Income rights to which the decedent had no legally enforceable rights at death
3. Income rights regardless of status at death which would have been income to the decedent had he lived to receive them

This summary demonstrates the need to scrutinize all incomplete transactions existing at the decedent's death to determine if there is an income right involved. Section 1014, concerning basis of property transmitted at death, is specifically made inapplicable to property which constitutes a right to receive an item of income in respect of a decedent under Section 691. Reference is made to the provocative case, *Comm'r* v. *Linde,* 213 F.2d 1 (9th Cir.) Rev'g 17 T.C. 584. In that case it was held that a taxable event in the decedent's lifetime is not required for realization of "income in respect of a decedent." Also see Revenue Ruling 55-463, wherein it was held that income realized by an estate resulting from a claim which was in process of litigation at date of death constitutes income in respect of a decedent. These references are indicative of the expanding concept of Section 691 items being developed by the courts.

As to the second aspect, the determination of the portion of the estate tax which is allocable to Section 691 items under Section 691(c) is not too difficult to compute in the average situation falling within the scope of the example given in the Regulations. *Sec. 691*

Difficulties arise, however, where there is a marital deduction involved in the estate tax return. See Example (2) of Regulations Section 1.691(d)-1(e). There is one case, *Estate of Thomas Desmond,* 13 T.C.M. 889, wherein the Court would appear to have agreed with the Commissioner that the inclusion of the full income rights in the marital deduction could be tantamount to cancelling out the inclusion of the income rights in the gross estate. Under these circumstances, no estate tax may be attributed to the income rights. For this reason, carefully drawn wills often seek to exclude Section 691(a) items from the amounts passing to the surviving spouse which qualify for the marital deduction. On the other hand, once the amount of the 691(c) deduction is computed, each person who includes a 691(a) item in income (including the surviving spouse) is entitled to a pro rata portion of such deduction (*Helen Rich Findlay,* 39 T.C. 580, affirmed C.A. 2, 6/2/64).

PARTNERS AND PARTNERSHIPS (Subchapter K)

Limitation on Partner's Share Of a Partnership Loss

Sec. 704

A partner's deductible losses are not limited by the amount of his capital account.

Section 704(d) of the 1954 Code provides that "a partner's distributive share of a partnership loss shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership. . . ."

At first blush, one would consider the basis of a partner's inter-

Sec. 704 est in a partnership as the balance of his capital account (subject to some possible adjustments not reflected on the books). From this it follows that if a partner's share of the partnership loss exceeds his capital account, then to the extent of such excess, the loss is not deductible until the capital is restored.

The shortsightedness of this treatment is in assuming that the tax basis of a partner's interest consists solely of his capital account. Section 752 provides that an increase in the basis of a partner's interest in a partnership results from an increase in a partner's share of the liabilities of a partnership, even if the partnership is on a cash basis (Rev. Rul. 60-345, 1960–2 C.B. 211).

Therefore, if a partnership increases its liabilities (as well it might do when a loss is sustained) and this results in an increase in the individual partner's share of these liabilities (as it usually does), the partner's basis of his partnership interest has increased. Therefore, a greater portion (if not all) of the loss would be deductible.

Sec. 706 Partnership's Tax Year Different From That of All Its Partners

What partnership year may be elected if there is no principal partner?

A partnership may not adopt a taxable year different from that of all its principal partners without the Commissioner's permission under the provisions of Section 706. Section 706(b)(3) defines a principal partner as one having an interest of 5 per cent or more in partnership profits or capital. But what about a partnership having no principal partner? May it, for example, adopt a fiscal year without permission where all its partners are on a calendar-year basis?

The House Committee proposed that a partnership had to adopt a calendar year unless permission was obtained to adopt a different year. This proposal was liberalized by the Senate, which provided restrictions only in the case of partnerships having "principal partners." As passed, the statute reflects the Senate's less restrictive view; therefore, where a partnership has no principal partner it would seem free to adopt any year it pleases without permission. Nevertheless, a literal reading of the last sentence of Regs. Section 1.706-1(b)(1)(ii) would indicate an opposite conclusion. This sentence does not appear to be in accord with the statute, and a possible dispute with the Service could result if contrary action were taken by a partnership. *Sec. 706*

Income in Respect of a Deceased Partner

Imaginative planning may be required to avoid an increased tax resulting from a "relief" provision.

Section 706(c) of the 1954 Code, providing that a deceased partner's share of current partnership income is includable in the return of his estate, was intended to prevent the pyramiding of partnership income for two taxable periods in the deceased's last return.

As with many remedial provisions in the Internal Revenue Code, this one can be detrimental in some circumstances. Where the death of a partner occurs late in his taxable year and he is survived by his wife, the joint return for the year of death would include no income from the partnership and perhaps no net income from other sources, while the return for the estate would include the distributive share of partnership income for the entire year. The estate's income tax might then be higher than would result for the individuals if the partnership income were fully includable in the joint return of the decedent and his surviving spouse. Also, there is then no accrued income tax liability on the income from the partnership allowable as a deduction in computing the taxable estate of the decedent, even though nearly all of the income was earned during the decedent's lifetime. The estate would, however, be able to treat the partnership income attributable to the predeath period as "income in respect of a decedent" and claim a deduction for the estate tax paid with respect to such income (Regs. Section 1.753-1(b)).

When time permits, the income tax problem may be resolved by means of a distribution from the estate to the wife prior to the close of her taxable year. Another corrective can come from selection of the best fiscal year for the estate in co-ordination with the years and income of the beneficiaries.

Sec. 707 Problems Involved When a Partner Acquires Partnership Property

Different approaches have varying tax consequences.

The tax problems of a partnership are some of the most difficult in the field of the income tax law. They may come sharply into focus when a partner desires to acquire personally a property that constitutes part of the partnership's assets. To effect this acquisition, two methods occur to him. The first is the simple purchase from the partnership. If the cash for this purpose is not available, the partner may purchase the asset by giving his obligation for the price. If this method is not satisfactory, he may simply withdraw the property from the partnership, reflecting it by a charge against his capital account. His choice of method may have a marked effect on immediate tax results as well as future tax considerations.

Code Section 707 makes it possible for a partnership to sell to a partner as though he were an unrelated person, with two exceptions: (1) a loss on such a sale is disallowed if the partner owns directly or indirectly an interest of more than 50 per cent in the partnership; (2) a gain is taxed as ordinary income if realized on the sale of property (whether or not depreciable) which is not a capital asset in the hands of the transferee, if the partner has more than 80 per cent interest in the capital or profits. It is interesting, incidentally, to contrast this ordinary income provision with Section 1239. That section calls for ordinary income treatment on sales between spouses and between more than 80 per cent stockholders and their corporations, limited to property which in the hands of the transferee is subject to an allowance for depreciation.

Suppose, however, that the partner does not wish to obligate himself for the purchase price of the asset, but that with consent of the other partners, he withdraws the equipment in question as a distribution of part of his share of the partnership. The basis of the asset in his hands is then determined by reference to his capital account, following the rules set forth in Code Section 732(a). Note, however, that this section does not apply to the extent that a distribution is treated as a sale or exchange of property under Section 751(b) (relating to unrealized receivables and inventory items). Section 732(a) provides that the basis of the property distributed in this fashion shall be its ad-

Sec. 707

justed basis in the partnership's hands, but no more than the adjusted basis of the partner's interest in the partnership before distribution. Section 733 provides that the partner's basis for his partnership interest is reduced (but not below zero) by the adjusted basis to him (determined under Section 732) of the asset received. This can result in the reduction of the withdrawing partner's capital account to a very substantial degree, while a bona fide purchase, which would result in the substitution of a receivable for the asset, would leave the capital account intact. If the partnership should sustain an operating loss in the year in which this distribution of property occurs, it is possible that a portion thereof might not be allowable to this particular partner because of this reduction in his capital account. Code Section 704(d) disallows such a loss to the extent that it exceeds the basis of the partners' interest in the partnership at the end of the loss year, and it may not be deducted until the deficit in the account is restored by payments into the partnership or by subsequent partnership earnings. This reduction of the capital account, and therefore of the allowable operating loss, might have been avoided by the purchase of the asset instead of its withdrawal.

Let us assume that the asset is purchased by the partner and the receivable representing his purchase obligation is greater than his capital account. If this obligation should be cancelled by the partnership at a later date, it would doubtlessly be considered to represent the receipt of cash by the partner. Therefore, under Code Section 731, he might be subject to capital gain tax on the difference between the amount of the obligation thus cancelled and the basis of his partnership interest.

Needless to say, a careful examination of possible tax consequences should be made in this situation before any steps are taken to accomplish the partner's purpose. It may prevent later frustration and disillusionment when the tax returns of the parties are prepared.

Avoiding the Taxation of More Than a Year's Income

Sec. 708

A pitfall and a way around it.

The taxation of substantially more than a year's income in one year can be quite expensive taxwise and is certainly a state of affairs to be avoided if at all practicable. Unless caution is exercised, this may occur under some circumstances in the case of partners in a partnership having a fiscal year ending within the calendar year of the partners.

Under Section 706(b) of the Internal Revenue Code, a partnership may not change to or adopt a taxable year different from that of any partner having an interest of 5 per cent or more in partnership profits or capital without establishing to the satisfaction of the Commissioner a sound business purpose therefor. Nevertheless, prior to the 1954 Internal Revenue Code, a partnership fiscal year could be established on such a basis and numerous such fiscal year partnerships are presently in existence.

A potentially dangerous situation can arise in the case of such a fiscal year partnership when, within a twelve-month period, there is a sale or exchange of 50 per cent or more of the total interest in partnership capital and profits. Section 708(b) of the 1954 Internal Revenue Code provides that a partnership shall be considered to be terminated for income tax purposes if this occurs. This would mean that the partnership year would end at that time, resulting in the taxation of the income of the entire fiscal year to that date in the returns of the partners for the calendar year in which the termination takes place. After the sale of the interest, the partnership as it is newly constituted would necessarily have an accounting period ending December 31 unless permission could be obtained from the Internal Revenue Service to adopt a fiscal year. This could result in the taxation of substantially more than a year's income in this one calendar year.

Section 1.708-1 of the regulations provides that a liquidation of a partnership interest is not a sale or exchange for purposes of Code Section 708. Therefore, if the partnership interest of the retiring partner is being acquired by the other partners, the practical solution to this problem might be the liquidation of the retiring partner's interest by the partnership itself rather than its purchase by the remaining partners. Such a liquidation could, however, be disadvantageous to the retiring partner. Because of the operation of Section 736, a portion of the cash which would have been treated as capital gain on a sale might be considered as ordinary income on a liquidation. For example, a liquidating payment for goodwill will be treated as ordinary income unless the partnership agreement specifically requires a payment for such goodwill (*Smith et. al.* v. *Comm'r* 313 F.2d 16 (C.A.-10, 1962); *Jackson Investment Co.,* 41 T.C. No. 67). This phase of the problem must be carefully analyzed before the liquidation route is selected. *Sec. 708*

TAXES ON FOREIGN INCOME (Subchapter N)

Foreign Corporations and Withholding

Sec. 882

Doing business in the U.S. may save tax.

Unless a tax treaty applies, the withholding rate on dividends, interest and other determinable income is 30 per cent, in respect of foreign corporations that do not do business in the United States. It may pay such corporations deliberately to establish a place of business here and transact business, since there is then no withholding and, generally, only 15 per cent of U.S. dividends are subject to tax. Of course, the business earnings within the U.S. then become taxable, but the nature of the business can be such as to involve little or no income. If the earnings are substantially from dividends, personal holding company status must be considered. This is automatically surmounted if five families do not control more than 50 per cent of the stock. Also if business is done here, capital gains on sales here are taxable. This can be overcome by making the sales abroad.

Equipment Transfer From American Companies to Canadian Branches

Sec. 901 et seq.

Valuable tax background for U.S. corporations expanding operations in Canada.

The rapid development of Canada in the last decade has led to the establishment there of many subsidiaries and branches of United States businesses. Their ventures across the border have

Sec. 901 et seq.

acquainted our business executives with provisions of the Internal Revenue Code which had not previously come to the attention of many of them. They also have encountered provisions of the Canadian tax law, the generosity of which startles those of us used to the often restrictive aspects of our own Code.

Frequently the parent company has excess equipment available in its United States plant which will fit nicely into its Canadian plants. Suppose a subsidiary is to be incorporated under Canadian law and this equipment will be part of the consideration paid for the capital stock. Assume also that the current fair market value of the equipment is substantially in excess of its adjusted tax basis. Section 351 provides that gain is not recognized on the transfer of property to a controlled corporation for stock. But Section 367 makes Section 351 inapplicable to transfers to a foreign corporation unless, before the transfer, our Internal Revenue Service has been satisfied that the transfer is not pursuant to a plan having tax avoidance as a principal purpose. The transferor must obtain a ruling, approving the transfer as tax free, before equipment is paid into the Canadian corporation for stock. Ordinarily, in this type of situation, such a ruling is readily obtainable. A ruling must also be obtained in order to avoid tax on a subsequent transfer of appreciated machinery, even if no additional stock is issued, because the IRS has ruled that a contribution to the capital of a wholly owned foreign subsidiary will be treated as a Section 351 exchange (Rev. Rul. 64-155, IRB 1964-21).

What value will be recorded for the donated property on the books of the Canadian company? When the equipment entered Canada, it is likely that a value for duty purposes was placed on it which may be considerably more than book value to the parent company. The Canadian tax authorities will accept this duty value as cost for computing depreciation (except that the amount allowed for depreciation purposes apparently may not exceed original cost to the parent company).

The United States businessman will be interested to find that declining-balance depreciation was discovered by the Canadians somewhat earlier than it was by us. He will also find that the rates are generous — for example, 20 per cent is the accepted rate for machinery and equipment.

Accountants in the United States have grown up under what might be called the "allowed or allowable" rule – the basis of property is reduced by depreciation allowed, but if a higher amount was allowable, the reduction is in the higher amount. For example, failure to claim allowable depreciation for any reason does not forestall the reduction of basis under our tax laws. *Sec. 901 et seq.*

By comparison, the attitude toward depreciation allowances in Canada is remarkably refreshing. The taxpayer there may claim his full depreciation allowance, any portion thereof or none at all, as he sees fit, and the tax basis of property will be adjusted accordingly. This rule is often helpful in the early years of a Canadian operation when the deduction for depreciation would only increase a loss.

U.S. Capital Gain Tax Offset by Foreign Tax Credit

U.S. citizens residing in Canada, please note!

The foreign tax credit computation under Code Section 904 can produce some interesting results.

Assume that a United States citizen is a permanent resident of Canada. He receives substantial salaries which qualify as "earned income" as defined by Code Section 911(b). These salaries are taxable in Canada, but are exempt from United States tax under Code Section 911(a)(1), subject to the limitations on amounts imposed by Section 911(c)(1). Assume he sells in Canada securities which he owns at a substantial capital gain. Under Canadian law he will incur no tax on the gain.

If the Canadian tax on his salaries during the year of sale exceeds the United States capital gain tax on the sale no United States tax will be payable, even though the capital gains will, of course, be includable in his United States return. Canadian taxes of other years not used as foreign tax credits may also be used as credits against the capital gains tax within the limits of Code Section 904(d).

Such gains are considered to be income derived from Canada

Sec. 901 et seq.

even though they are not subject to Canadian tax (G.C.M. 22556). Revenue Ruling 54-15 concedes that the Canadian taxes paid on the salaries may be used as a basis for credit against United States tax even though incurred on Canadian income exempt from taxation in this country. (See also *James H. Brace* (1952) 11 T.C.M. 906.)

Sec. 902

Deemed Paid Credit Under Section 902(b)

No credit may be claimed in respect of third-tier foreign subsidiaries.

Domestic parent P owns 100 per cent of the voting stock of a first-tier Canadian subsidiary (S-1). S-1 owns 100 per cent of the voting stock of a second-tier Canadian subsidiary (S-2). In turn, S-2 owns 100 per cent of the voting stock of the third-tier Canadian subsidiary (S-3). During the taxable year S-3 pays a dividend up to P through S-2 and S-1.

Query: Are the foreign income taxes paid on S-3's dividend available for the "deemed paid" credit under Section 902(b)?

Section 902(b) specifically allows the "deemed paid" credit to a domestic parent who has received dividends from a second-tier foreign subsidiary. Dividends received by the parent past the second-tier level are not mentioned.

Prior to the 1942 Act, taxes paid by a second-tier foreign subsidiary could not be claimed (I.T. 1755, II-2 Cum. Bull. p. 209; *Peavey & Co.* v. *U.S.* (1932), 73 Ct. Cls. 600, 55 F.2d 516). The credit has been held to be a "privilege"; thus, the Code section is to be strictly construed (*Burroughs Adding Machine Company* v. *Terwilliger*, 6th Cir. (1943), 135 F.2d 608).

The Revenue Act of 1942 amended the Internal Revenue Code by inserting a provision allowing the "deemed paid" credit for income taxes paid by a second-tier foreign subsidiary.

Therefore, the same principles applicable prior to the 1942 Revenue Act would appear to apply, except that the "privilege" is extended to a second-tier company. Past this level, the credit would not seem to be available to P.

The Base Company: Paradise Lost — And Regained

Sec. 951-61

The foreign provisions of Section 951-961 are not all encompassing.

The base company, long a favorite of the astute tax practitioner, was struck a significant blow by Subpart F added to the Code by the Revenue Act of 1962. While substantial loophole plugging has been effected by the legislation, it would appear that the base company is not dead as a tax planning tool.

For example, if the foreign corporation is not "controlled" by U.S. persons, then the new provisions do not apply to it. Control for this purpose means ownership of more than 50 per cent of the voting power of all classes of stock entitled to vote by U. S. persons who each own 10 per cent or more of the voting power of the foreign corporation's outstanding stock. Therefore, if six U.S. persons who are not related for tax purposes each own 9 per cent of the stock, the foreign corporation will not be covered by the new provisions. Similarly, if a U.S. corporation owns not more than 50 per cent of the stock in its foreign subsidiaries, directly and indirectly, it will avoid the problems of Subpart F. Thus, a tax planning approach which may be called "decontrol" is available. If sufficient ownership in a base company can be held by foreign persons, the tax advantages of accumulating income in a low-tax foreign country can still be realized.

Another loophole which can provide substantial benefits in appropriate situations is the so-called "30-70" test. Under this test if less than 30 per cent of the foreign corporation's gross income is income subject to the new provisions, then no part of the income of the foreign corporation will be subject to the provisions. If a U.S. corporation has a manufacturing subsidiary in a foreign country with a low tax rate, such subsidiary may be a convenient depositary of foreign profits from royalties, dividends, interest and other types of income covered by the new rules. So long as the gross income (net of cost of goods sold) derived from manufacturing is more than 70 per cent of the total gross income of the foreign corporation, no U.S. tax consequences will result.

One type of income which is subject to the new rules is "foreign base company sales income." However, if the selling com-

Sec. 951-61 pany is located in the country where the product sold will be used or consumed, the income can be accumulated in such company free of U.S. tax consequences. While the proliferation of subsidiaries to countries with unstable political situations is not suggested, it may nevertheless be possible to locate some selling subsidiaries in the country of use or consumption, thereby avoiding the effect of the new rules.

GAIN OR LOSS ON DISPOSITION OF PROPERTY (Subchapter O)

Sec. 1001

Payment of Debt With Property May Create Taxable Income

The General Shoe *and* Davis *cases (see below) go even a step further than this.*

The general rule is that payment of a debt by transferring property to the creditor is a sale or exchange of the property. The situation is the same as if the property had been sold for cash and the cash used to pay the debt. The same rule applies to a cash legacy paid in property by an executor or trustee. The fiduciary realizes gain or loss equal to the difference between the face amount of the debt and the adjusted basis of the property transferred in settlement of the debt.

A statutory exception to the rule is made with respect to indebtedness of a subsidiary to its parent. If the subsidiary is completely liquidated in a transaction in which no gain or loss is recognized to the parent, then no gain or loss is recognized to the subsidiary upon the transfer of properties in satisfaction of its indebtedness to its parent.

Another exception to the rule relates to charitable contributions. The satisfaction of a pledge to a charitable organization by means of a donation of property does not give rise to a taxable gain or deductible loss whether or not the property has appreciated or depreciated in value (Rev. Rul. 54-410, 1955-1 C.B. 297). A contribution is deductible only to the extent that it is actually paid regardless of when pledged and regardless of the method of accounting employed by the taxpayer. Since the pledge itself is not deductible, it would be inconsistent to treat the payment of the pledge as a deductible contribution and, at the same time, the satisfaction of a debt. Accordingly, the transaction is not viewed as the payment of an indebtedness with the tax consequences which would ordinarily follow from the use of appreciated or depreciated property to pay the debt. *Sec. 1001*

In *General Shoe Corporation* (230 F. 2d 953, C.A.-6, reversing D.C.) the court ruled that a contribution of appreciated realty to a tax-exempt employees' pension trust resulted in capital gain to the employer to the extent the market value exceeded the basis of the property. This was so even though the employer had no legal obligation to make the contribution. The Supreme Court in *Thomas Crawley Davis* (370 U.S. 65, 1962) extended this principle of capital gain realization to appreciated property transferred from a husband to his wife in a divorce settlement. The value of the consideration passing to the husband could not be measured directly, so it was assumed that such consideration was equal in value to the value of the property transferred by the husband.

Joint Property Detriment

Sec. 1014

Full benefit of step-up in basis at date of death not realized.

Among the detrimental tax effects of jointly owned real estate of husband and wife is an easily overlooked provision in Section 1014(b)(9) requiring the basis of property which had been owned as tenants by the entireties to be reduced by the amount of depreciation deductions applied against the survivor's share of the income from such property prior to the death of the deceased co-owner. This applies if under local law the survivor had been entitled to a share of the income during joint lives, even though for estate tax purposes the property is treated in full as part of the deceased estate.

For instance, assume that a depreciable asset was acquired, all of the purchase price having been furnished by the deceased co-owner husband. The wife survivor would suffer a reduction in basis by the amount of depreciation attributed to her share of the income prior to the death of the husband. Assuming her share of the depreciation to have amounted to $40,000 and that the property was valued in the decedent's estate at $60,000. The adjusted basis would then be $20,000. In other words, a sale at the estate tax value of $60,000 would result in a gain of $40,000 (Regs. Section 1.1014-6(a)(2) and (a)(3) Example (2)).

Note that in the case of depletion, this rule applies only to cost depletion, not percentage depletion (G.C.M. 17,760).

Basis of Property Acquired by Inheritance

There is a rebuttable presumption that the estate tax value is the basis.

When an estate tax return is prepared, ordinarily every effort is made to establish the lowest reasonably defensible figure as the value at the date of the decedent's death. Sometimes this is not subjected to intensive examination after the filing of the estate tax return, perhaps because the estate is so small that no tax would result if there should be a change. It is likewise possible that all facts necessary to evaluate the asset properly at that time are not available so that a substantial error has resulted.

The problem carries over into the field of income taxation because the basis for gain or loss in the case of property acquired by inheritance is normally its value on the Federal estate tax return. The question may come sharply into focus in a much later year when the property is sold and the owners at that time may be anxious to use, as a basis for gain, a value substantially higher than the amount shown on the Federal estate tax return. At this time, because of the Statute of Limitations, the imposition of additional Federal estate tax may be impossible.

The regulations in point cause a presumption to arise that the valuation for estate tax purposes constitutes the fair market value of property in the absence of clear and convincing evidence to the contrary. This estate tax valuation may be disproven, however, if sufficient evidence is adduced. If this is done, will it result in the imposition of any additional estate tax if the Statute of Limitations has already barred action on the estate tax return? Possible theories to be considered are: (a) recoupment, (b) inconsistent position, and (c) estoppel.

With respect to recoupment, in the celebrated *Bull* case, 295 U.S. 247, the doctrine of recoupment was successfully invoked by the taxpayer when the Supreme Court permitted the offset of estate tax paid through error in a previous year barred by the Statute of Limitations against income tax on the same item in a later year. However, this ruling is not applicable to the situation we are discussing since it is apparently related to two or more taxes growing out of a single transaction or taxable event.

With respect to inconsistent position, Sections 1311 through 1313 of the Revenue Code seem applicable only with respect to the income tax treatment of the same item and apparently do not correlate the estate tax determination with the income tax result of a transaction. Therefore, in the type of case we are considering, it does not appear that these sections would have application.

As to estoppel, this doctrine has ordinarily been applied when a taxpayer has made a statement of material fact in a previous year upon which the Government has relied to its detriment, and in a later year seeks to change its position. In the case where estoppel has been successfully invoked it appears that the taxpayer has been in possession of information not possessed by the Commissioner and having full knowledge of the facts has misled the Commissioner, intentionally or otherwise.

In the case of *Achille F. Ford,* U.S. Court of Claims (4-6-60), 60-1 U.S.T.C. Para. 9375, the Court decided a question which involved the sale by individuals of stock which had been acquired by them through inheritance. The Court permitted these taxpayers, in computing their income tax on the profit from the sale of this stock, to use as its basis a figure higher than that which had been used in settling the Federal estate tax liability, even though at the time the stock was sold, additional estate tax could not be assessed because of the Statute of Limitations. It emphasized the fact that when the value was established for Federal estate tax purposes the individuals whose income tax liability was presently under consideration were minors and had nothing to do with its determination.

Sec. 1014

It appears that by the introduction of sufficient evidence a higher value than that used for estate tax purposes may be established as the income tax basis on the sale of an asset even though the assessment of additional estate tax is not possible because of the Statute of Limitations; however, the measure of proof required is quite substantial. It would likewise seem to follow that if the individuals who are to benefit from the higher income tax basis had participated actively in the estate tax determination more difficulty might be experienced in making this change (*McMillan* v. *U.S.*, 64-2 U.S.T.C. Para. 9720 (S.D. W. Va., 1964)).

Sec. 1015

Gift of Appreciated or Depreciated Assets

The correct choice may have a substantial income tax effect.

All other things being equal, a gift of appreciated assets is better than a gift of the same values in cash. The reason is that with the appreciated assets, part of the gift tax is salvaged through the addition of that tax to the base of the assets, which means that there will ultimately be less profit on the sale of those assets and hence less income tax.

In the case of depreciated assets, the pendulum can swing in favor of the cash. The depreciated assets in the hands of the donor retain their original cost bases, making available the full loss, when realized. However, in the hands of the recipient no loss can be taken unless it represents further depreciation in values after the gift.

Sec. 1016

Contributions to Capital

What authority is there for a basis adjustment?

Investigation was recently made to determine whether there is any specific authority in the Code for increasing the basis of shareholders' stock upon a contribution of capital to a corporation.

As far as can be determined, there is nothing in the Code which specifically provides for a basis adjustment, other than the general provisions of Section 1016. Of course, there are a number of cases and rulings on this question (see 1965 CCH ¶4536.991) but these cases and rulings do not provide a very satisfactory explanation of why a basis adjustment is permitted. *Sec. 1016*

A reviewer in the Reorganization Branch of the Revenue Service stated that he thought Section 1016 would authorize a basis adjustment. In the alternative, if the stockholders making the capital contribution own all of the stock of the corporation, he felt that cases such as *Frye*, 5 T.C. 1058; *Heller*, 2 T.C. 371; and *Morgan*, 61-1 U.S.T.C. 9317, would be authority for treating the capital contribution as a Section 351 transfer, even though the stockholders do not receive additional stock. Rev. Rul. 64-155, IRB 1964-21, is also authority for this position.

Involuntary Conversions — Use and Occupancy Insurance

Sec. 1033

Note particularly how the policy should be worded.

The M Company has a use and occupancy insurance policy which provides for a flat per diem allowance for the loss of the use and occupancy of its property destroyed in whole or in part by fire or other specified casualties. This policy does not provide for the reimbursement of any profits that would otherwise be earned during the period of business interruption. The company has a building with a tax basis of $500,000; it is covered by a fire insurance policy in a maximum amount of $1 million replacement cost, and by the U&O policy in the maximum amount of $800,000. The building was totally destroyed by fire, and the company recovered $1,800,000 under the two policies.

Query: How should the $800,000 which was received under the U&O policy be treated for tax purposes?

An official of the Internal Revenue Service in Washington advises that the proceeds of the U&O policy would be considered as proceeds of an involuntary conversion only if the insurance contract were completely silent as to reimbursement for loss of profits. Therefore, the tax treatment is entirely contingent upon the wording of the policy. If, in arriving at the per diem amount, the computation relates in any way to the estimated profits during the period of interruption, the entire proceeds are

Sec. 1033 includable in gross income pursuant to Section 1.1033(a)-2(c)(8) of the regulations.

Assuming, however, that there is no element of profit reimbursement, the $800,000 recovered under the U&O policy would be treated exactly the same as the $1 million recovered under the fire insurance policy. Thus, the proceeds of the conversion would be $1,800,000.

If this entire amount is expended in the purchase of property similar or related in service or use, then no gain would be recognized under Section 1033. If no part of the $1,800,000 recovered from the two policies is used in acquiring replacement property, the taxpayer would have a $1,300,000 capital gain under Section 1231 because the building converted into money was property used in the taxpayer's trade or business.

If only $1 million of the aggregate recovery is used in acquiring a new building, then gain would be recognized as to the unexpended portion of the recovery or $800,000. Again, this gain would be taxed as capital gain under Section 1231. The basis of the new building would be $500,000.

There would be certain expenses in connection with the fire loss including overhead items (salaries of executive personnel), plus the expense of cleaning up the debris. A Service representative advised that it would not be necessary to offset such expenses against the insurance proceeds. Such expenses could be deducted under Section 162 even though any gain was taxed as a capital gain. However, if attorney's fees or other expenses were incurred in connection with obtaining insurance proceeds such expense items would be required to be offset against the gain.

In the case of *Shakertown Corporation*, 18 T.C.M. 106, February 10, 1959, the Tax Court had agreed with the Commissioner that certain "business interruption" policies were intended to reimburse petitioner for its loss of net profit plus its fixed charges and not for the loss of the right to use property and therefore the recovery was not an involuntary conversion under Section 1033. On April 22, 1960, the Sixth Circuit reversed the Tax Court (277 F.2d 625). The Circuit Court pointed out that the insurance policies made no mention of loss of profit, but provided for payment of a fixed sum per week in event of a total suspension of business, not dependent in any way upon the amount of profit, and for a lesser sum in event of a partial suspension of business, such lesser amount to be determined on the basis of that proportion of the total fixed sum which the reduction in production output bears to the total production which would have been obtained had the partial suspension not occurred. Moreover, the Court noted that even had the plant operated at a loss during the twelve months preceding the suspension, the petitioner would have been entitled to receive such percentage of the total sum.

Application of Proceeds From Condemnation Awards

Note the importance of a 1958 change in the law.

May the proceeds from the condemnation of unimproved property used as a parking lot be utilized for the construction of an office building on leased land and still qualify for nonrecognition of gain? While on the surface it may appear that construction costs of an office building and an unimproved lot are not similar assets, under the regulations such a transaction should qualify.

Generally, to avoid recognition of gain, the proceeds of a condemnation must be invested in property which is similar or related in service or use to the property condemned. (See Rev. Rul. 64-237, IRB 1964-35, 12, for a more liberal definition of "similar or related" when investment property is involved.) Under Code Section 1033(g), however, where the condemned property is real property used in a trade or business or for investment, it may be replaced by "like kind" property which will be treated as property similar or related in service or use to the condemned property.

The definition of "like kind" is covered in Regulations Section 1.1031(a)-1(b) and is very broad in scope. A leasehold of a fee with thirty years or more to run is considered to be "like" real estate. Furthermore, under the regulations, the fact that any real estate involved is improved or unimproved is not material. Thus, there would be an investment in "like kind" property where a leasehold of thirty years or more is acquired and improved with a building by utilizing the proceeds of the condemnation of the unimproved parking lot. However, as provided in Section 1033(a)(3)(B) and Revenue Ruling 56-543, *Sec. 1033* the improvements to the property should be completed not later than one year after the close of the first taxable year in which any part of the gain on the condemnation is realized unless an extension of time has been obtained.

The regulations covering involuntary conversions may be confusing in that Regulations Section 1.1033(a)-2(c)(9) states that with respect to involuntary conversions occurring after December 31, 1950, there is no investment in property which would be similar in character and use if the proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate. If one were to read this section without reading subsequent Regulations Section 1.1033 (g)-1, a mistake could easily be made. This latter section resulted from the Revenue Act of 1958 and applies to condemnations of real property occurring after December 31, 1957. It provides that a reinvestment in "like kind" qualifies for deferment of tax. The prior section of the regulations which was published on January 9, 1957, has not been changed to conform to the new law.

CAPITAL GAINS AND LOSSES (Subchapter P)

Sec. 1201

Using New Subsidiary's Stock To Provide Executive Incentive

A useful method of getting capital gain money to a key man.

In view of the changes in the Revenue Act of 1964, stock options may not be as attractive as they once were. Another interesting method of furnishing proprietary incentive is to permit the key man of a newly purchased subsidiary to purchase a minority interest in the subsidiary at the same time and at the same price at which the parent acquires the controlling stock.

The subsidiary may be a raw-material "supplier" for the parent or a new sales outlet.

In any event, the value of the newly acquired company's stock is fixed by reference to the cash price paid by the parent to a third party for the majority of the subsidiary's stock. Any increment in the value of the subsidiary's stock accrues to the parent — and also to the minority stockholding executive. If and when the subsidiary's stock becomes more valuable, the parent can buy the executive's interest. *Sec. 1201*

Effect: A substantial incentive to the executive in the form of potential long-term capital gain.

"Seller's Option" Used to Extend Stockholding Period *Sec. 1223*

A means of stretching the holding period to more than six months.

In a private ruling, an investor, anticipating a drop in the price of appreciated stock held for less than six months, was allowed to make a sale at "seller's option" with delivery delayed until after the expiration of the six-month period in order to insure realization of the gain without sacrificing long-term capital gain treatment.

In this ruling the Revenue Service approved long-term capital gain treatment where a taxpayer sold shares at "seller's option" (as provided in Rule 64(3) of the New York Stock Exchange) before the end of the six-month holding period but with delivery to be made a month later, which was after the expiration of the six-month period. Under the terms of the sale, the taxpayer was paid the opening sales price on the New York Stock Exchange for the day of sale less the necessary price concession usual for this type of transaction. Any dividends payable before the delivery date and all other incidents of ownership of the stock remained with the seller. The ruling was based on the conclusion that the "seller's option" contract was an executory contract to sell the taxpayer's shares, at a fixed price, on the delivery date and that the taxpayer retained all incidents of ownership until that time. Accordingly, the holding period was deemed to run through the delivery date.

A sale at "seller's option" is described in Rule 64(3) as "... for delivery within the time specified in the option, which time

Sec. 1223 shall be not less than five business days nor more than sixty days following the day of the contract; except that the Exchange may provide otherwise in specific issues of stocks or classes of stock. . . ." Rule 179(a) makes it clear that the delivery of securities sold in this way may be made at the option of the seller before the expiration of the option but otherwise delivery shall be due on the day of the expiration.

Despite the IRS ruling, some concern has been expressed as to whether a "seller's option" transaction might be considered to be equivalent to the acquisition of a "put" (option to sell), exercisable at any time during the option period. Such a determination would bring the rules of Section 1233(b) into play and the gain would still be considered as short-term.

Holding Period for Optional Valuation Date

A point not covered by the statute.

Where the optional valuation date is selected by the executor in valuing securities includable in the gross estate, and a sale of securities takes place within six months thereafter at a substantial profit, is the gain long-term or short-term? Section 1223 of the Code which deals with the holding period of property does not make any reference to the alternate valuation date privilege and for that matter does not make any specific reference to the date of acquisition of property acquired from the decedent. The court-established rule, which deals with property acquired from a decedent which was valued in the gross estate at date of death, is that the holding period starts on the date of death. It would seem in the absence of a specific requirement concerning the optional valuation date, that the same rule should apply and the holding period would begin on the date of death. The only published authority on the point is a special ruling dated September 24, 1946 (to which some of the services refer) which confirms this conclusion. The special ruling dealt with inclusions of property in the gross estate at the alternate valuation date. Accordingly, it would appear that the gain would be long-term even though measured by the fair market value on the optional valuation date.

Obtaining Maximum Benefits of Section 1231

Application of installment method to gains may preserve maximum tax benefits from losses.

In order to obtain the maximum tax benefits for the sale of assets used in a trade or business and owned for more than six months, it is axiomatic that sales resulting in a profit and those resulting in a loss should occur in different taxable years. The reason is, of course, that net gains are taxable at the capital gains rate of 25 per cent, while net losses are deductible in full against ordinary income. However, it is necessary that all such sales be aggregated to determine whether there has been a net gain or loss for each taxable year.

However, it often happens that reasons other than tax planning demand the sale of many fixed assets within one taxable year and substantial gains are realized on some while substantial losses are incurred on others.

One suggested method for minimizing the detrimental tax effect is to arrange the profitable sales so that they may be reported under the installment sale provisions of Section 453. Thus, only a portion of the gain would offset the fully deductible losses in the year of sale.

In determining the capital gain consequences of sales of Section 1231 property, consideration must now also be given to the effects of Section 1245. Pursuant to that section, the profit on sale or other disposition of most depreciable property, other than buildings, will be taxed as ordinary income to the extent of post-1961 depreciation. The disposition of depreciable real property may now also produce some ordinary income under new Section 1250.

Stepping Up Property Basis by Transfer to Corporation Less Than 80 Per Cent Owned

Where the fair market value of property owned by an individual greatly exceeds its cost, the basis of the property may be stepped up by transferring it to a corporation in a taxable transaction.

If the individual (together with his spouse, minor children, or minor grandchildren) owns less than 80 per cent of the

Sec. 1231 corporation's stock, he will incur only a capital gain tax on the appreciation (subject, of course, to the application of Sections 1245 and 1250). However, the basis of the property to the corporation will be its appreciated value; the depreciation deduction computed on the stepped-up basis will reduce income taxed at the top corporate rate.

Here's an example. An office building has an adjusted cost to an individual of $200,000. It's worth $500,000. He obtains a mortgage of $500,000 on the building and transfers the building to a corporation subject to the mortgage. The transfer is taxable —he has a gain of $300,000.

So long as he (or his wife, minor children, or minor grandchildren) does not own more than 80 per cent of the corporation's stock (and new Section 1250 does not affect the transaction), the gain is a capital gain (Sec. 1231). Otherwise, it's ordinary income (Sec. 1239(a)(2)).

The basis of the office building to the corporation is $500,000.

A recent case, in which capital gain was determined to have been realized, involved the sale of a building to a family corporation where the corporation's stock was owned by trusts of which the grantor's children were beneficiaries. The Circuit Court emphasized that "ownership" for purposes of Section 1239 means direct ownership and does not include indirect beneficial ownership (*Mitchell*, C.A.-4, reversing 35 T.C. 550).

Uninsured Casualty Loss: Ordinary or Capital Loss?

Recent court cases indicate that uninsured personal casualty losses are not subject to Section 1231.

Section 1231 generally provides that only the excess of Section 1231 gains over Section 1231 losses will give rise to capital gain treatment. The regulations interpreting Section 1231(a)(2) provide that a loss upon complete or partial destruction of property subject to the Section will be treated as from an involuntary conversion and, therefore, a Section 1231 loss. With the exception of loss on uninsured business or income-producing property, it makes no difference whether the property converted was or was not covered by insurance.

Thus, under these regulations, T, who realized $5,000 of Section 1231 capital gains from the sale of depreciable property, must offset a $1,000 uninsured casualty loss to his yacht held for more than six months (after disallowing the first $100 of loss), resulting in a net Section 1231 capital gain of $4,000. *Sec. 1231*

The Tenth Circuit (*Maurer,* 284 F. 2d 122 (1960)) held that Section 1231 is inapplicable to an *uninsured* casualty loss and that such loss was deductible in full as an ordinary deduction. Under this decision, the result in the example would be that the Section 1231 capital gain would be $5,000 and the $1,000 loss would be deducted under Section 165 as an ordinary deduction. The Court restricted 1231 application to *insured* casualty losses because it deemed an uninsured casualty loss not an involuntary conversion.

The decision in *Maurer* was followed in several recent district court cases; see, for example, *Morrison* v. *U.S.* D.C. East. Dist. Tenn., 4/17/64. An argument was made by the government in this case that Congress in 1958, by enacting a specific exclusion from 1231 treatment of certain uninsured casualty losses arising from business or income-producing property, left uninsured casualty losses with respect to the property in issue here within the Section. The Court never answered this argument. A possible conclusion would be that the *Maurer* decision represented what the law was prior to 1958.

Be that as it may, these court decisions are authority for the more beneficial tax treatment of deducting the personal casualty loss as an ordinary deduction, as opposed to throwing such losses into the hodgepodge of 1231, thus possibly limiting them to capital loss treatment.

Short Sale Closed Out by an Estate

Sec. 1233

Tax on the gain is postponed and perhaps avoided.

A person who owns securities which have substantially increased in value may, for various reasons, wish to make a short sale of substantially identical securities. If he dies before the short sale is closed, the estate will close the short sale by delivering the substantially identical securities which were owned by the decedent at the time of his death and which pass to the estate. Internal Revenue Service has ruled privately that the gain

Sec. 1233 or loss on the short sale is to be computed by using the estate tax valuation as the basis of the securities used to cover the short sale, and that there is no income with respect to a decedent in connection with such transaction.

Sec. 1245 Depreciation Recapture Traps in Section 1245

A general review of the scope and operation of the section.

Code Section 1245, added by the Revenue Act of 1962, provides that gain realized on the disposition of "Section 1245 property" equal to or less than the depreciation deducted since December 31, 1961, is to be taxed as ordinary income where the disposition occurs in a taxable year beginning on or after January 1, 1963. Unlike Section 1250, added by the Revenue Act of 1964, the full amount of depreciation deducted in 1962 and later years is subject to recapture and it matters not how long the property is owned. Generally speaking, "Section 1245 property" consists of all tangible or intangible property, except livestock and buildings with their structural components, which qualifies for a depreciation deduction under Code Section 167. Machinery and equipment, patents and copyrights are "Section 1245 property" and subject to the depreciation recapture rules. So also are contracts and franchises.

Section 1245 overrides all contrary provisions of the Code. This means that, even though some other section may state that no gain or loss shall be recognized on a particular disposition or exchange, nevertheless ordinary income will arise unless some portion of Section 1245 itself states it is not to be applicable to such a type of transaction.

Sales. The most common type of disposition giving rise to recapture is a sale. There that portion of the realized gain which is not in excess of the post 1961 depreciation deductions is taxed as ordinary income. The balance of the gain continues to receive capital gain treatment to the extent provided in Code Section 1231.

Distributions in kind. If Section 1245 property is distributed to shareholders as a property dividend or as a distribution in either partial liquidation or complete liquidation, ordinary income will result to the distributing corporation. In such an instance, the amount of the gain constituting ordinary income is the amount by which the fair market value of the property on the date of disposition or its recomputed basis, whichever is lower, exceeds its adjusted basis.

Section 337 inoperative. A sale of property at a gain by a corporation during a twelve-month period following the adoption of a plan of complete liquidation will give rise to a Section 1245 problem despite the existence of Code Section 337.

One-month liquidation. A liquidation under Section 333, under which Section 1245 property is distributed to shareholders, holds a trap for the unwary. The liquidating corporation will pick up Section 1245 income in its final return, and this income in turn will increase the accumulated earnings and profits of the corporation, thus subjecting the individual stockholders to a higher tax on their ratable share of the earnings and profits. In this instance the tax collector gets a double-barreled benefit from the operation of Section 1245.

Capital contribution. Contrary to what might be expected, a shareholder may realize a Section 1245 gain if he makes a capital contribution of property to a corporation. It does not seem that the exception granted gifts can be relied upon. However, perhaps the exception granted Section 351 transactions in Code Section 1245 can be used if the necessary 80 per cent control exists between the recipient corporation and the contributor and if additional shares are issued to the contributor. Even if no additional stock is issued, it has been the unwritten policy of the Internal Revenue Service over the past several years to treat a capital contribution of property in such an instance as coming within Code Section 351. Nevertheless, now that tax can be obtained by treating a pure capital contribution as being outside Section 351, it is to be expected that the Internal Revenue Service in such an instance may apply Code Section 1245 (see, however, Rev. Rul. 64-155, IRB 1964-2).

Consolidated return years. Even though the proposed regulations under Section 1245 do not deal with the problem, the existence of Regulations Section 1.1502-51(c)(2)(i) pertaining to the investment credit indicates that perhaps the Internal Revenue Service will not claim recapture under Code Section 1245 when the depreciable property was acquired by a member of an affiliated group during a consolidated return year and is thereafter transferred to another member of the same affiliated group in a consolidated return year. The cited section of the regulations provides that there shall not be any recapture of an investment credit in such a circumstance. However, if the depreciable property was acquired in a separate return year and is then transferred to an affiliated corporation in a subsequent consolidated return year, there may well be recapture under Code Section 1245.

Liquidation under Section 334(b)(2). As previously noted, a sale of machinery, equipment, and other Section 1245 property at a gain will give rise to ordinary income even if pursuant to Section 337. Similarly, a sale of stock followed by a liquidation under Section 334(b)(2) will cause Section 1245 ordinary income. The buyer will undoubtedly take this into consideration. However, if the purchase price is exactly the same in both cases, there will be a higher basis for the assets where the acquisition follows the Section 334(b)(2) route.

Where the assets are directly purchased for cash, the tax paid by the seller on the recapture gain has no effect on basis to the buyer. However, where the buying corporation first acquires 80 per cent or more of the outstanding stock for cash and then shortly thereafter liquidates the newly acquired subsidiary, the tax on the recapture gain is added to the basis of the stock because under Regulations 1.334-1(c)(4)(v)(a)(1) it becomes an unsecured liability assumed by the parent corporation. Such increased stock basis is then apportioned among the assets acquired.

These regulations also provide that an increase in earnings of the subsidiary occurring between the date of purchase of the stock control and the date of liquidation shall also be added to the basis of the stock. However, it is debatable whether an increase in earnings and profits of a subsidiary attributable to a recapture gain can be so added to the basis of the parent corporation's stock investment. The problem arises because these regulations were written before recapture was even thought of. For example, if in January 1964, a parent corporation, a calendar year taxpayer, purchased 100 per cent of the stock of another corporation and then liquidated that corporation within a week after its acquisition, there is potential ordinary income with respect to every piece of machinery and equipment which was purchased in 1964 and prior years, and which on the date of liquidation had a fair market value of more than the depreciated cost. If a particular machine had a fair market value of $200 more than its depreciated cost, but only $100 of depreciation was claimed and allowed for the years 1962, 1963 and 1964, the recapture gain would be $100, which at a 48 per cent tax rate would result in an increase in earnings of $52 and an increase in unsecured tax liabilities of $48. Although it seems clear that the $48 of tax can be added to basis, Regulations Section 1.334-1(c)(4)(vi)(a) can be interpreted to require that the net increase in earnings of $52 can be disregarded. It is there provided that any gain or loss "from sales or exchanges" of property owned on the date of purchase of stock control shall be recomputed by reference to the basis of the stock for purpose of determining an increase in earnings arising after acquisition of control. A distribution in complete liquidation of a subsidiary is treated by Code Section 331(a)(1) as an exchange. As this increase in earnings is attributable to an exchange, then under the regulations just cited, for the sole purpose of determining any increase in earnings, perhaps the basis of the machine should be adjusted upwards to an amount having a relationship to the price paid for the stock. As a result, under such a computation there probably would be no gain and therefore no increase in earnings to be added to the basis of the stock for the purpose of calculating the new bases of the underlying assets.

Depreciation Recapture Sours Market for Citrus Groves

A tax shelter is made less desirable by Section 1245.

In years gone by, an investment offering many tax advantages was the purchase of a matured citrus grove. The purchaser would depreciate the trees under the 150 per cent declining-balance depreciation method and thereby realize a tax loss during the

Sec. 1245 early years of ownership of the grove. As soon as the depreciation deductions became so small that they would no longer offset net proceeds from the sale of fruit, he would sell the grove to another individual. That portion of the gain, which would be most of it, attributable to the trees would constitute Section 1231 capital gain. The new owner would then start the depreciation cycle all over again. This device no longer works because of the provision for depreciation recapture added to the Internal Revenue Code by the Revenue Act of 1962 inserting Code Section 1245. The result is that, according to a representative of the citrus industry who testified a few months ago before the Internal Revenue Service, sales of developed citrus groves have virtually ceased.

Upon the sale today of a developed citrus grove, that portion of the gain attributable to the trees will result in ordinary income to the extent of depreciation allowed since 1961. Depreciation recapture under Section 1245 applies to tangible property used in production. The term "production" has been defined in proposed Regulations 1.1245-3(c)(2) by cross reference to Regulations 1.48-1(d)(2) as including depreciable property used in the cultivation of orchards.

It is true that the 7 per cent investment credit is applicable to the purchase of citrus groves. However, as mature trees would constitute used property, the credit would apply only to the first $50,000 of income producing trees purchased each year. (Rev. Rul. 65-104, IRB 1965-16, 7.) If the trees were not at the income producing stage when purchased, the revenue ruling held that the trees would be new "Section 38" property when they become income producing.

Sec. 1250 Depreciation Recapture Traps and Depreciable Real Estate

The Revenue Act of 1964 extends Section 1245 problems to depreciable real estate.

Recapture of a portion of depreciation allowed on depreciable real property in 1964 and subsequent years is provided for in Code Section 1250, added by the Revenue Act of 1964. The new section applies to any real property, other than Section 1245 property, which is or has been property of a character subject to the allowance for depreciation provided in Code Section 167. *Sec. 1250* In other words, it applies to shopping centers, office buildings, hotels, motels, and apartment buildings. It does not apply to railroad tracks, bridges, and blast furnaces because those types of depreciable real property are covered by Section 1245. An air strip built by a manufacturing company on its land for the use of its company airplanes will be Section 1250 property rather than Section 1245 property because the manufacturing firm is not engaged in the transportation business (Senate Finance Committee Report, Revenue Act of 1962). Further, sidewalks, private streets, parking areas, advertising displays (if constituting real property), outdoor lighting facilities, and swimming pools are Section 1250 property. Fences are Section 1245 property in the case of farmers and ranchers, but are Section 1250 property in the case of manufacturers (Senate Finance Committee Report, *idem*).

In the case of property held more than one year, the only depreciation subject to recapture is the excess of accelerated depreciation over straight-line depreciation claimed for any period after December 31, 1963. In other words, the excess of the amount of depreciation determined under the 200 per cent declining-balance method, the 150 per cent declining-balance method, or the sum-of-the-years-digits method over the amount of depreciation that would have been allowable under a straight-line method is potentially subject to recapture. The amount actually subject to recapture is determined by applying a percentage to such amount. The percentage decreases with the length of time that the property is held. If the property is held ten years, the percentage is zero, nine years—12 per cent, eight years—24 per cent, five years—60 per cent, three years—84 per cent, one year—100 per cent.

In every instance in which depreciation recapture is triggered by Section 1245, recapture will also occur under Section 1250 if the property has been held for less than ten years. In other words, recapture will occur on a distribution in kind to shareholders, on a sale during the liquidation period under Code Section 337, on a sale during the one-month liquidation period under Code Section 333, and on a liquidation of a newly acquired subsidiary corporation under Code Section 334(b)(2).

Unlike the Revenue Act of 1962, the new Revenue Act does not grant any new election to change to a more conservative

Sec. 1250 method of depreciation applicable to Section 1250 property. This means that in the case of a building or other Section 1250 property a taxpayer cannot change from one of the accelerated methods of depreciation to the straight-line method without first obtaining the Commissioner's consent, with two exceptions. He may change from the 200 per cent declining-balance method to the straight-line method by the right given him under Code Section 167(e)(1). Further, a taxpayer has an automatic right to change from the 150 per cent declining-balance method to the straight-line method with respect to new property acquired in 1954 and later years, but not with respect to new property acquired prior to 1954 or used property acquired at any time. (Rev. Rul. 57-510, 1957-2 C.B. p. 152.)

Salvage Value in Computation of Section 1250 Income

The committee report indicates that salvage value must be used in computing the "as if" straight-line depreciation.

Section 1250 provides that ordinary income will be realized on the disposition of depreciable real property to the extent of all or a part of post-1963 depreciation in excess of straight-line depreciation. Assuming the taxpayer was using the declining-balance method for actual depreciation computation, would he be required to use salvage value in the computation of straight-line depreciation? This becomes important as it would decrease the amount of straight-line depreciation and increase the amount of Section 1250 income.

Section 1250(b)(1) states that the same useful life and salvage value used in determining the deduction for depreciation should be used in computing Section 1250 straight-line depreciation. Since no salvage value is used in declining-balance depreciation, it would appear that salvage value would not be required for the computation of straight-line depreciation. However, the committee report states that if salvage value was not taken into account in determining the depreciation deduction, as in the case of declining-balance method, salvage value which would have been proper if depreciation had actually been determined under the straight-line method must be used.

If a taxpayer has adopted guideline depreciation, he should have a somewhat stronger position for ignoring salvage value since the guideline lives are based upon computation of depreciation without salvage value. *Sec. 1250*

READJUSTMENT OF TAX BETWEEN YEARS AND SPECIAL LIMITATIONS (Subchapter Q)

How to Take Maximum Advantage of Averaging Provisions

Sec. 1301-05

The consequences of long-term capital gains on income averaging are not obvious.

Taxpayers who will qualify for income averaging under the relief provisions enacted in the Revenue Act of 1964 (Sections 1301-1305) should pay particular attention to their year-end tax planning regarding capital gains and losses, if they have capital gain net income (i.e., 50 per cent of net long-term capital gain) in the preceding four-taxable-year base period.

Section 1301 limits the tax on averageable income to five times the tax attributable to one-fifth of averageable income added to 133-1/3 per cent of average base period income plus average base period capital gain. Section 1302(a)(2) provides that if the average net capital gain included in taxable income for the four preceding taxable years exceeds the capital gain net income for the current or computation year, then the amount of income subject to averaging must be reduced by an amount equal to such excess.

Some writers on this subject have indicated that if this situation exists, the taxpayer should realize capital gain net income to the extent of the average base period capital gain net income. It appears that this advice does not apply in all cases and that it must be determined in each instance by an actual computation, Sec. 1301-05 using all the facts known – including what effect the gain would have if realized in the succeeding taxable year, when the taxable income may be considerably smaller. It may even prove advantageous to realize capital losses to offset existing computation year capital gains in some cases.

For a taxpayer to take maximum advantage of the averaging provisions when there are base period capital gains, it will be necessary for him to: (1) compute the tax under these sections using the facts known both before and after any prospective year-end capital gain positioning transaction; (2) determine the effective rate paid on the additional gain, if realized, or the value of realizing a loss; and (3) determine the effective rate of tax if the transaction is postponed to the next year, when the extraordinary income that qualified the taxpayer for averaging may not be present. The difference is the current year's tax if it is less than the amount computed without the benefit of this relief provision.

The Surviving Spouse and Income Averaging

Income averaging makes the right to file as a surviving spouse even more valuable.

The income averaging rules dealing with the surviving spouse are among the more complicated parts of the averaging provisions. If an individual was married for the current computation year or any of the four preceding years and files an individual return for the computation year, then his income must be "reconstructed." His base period income for the purposes of averaging may not be less than: (a) his actual income, (b) 50 per cent of the combined income of himself and his spouse for the computation year, or (c) 50 per cent of the combined income of himself and the person who was his spouse for the base period year, whichever is the greatest.

Averageable income includes net income on gift or bequest property where the gift or bequest was between spouses making a joint return for the computation year, or between spouses making a joint return for the base period year, or between spouses where one of them makes a surviving-spouse return for the computation year. Pity the poor widow who receives large net income from a bequest from her decedent spouse but cannot file a surviving-spouse return because she has no dependent. Her base period income will have to be reconstructed under the rules described in the preceding paragraph. The income from the bequest will not be subject to averaging but her base period income after reconstructing will be quite high. Therefore, in spite of the substantial jump in her income and the fact that she cannot split her income by using the joint return rates, she will still be unable to obtain the benefits of income averaging. *Sec. 1301-05*

The young widow with at least one dependent child would, on the other hand, probably be able to obtain substantial benefits from income averaging because her base period income would only be the greater of her actual base period income or 50 per cent of the income of herself and her decedent spouse, but the substantial income on the property received from her husband would be subject to averaging for the two years she files a surviving-spouse return. This results from the fact that the income averaging provisions will apparently treat a surviving-spouse return as a return by a single individual who was married in a prior year and will not require the average base period income to include the total income of the spouses but only the greater of the actual income or 50 per cent of the total income of the spouses.

Don't Overlook Section 1341

Sec. 1341

How a current loss can, in effect, reduce a prior tax.

Frequently taxpayers may have to report a substantial capital gain upon the liquidation of a corporation, and then subsequently repay an amount in excess of $3,000 on behalf of the corporation. The capital loss arising from the repayment may be of little tax benefit in the year of payment.

Under these circumstances, the benefit of Code Section 1341 should not be overlooked. This section, in effect, permits recomputation of the *prior* year's tax liabilities after reducing the gain previously reported by the repayment in the *current* year. The tax reduction for the prior year is then deducted from the tax liability for the current year computed without taking the repayment into account.

ELECTION TO BE TAXED AS CORPORATION (Subchapter R)

Sec. 1361

Election to Be Taxed a Corporation Can Be a Reincorporation

Unexpected dividend consequences may result.

A corporation has a Section 531 problem represented by substantial accumulated earnings and attendant excess of liquid assets. It adopts a plan of complete liquidation on November 30, and all of the assets are distributed to the stockholders in kind. The stockholders retain the liquid assets and form a partnership to continue the conduct of the business. The partnership adopts the calendar year for its taxable year and files a first return for the month of December. An election then is made to be taxed as a corporation under the provisions of Section 1361 of the Code for the next taxable year of the partnership.

Under the provisions of Section 1361(m), it is clear that if the Section 1361 election were made in December, the first taxable year of the partnership, the Section 1361 corporation would be considered to be a corporation for purposes of the reorganization provisions of Subchapter C. Accordingly, the liquidation of the *de jure* corporation and formation of the Section 1361 corporation would constitute a reorganization with the result that the liquid assets retained by the stockholders on liquidation would be taxed as a dividend under Section 356(a)(2).

Query: Will the one-month delay in the Section 1361 election, so that it does not occur in the first taxable year of the partnership, remove the threat of application of the reorganization provisions and insure capital gain treatment for the liquidation distributions?

We understand that technicians in the National Office of the IRS have indicated informally that if such a transaction were presented to them for a ruling, they would regard the establishment of the one-month first taxable year of the partnership as having no real purpose other than tax avoidance. The liquidation of the corporation, the creation of the partnership, and the Section 1361 election would be considered to be parts of a single transaction requiring taxation of the assets withheld from the partnership by the stockholders as an ordinary dividend. *Sec. 1361*

ELECTION TO HAVE CORPORATION INCOME TAXED TO SHAREHOLDERS (Subchapter S)

Subchapter S Profit Year Followed By a Loss Year *Sec. 1371-77*

The importance of timing.

Corporation X (calendar-year basis) had substantial retained earnings before it elected to be a Subchapter S corporation. In its first year as a Subchapter S corporation (1959) it had a profit of $10,000 but, because of need of working capital, it did not distribute the profit to the stockholders. In the second year as a Subchapter S corporation (1960) it incurred a loss of $20,000. The corporation and its stockholders are on the same taxable year.

It will be to the advantage of the shareholders for the corporation to distribute the profit of the first year before the end of the loss year. The reason for this is that the net operating loss does not affect the shareholders' share of previously taxed income for purposes of determining the nature of distributions during the loss year but the previously taxed income is reduced by losses allowable for taxable years of the shareholder ending before the distribution. For example, if the above corporation distributed the $10,000 1959 income in 1960, it would not be taxable to the stockholders. If distributed in 1961, it would be taxable.

Authority for this is in Section 1375(d)(1) and Regulations Section 1.1375-4(d). (See also the following item which indi-

Sec. 1371-77 cates similar treatment when the gain and loss years are reversed.)

Net Operating Loss Benefit May Be Lost

Timing is also important when the income year follows the loss year!

A corporation electing under the provisions of Subchapter S, having accumulated earnings and profits at the time of making such election, offers special problems concerning the timing of distributions to the shareholders. Assume the following facts with respect to a corporation which has properly elected under the provisions of Section 1372 to be treated as a Subchapter S corporation for the calendar year 1963:

Accumulated earnings and profits from inception to December 31, 1962		$10,000
Corporation net operating loss allowed to shareholders for year ended December 31, 1963	$(10,000)	
Shareholders' undistributed taxable income for the year ended December 31, 1964	30,000	20,000
		$30,000

If no cash distributions are made during 1964 with respect to the earnings and profits for that year, Regulations Section 1.1375-4 (d) provides that the shareholders' net share of previously taxed income which may be distributed tax-free in 1965 is $20,000. However, the shareholders will be required to report their respective shares of the undistributed taxable income of $30,000 allocable to them on December 31, 1964, in accordance with Section 1373(b). Under these circumstances, and assuming zero earnings and profits for calendar year 1965, a cash distribution of $30,000 made in 1965 would be, in part, a recovery of shareholders' net share of previously taxed income of $20,000 and a dividend from accumulated earnings and profits of $10,000. The shareholders will be taxed on $30,000 of undistributed taxable income in 1964 and $10,000 of dividend income in 1965, but will receive only $30,000 in cash.

The most advantageous procedure would be to distribute

$30,000 in cash prior to December 31, 1964. The shareholders would then be required to report only $30,000 as dividend income from a Subchapter S corporation in 1964. In subsequent years it would also be necessary to make similar distributions from current earnings prior to year-end to avoid losing the full benefit of the net operating loss previously allowed to shareholders. *Sec. 1371-77*

Subchapter S Corporations Claiming Percentage Depletion

Section 1.1377-2(b) of the regulations treats the excess of percentage depletion over cost as "earnings and profits."

Because of the difference between "taxable income" and "current earnings and profits" a venture entitled to percentage depletion (in excess of cost depletion) will be denied the percentage deduction with respect to "earnings and profits" if it incorporates and elects taxable status under Subchapter S.

The excess of percentage depletion over cost depletion is considered "earnings and profits" of a corporation. Thus, if the stockholders withdrew in cash such excess, it would be taxable as a dividend out of current earnings and profits, thus placing the stockholders in the position of paying tax on taxable income computed without percentage depletion.

Disallowed Expenses Under Subchapter S

The tax consequences may not be as serious as in the case of an ordinary corporate disallowance. However, they may be more serious where a loss is incurred.

Practitioners have become familiar in recent years with the Revenue Service practice of disallowing travel and entertaining expenses of a closely held corporation and of taxing the disallowed expenses as dividends to a shareholder. It is interesting to note how this affects the taxpayer where an election is made under Subchapter S.

Assume an electing corporation has accumulated earnings of $20,000. During 1960, the corporation has a profit of $15,000.

Sec. 1371-77 There are no distributions during the year. Thus, the $15,000 is picked up by the shareholders on their returns for 1960 as undistributed taxable income. Upon examination of the return the Revenue Service disallows $5,000 of travel and entertaining expenses.

Income of the shareholders will be increased by only $5,000 whether the $5,000 disallowance is considered an increase in undistributed taxable income (with a corresponding increase in the amount reported by the shareholders) or as a money distribution of current earnings (offsetting the increase in taxable income so that undistributed taxable income remains $15,000).

Now, assume that instead of a profit for 1960 the corporation has a loss of $15,000 and the loss is deducted by the shareholders on their returns for 1960. Again, upon examination of the return, the Revenue Service disallows $5,000 of travel and entertaining expenses which reduces by that amount the loss available to the shareholders. In addition, the $5,000 will be considered a distribution out of accumulated earnings and profits. The effect is to increase income of the shareholders by $10,000—twice the amount of disallowed expenses.

Income Averaging and Subchapter S

A new factor to be considered in connection with the Subchapter S election.

There are a number of important tie-ins between the income averaging provisions and Subchapter S. Obviously, in the first year or so under the Subchapter S election, a shareholder may experience a significant increase in his income as compared with the preceding four years. Therefore, the advisability of making the Subchapter S election in the first place may be increased because income averaging will reduce still further the overall taxes which would have been paid if the Subchapter S election had not been made. It is possible that certain situations will arise where it is advisable to make the Subchapter S election to obtain the benefits of averaging for a year or two, then revoke the election, wait five years, re-elect Subchapter S, and again take advantage of income averaging.

One of the unanswered questions present in the interrelationship between Subchapter S, if the stock in the corporation was received by gift or bequest, and income averaging is whether total Subchapter S income taxed to a shareholder will be eliminated from averaging, as income from gifts or bequests in the computation year (current year) or from base period years (four years prior to current year). It would appear that the elimination would be made if the stock was received by gift or bequest during the base period or during the computation year.

This raises some interesting possibilities. Suppose a shareholder receives stock in the first year of his base period and immediately a Subchapter S election is put into effect. For the entire base period he takes no salary and only receives distributions of taxable income from the Subchapter S corporation. For the computation year, the Subchapter S election is revoked and the shareholder receives a sizable salary and a small dividend which does exceed $3,000. The dividend would be excludable from averageable income as income from gifts or bequests and, consequently, average base period income would likewise have to be reduced by gift and bequest income which presumably would include the total Subchapter S income for the base period years. This reduction in average base period income would result in an increase in averageable income for the computation year thereby allowing the taxpayer the benefits of averaging on the sizable salary received in the computation year. Under appropriate circumstances, however, Section 1375(c), which permits the Treasury Department to allocate income of a Subchapter S corporation among family shareholders in order to reflect the value of services rendered, might be applied in the base years.

Excessive Salaries Also a Problem Under Subchapter S

The Internal Revenue Service is still probing.

Many have assumed that adoption of Subchapter S will eliminate the controversies regarding excessive salaries paid to officer-shareholders. The thinking is that such payments to the extent that they are disallowed as salaries will be considered as a dividend, thereby reducing the undistributed taxable income and leaving no net tax effect.

However, a question has been raised by agents examining Subchapter S corporations, suggesting that a problem still exists for the following reasons:

1. It does not follow that the disallowed compensation can only be considered a dividend. This is especially true where the excessive payments do not bear a close relationship to the stockholdings.

2. If the salary is paid in other than cash, the excessive portion will not reduce the undistributed taxable income created by a salary adjustment.

3. Limitations on pension and profit-sharing contributions may become operative. In this respect, note that the regulations provide that no deduction is allowable under Section 404 for the amount of any contribution for the benefit of an employee which, together with other amounts paid to or for the benefit of the employee, is in excess of a reasonable allowance for compensation for the services actually rendered. Some agents are taking the position that, where salaries are already unreasonable, this rule operates to prevent the allowance of any contribution at all to a profit-sharing plan. Therefore, the entire contribution for the employee-shareholder group may be disallowed, thereby increasing undistributed taxable income.

4. It can also be anticipated that the Commissioner will still challenge the reasonableness of salaries to avoid the establishment of a pattern of executive compensation which can create a precedent for periods during which an election is not in effect.

Watch Out for Effect of Termination of Subchapter S Status

The form and timing of a transaction may determine the fate of "locked-in" earnings.

The shareholders of a small business corporation as defined in Section 1371 must constantly be on guard against an inadvertent termination of their Subchapter S status. Such a termination would result in the undistributed previously taxed income being locked in the corporation until final liquidation. Alternatively, unintended dividend consequences could occur. Section 1372(e)(3) provides that termination shall be effective for the taxable year of a corporation in which it ceases to be a small business corporation and for all succeeding taxable years. *Sec. 1371-77*

For most Subchapter S companies, the problem of "locked-in" earnings in the year an election is terminated may only be avoided by timely distributions. In many situations, however, distributions are not made for one reason or another, and a substantial amount of undistributed previously taxed income may exist at any given time. Such a situation presents a crisis at a time when the shareholders are approached to "go public" or to be absorbed in an advantageous merger, etc. Since either of these events would result in a loss of Subchapter S status under Section 1371, must these possibilities be given up because of a freezing in of earnings which would be unpalatable to the Subchapter S shareholders?

In Rev. Rul. 64-94, IRB 1964-12, 13, it is held that a Subchapter S election of a small business corporation which merges into another corporation in a Section 368(a)(1)(A) statutory merger does not terminate with respect to its final taxable year ending on the date of the merger. The reason advanced is that Section 1372(e)(3) applies only to a corporation which ceases to be a small business corporation by virtue of an event which does not terminate its taxable year. In the case of a statutory merger, the event causing the disqualification as a small business corporation also terminates the taxable year. Accordingly, it retains its electing status throughout the entire year so terminated. This ruling permits shareholders, prior to the date of a statutory merger, to draw out their previously taxed income.

Since the ruling applies only to a statutory merger, if the stock of the Subchapter S corporation were disposed of in a taxable transaction or in a "stock for stock" reorganization under the provisions of Section 368(a)(1)(B), it would appear that a termination of the election for the current taxable year under Section 1372(e) would occur, with no opportunity to distribute previously taxed income. In such a situation, if the acquiring company files a consolidated return with its new subsidiary, an interesting question is presented.

Under consolidated return Regulation 1.1502-13(g), the Subchapter S corporation will be required to file a separate return for the short taxable year ending with the day preceding the date its stock was sold. Applying the reasoning of Rev. Rul. 64-94, this short period might therefore be held to constitute a taxable year for purposes of Section 1372(e)(3), in which event the Subchapter S status would not terminate until the following day (next taxable year). This would permit the Subchapter S shareholders, as in the case of a merger, to make distributions of previously taxed income. Since Rev. Rul. 64-94 does not cover this possibility, however, there is no assurance the Service would adopt this view.

Where a Subchapter S corporation desires to go public, automatically resulting in a retroactive termination (more than ten shareholders), and because of market conditions the underwriters do not deem it desirable to wait until the end of its taxable year, the shareholders are again faced with a problem of locked in previously taxed earnings. The solution would be simple if the corporation could close its taxable year prior to the public offering, but this requires permission of the Commissioner (see Regulation 1.442-1(c)(4). We understand where such facts were present the Commissioner has not considered the request to close the taxable year to be a tax-saving gimmick and has ruled favorably.

How to Recover an Ordinary Loss At Capital Gain Rates

Careful planning is necessary, however.

Under the rules applicable to Subchapter S corporations, a shareholder reduces the basis of his stock in such corporation by the amount of his share of the net operating loss for the year but does not reduce such basis below zero. If the shareholder's share of the net operating loss exceeds his basis for his stock, he reduces the basis of any indebtedness of the corporation to such shareholder, but not below zero. For example, assume the shareholder's basis in his stock in a Subchapter S corporation is $10,000 and he has a note receivable from such corporation in the amount of $20,000. The shareholder's share of the net operating loss for the year 1964 is $20,000 and he uses this to offset ordinary income from other sources in his 1964 return. Thus, according to the rules of Section 1376, he has a zero basis for his stock and a $10,000 basis for the note receivable. In the year 1965, the Subchapter S corporation makes a principal payment of $8,000 on the $20,000 note payable. The questions which are not answered in the Code or regulations are how much, if any, income does the shareholder have in 1965 as a result of receipt of the $8,000 payment on the loan and what is the nature of the income, if any. *Sec. 1371-77*

In Rev. Rul. 64-162, IRB 1964-21, 24, the Service has held that each payment on the note consists in part of return of capital and in part of income. Thus, in our example, with a basis of $10,000 for a note in the face amount of $20,000, 50 per cent of each payment would be treated as income and accordingly $4,000 of the $8,000 received constitutes income and $4,000 represents return of capital. The Service has taken the further position that if the note is a capital asset in the hands of the shareholder, the amount of $8,000 received in payment on the note represents an amount received by the holder on retirement of an evidence of indebtedness and pursuant to Section 1232(a)(1) is considered as an amount received in exchange therefor. Thus, assuming the note had been held by the shareholder for more than six months, the $4,000 of income considered to have been received would be treated as a long-term capital gain.

Despite the above, do not overlook the thin corporation problem explained in the next item.

Stockholder Loans May Invalidate Subchapter S Election

A very important problem for all Subchapter S corporations.

Thin capitalization of any corporation is to be avoided, but is particularly dangerous in the case of a corporation for which a Subchapter S election is to be made. Regulations 1.1371-1 state that with such a corporation if "an instrument" purporting to be a debt obligation is actually stock, it will constitute a second class of stock, and so the election becomes void.

In the case of *Catalina Homes, Inc.*, 23 T.C.M. 1361, advances by shareholders to a Subchapter S corporation were held to constitute a second class of stock. The result was that the in-

Sec. 1371-77 come was taxed to the corporation and money paid as interest on the advances was treated as a nondeductible dividend.

A number of writers and tax services have recommended that it is generally advisable to withdraw the taxable income of a Subchapter S corporation in the same year it is realized. They have further stated that if the funds are needed, the amount distributed as a dividend can be loaned back.

It is important that the loans back to the corporation not result in thin capitalization. If thin capitalization does result, the IRS could readily assert that the "loan equity" constituted a second class of stock. In the case of loans on open account, if state law gives a preference to such loans over distributions on stock in the event of liquidation, perhaps such "equity advances" constitute a second class of stock.

In the case of loans represented by notes, again, such notes could be held to constitute a second class of stock if in substance they represent equity. Nevertheless, it will be quite helpful in rebutting the contention of thin capitalization to have the loans back to the corporation evidenced by notes having a fixed maturity date and bearing a fair rate of interest payable on fixed dates. Subordination of such notes to other creditors' claims should be avoided, as such a circumstance gives rise to the possibility that in substance such loans are equity.

WITHHOLDING OF TAX ON NONRESIDENT ALIENS AND FOREIGN CORPORATIONS (Chapter 3)

Sec. 1442 Income Tax Withholding on Dividends

A point which might be overlooked.

Company Y, a Western Hemisphere Trade Corporation, is a wholly owned subsidiary of Company X, a Canadian company not doing business in the United States. Company Y pays dividends regularly to its Canadian parent. Should the appropriate withholding tax be deducted from these dividends? *Sec. 1442*

It would appear that no withholding is necessary since, in order to qualify as a Western Hemisphere Trade Corporation, the U.S. company has to derive 95 per cent or more of its gross income from sources outside the United States. Code Section 861 makes it clear that, if less than 20 per cent of a domestic corporation's income is derived from sources within the United States, dividends paid by such corporation are not income from sources within the U.S.

Code Section 1442 provides that income tax withholding is required only where the income is from sources within the United States. Moreover, the U.S.-Canada income tax treaty requires withholding on dividends only where the income is from sources within the United States.

It seems clear, therefore, that in the case of this Western Hemisphere Trade Corporation no withholding is required on dividends paid to its Canadian parent.

CONSOLIDATED RETURNS (Chapter 6)

Loss Carryover to Consolidated Group From Separate Return Year

Sec. 1502

Follow the language of the regulations in this situation.

An interesting question presented is whether the net operating loss of S Corporation of approximately $260,000 from separate return years, or years when it was included in another consolidated group, may be carried over against the ordinary income of other members of a new consolidated group in the year 1965 where the income contributed to the group by S Corporation in 1965 is all long-term capital gain.

Under Regulations Section 1.1502-31(b)(3) such carryover is allowed to the extent that S Corporation has taxable income (including capital gains). Since S Corporation will have taxable income, all of which is capital gain, sufficient to absorb the net operating loss carryover, then the entire carryover is allowable in 1965 as a deduction. Once we have decided under (b)(3) that the deduction is allowable we look to the mechanical computations of consolidated taxable income to determine against what income the loss is deductible. By following the language of the regulations, it appears that the carryover is offset against ordinary income of the group and the capital gain is undiminished.

While this may seem to be a generous result, it appears to follow from the regulations.

Election to File Consolidated Return in Loss Year

A consolidated carryover may be more useful than individual carryovers.

In a year in which both parent and subsidiary have net operating losses, there is no immediate tax benefit in electing to file a consolidated return. If we assume that the facts are such that the losses cannot be carried back, they become net operating loss carryovers. However, before deciding to file separate returns, it is essential to determine, as closely as possible, the expected taxable income of the respective companies in the succeeding year.

To illustrate, assume that one company is reasonably expected to have taxable income considerably in excess of its loss carryover and the other company is expected to break even or have a small loss. In filing a consolidated return in the earlier year, the consolidated loss carryover can be used against the consolidated income in the succeeding year. However, the benefit of the unprofitable company's carryover loss cannot be used if separate returns are filed in the earlier year regardless of whether in the succeeding year the companies file a consolidated return or file separately. (Except with respect to losses carried from a pre-1964 separate return year to a post-1963 consolidated return year. Reg. Section 1.1502-31(b)(3)(i)(b).) The difficulty in forecasting the results of operation in the second year may be largely overcome in similar circumstances by using all the extensions of time available in filing the first consolidated return.

New Election by Consolidated Group

Method of tax-free acquisition affects right to new election.

An affiliated group of corporations wishes to file a consolidated return for calendar year 1962 but wants to file separately for 1963. The common parent intends to acquire control of a previously unaffiliated corporation in a tax-free exchange during 1963. If the acquisition is stock for stock under Section 368(a)(1)(B) and the acquired company is not immediately liquidated, it appears that a new election may be made (see Rev. Rul. 57-53, B.B. 1957-1).

If, however, acquisition of the same business is made on the basis of stock for assets under Section 386(a)(1)(C), we understand that the position of the IRS National Office is that a new election to file separate returns may not be made, even though such assets are acquired by a newly created subsidiary of one of the affiliated group companies or are immediately transferred to a subsidiary organized for the purpose. This position is based on the literal wording of 1.1502-11(a)(1), which permits a new election only if a corporation other than one created or organized directly or indirectly by a member of the group has become a member during the year.

In some cases this may appear to be an inequitable result, a harsh emphasis of form over substance, since the newly organized corporation succeeds to all the tax attributes of the transferor corporation under Section 381(a)(2). However, since this appears to be a firm view of the IRS, appropriate precautions should be taken, for example, by use of a "B"-type reorganization where a new election is desired.

Dividends in Consolidated Returns

A nondividend distribution may give rise to a capital gain.

A principal advantage of filing a consolidated return is the elimination of intercorporate dividends within the affiliated group. Under the 1964 Act this privilege also is available for qualifying dividends where separate returns are filed and an election is made to claim only one $25,000 corporate surtax exemption for the year. Paradoxically, the Commissioner has ruled (Rev. Rul. 57-201, 1957-1 C.B. 295) in the case of a consolidated

Sec. 1502 return that intercompany dividends are subject to elimination only to the extent that the distribution was from accumulated or current earnings. Consequently, dividends out of capital may give rise to capital gain even in a consolidated return, to the extent that the amount of the distribution exceeds cost basis. This latter point is controversial and may require litigation before the answer is really known.

Sec. 1552 Apportionment Election Required In First Consolidated Return

This rule applies even though no tax is due on such a first return.

While Section 1552 provides four methods under which the Federal income tax may be apportioned among the members of an affiliated group filing a consolidated income tax return, the first method will apply unless a timely election is made to have another method apply. Many times, because there is no consolidated tax liability in the first one or two consolidated returns, no election is made, since Section 1552 specifically speaks in terms of apportioning "the tax liability."

Regardless of whether there is tax payable, an election, if one is to be made, must be made in the first year in which a consolidated return is filed. The Revenue Service has held that failure to make such an election results in the application of method 1552(a)(1). The Service may allow a change to method (2) or (3) if the request for permission to change to either of these methods is accompanied by a schedule which shows the difference in results under method (1) and the method selected, but requests for the use of method (4) are generally not approved.

Sec. 1561-62 Dormant Corporations and Surtax Exemptions

Inactive corporations must be considered in an allocation election.

Many corporations have wholly owned subsidiaries which are dormant. Some of these may have been organized to protect the corporate name in various states without those corporations having ever been activated. In other instances a subsidiary may have been engaged in business at one time, but was subsequently liquidated without the corporation itself being dissolved. In almost all such instances the inactive corporations do not file Federal income tax returns. As a result, their existence may not even be known. *Sec. 1561-62*

Section 1561 states that, in the case of a controlled group of corporations, the surtax exemption of $25,000 shall be divided equally among the corporations in the group, unless an apportionment plan which allocates different portions of the surtax exemption among the members is filed and consented to.

To be on the safe side, every inactive subsidiary should be treated as constituting a component member of the controlled group of corporations. This means that if there is presently only one active corporation, an apportionment plan for that one corporation should be drawn up under which there would be assigned to it the full surtax exemption of $25,000 and there would be assigned a zero exemption to each of the inactive subsidiaries. Such apportionment plan then should be separately signed by the active parent corporation and be filed as a part of its return. Under the temporary and proposed regulations the consent of each wholly owned subsidiary would be presumed. Further, although it may perhaps not be necessary to do so, it would seem advisable also to file separately an additional copy of this apportionment plan with the local district director on behalf of each of the inactive subsidiaries, even though they do not file income tax returns.

What if there are two or more active corporations in a controlled group? A controlled group of corporations may consist of parents and subsidiaries or brother-sister corporations. Under Section 1562 each of such corporations will be entitled to a full surtax exemption if each of them so consents within three years after the due date of the return of that corporation in the group which has a taxable year ending first on or after December 31. If such a consent is made, then an additional 6 per cent tax becomes payable on the first $25,000 of taxable income of each such corporation. If such a consent is not filed, then the general rule of Section 1561 becomes applicable and only one surtax exemption of $25,000 is allowable to the entire group.

If an election is made to claim multiple surtax exemptions under Section 1562, under the temporary and proposed regula-

Sec. 1561-62 tions inactive subsidiaries will automatically be bound if they are wholly owned. On the other hand, if the levels of corporate income are such that multiple surtax exemptions will not be elected, a plan apportioning a single surtax exemption among the active corporations should be adopted and zero should be allocated to inactive subsidiaries.

Where the corporations are members of a controlled group by reason of the brother-sister relationship, the temporary and proposed regulations require separate signed consents to either a multiple surtax exemption or an apportionment plan. Here again these inactive subsidiaries should be taken into account.

Sec. 1563 Affiliated and Controlled Group Problems

There are important differences in the definitions.

There can be a difference between an affiliated group under Code Section 1504 for consolidated return purposes and a controlled group under Code Section 1563 for surtax exemption purposes. For example, where the parent of an affiliated group owns 26 per cent of the stock of A and holds an option to purchase the other 74 per cent of A's stock, A would not be an affiliate for consolidated return purposes, but it would be a component member of a controlled group for surtax exemption purposes. The option would make the parent the constructive owner of all the stock of A under Internal Revenue Code Section 1563(d)(1)(B) and (e)(1).

A domestic U.S. corporation may be excluded from an affiliated group under Code Section 1504(b) because it is entitled to the benefits of Code Section 931 (large percentage of income from sources within a possession of the United States). But the excluded corporation (and its subsidiaries, if any) would be a member of a controlled group.

Failure to recognize the difference between the definition of an affiliated group and a controlled group in exercising surtax exemption elections can result in the loss of surtax exemption benefits where no election or an improper election is made and the Commissioner arbitrarily allocates the surtax exemption among all the members of the component group, including loss or inactive corporations.

ESTATE AND GIFT TAXES (Subtitle B)

Some Thoughts on Stock Valuations *Sec. 2031*

Despite family ownership, look only to the actual number of shares being valued.

A difficult problem that often faces the CPA tax practitioner in the determination of gift and estate taxes is the fair market value of a block of stock constituting a minority interest in a closely held corporation. The following are a few thoughts for the person faced with this problem.

The often repeated definition of fair market value is the price at which property would change hands between a willing buyer and a willing seller, each being in possession of all significant facts and neither being under compulsion to act. This willing seller-willing buyer concept means simply the fair cash value of the property, the amount it would bring if offered for sale.

If the block of stock being valued is large enough to justify a public offering, the estimated amount that would be received by the seller in such a transaction should be a reasonable measure of value. In such a situation, the opinion of an experienced securities underwriter should carry substantial weight. His success or failure in the business is dependent upon his ability to determine the price at which a particular security would have to be offered to attract the investing public and thus make a successful underwriting. From the price to the public the underwriter determines the price he could offer the owner which should represent the fair market value, the cash that could be realized from the sale of the securities.

Assuming that the stock in question could not be sold by means of a public offering because of the small size of the block or for some other reason, a prospective purchaser would expect to buy the stock at a substantial discount from a valuation determined by comparison with similar listed stocks because of lack of actual or potential marketability. If it became necessary or desirable for the potential purchaser to dispose of the stock, he would probably be forced to accept a reduction or discount for lack of marketability and in the purchase of such a stock he would expect to pay an amount that recognized this factor.

At times the argument is raised that a particular stock is all owned "within the family" and that since the taxable transfer is between members of the family the taxable shares should be valued as a proportionate part of the value of all the stock of the corporation or at least as a part of the "controlling" stock. The simple answer to this argument is that the shares subject to tax are the only ones under consideration. There are many cases holding that in such a situation the only issue is the value of the particular shares involved in the gift or estate and that whoever owns the balance of the stock is not relevant.

Occasionally, an attempt will be made to value a small fraction of the outstanding shares of a closely held corporation on a liquidating basis. This would not be a proper basis of valuation since the minority interest subject to tax could not effect a liquidation even though the remainder of the shares were "in the family." The proper approach to the problem should be what the willing buyer would pay the willing seller for the number of shares being valued.

In compiling statistical data for use in arriving at a stock valuation, adjustments are sometimes made to earnings based upon certain assumptions or the dividend rate is increased on the ground that the corporation could and should pay out a greater portion of its earnings. It should be remembered that a minority interest in the outstanding shares probably could not change any corporate practices and policies and a buyer of the stock being valued would have to accept the existing conditions and would determine the price he would be willing to pay with these factors in mind.

Assume that a corporation owns a valuable piece of real estate that brings in little income but could be sold at a very substantial gain. The present majority shareholders have no intention of selling the property and a small fraction of the stock is to be valued. It would appear that a potential buyer of these shares would offer a price based upon the usual factors plus an amount for the possibility that some event might cause the potential profit on the property to be realized. It would not be proper to add the applicable portion of the full appreciation to the shares being valued since the potential profit might be far in the future or might never be realized and no purchaser would buy the shares at a price thus determined. *Sec. 2031*

Test any valuation that is established by considering whether it would be reasonable to expect that the shares could be sold at that price.

Optional Valuation Date Sometimes Prohibited *Sec. 2032*

Where a decedent leaves an estate of less than $60,000 so that an estate tax return is not required to be filed, Regulations Section 20.2032-1(b)(1) denies the executor the election of using the optional valuation date in order to take advantage of an increased basis for the beneficiaries. This rule applies even if the value of the gross estate, which did not exceed $60,000 on the date of death, does exceed $60,000 on the optional valuation date.

There is no prohibition against using the optional valuation date to obtain an increase in basis, however, where the value of an estate at date of death is, for example, $100,000, and where the marital deduction reduces the estate below $60,000 and no estate tax is due. In the latter situation, an estate tax return is required to be filed.

Gifts in Contemplation of Death *Sec. 2035*

A defeat turned into a victory.

Why not a gift in contemplation of death in lieu of a testamentary disposition? Normally it is desirable to avoid gifts in contemplation of death because amounts so transferred are included in the decedent-donor's taxable estate. Where death is imminent, however, tax savings can result through a gift in contemplation of death. Although a gift so tainted is included in full in the decedent's gross estate, the gift tax payable thereon is deductible as a debt of the estate, and in addition is a direct credit against the estate tax liability.

For example, a single individual with an estate of $1 million makes a taxable gift of $500,000 to the person named as sole beneficiary in his will. The gift is made although the donor does

Sec. 2035 not expect to survive the three-year statutory period, and dies before the gift tax is paid. The gift tax liability is $109,275 (disregarding previous gifts, exemptions and exclusions). The gross estate including the $500,000 gift in contemplation of death is $1 million. But the net taxable estate is reduced by the gift tax liability of $109,275. The estate tax liability amounts to $285,268 less the credit of $109,275 for gift tax, or a net estate tax of $175,993. The combined estate and gift taxes of $285,268 compares to an estate tax liability of $325,700 which would have been payable on an estate of $1 million had no gift been made. The tax saving of $40,432 represents 37 per cent (the top estate tax bracket) of the amount of gift tax ($109,275) for which credit has been received. Thus the gift tax serves as both a credit and a deduction.

Sec. 2038

Double Value From Charity— Income Tax and Marital Deductions

By retaining certain rights, the transfer is included in the marital deduction base.

A transfer in trust with income to certain individuals and principal to a designated charity brings an income tax deduction to the transferor. However, the elimination of this amount from the transferor's estate cuts into the maximum marital deduction otherwise possible. A simple adjustment can secure both the income and estate tax benefits. Instead of the principal going to a designated charity, the trust should provide that it is to go to such charity as the transferor designates by will. Because the transferor has thus held on to the strings, the principal is considered part of his gross estate for marital deduction purposes, even though the amount included in the estate is offset by a corresponding deduction for charity.

Sec. 2056

Marital Deduction Mathematics

Don't overlook the advantages of tax deferral.

In financial planning for a married couple, provisions for the estate tax effects of a marital deduction, if otherwise desirable, should not be avoided merely because the separate estates of the spouses are not materially different in value. Except in cases of advanced ages of both parties the survivor will ordinarily have a life expectancy of several years after the death of the first to die. Investment of the funds made available from the saving in estate tax by using part or all of the available marital deduction in the first estate can be expected to exceed the sum necessary to compensate for the resulting increase of tax on the ultimate estate of the surviving spouse. In a given situation the effect to be expected can be reasonably calculated on the basis of the life expectancies of the spouses and other relevant factors. *Sec. 2056*

What to Give Away

Sec. 2501

Some interesting thoughts on the selection of gift property.

Occasionally a client will ask the practitioner's advice on the selection of property to be made the subject of gifts. The practitioner might offer a few suggestions such as these:

From the standpoint of the donor it is generally not considered good planning to give away cash. Many estates have serious cash problems in meeting death taxes and expenses of administration, and gifts of cash in any substantial amounts tend to make an individual's estate less liquid and to increase the problem of the executor.

Assuming that one of the purposes of the gift is to reduce the donor's estate, it would appear reasonable to transfer property that has a potential for appreciation in value. For example, if an individual makes a gift of bonds and retains a substantial number of shares of a young and vigorously growing company, the shares may rapidly appreciate to the point that the individual's estate exceeds what it was before any gifts were made. In such a case it would seem prudent to include at least a portion of such shares in gifts.

Another general proposition to consider might be the desirability of giving away property that the donor might not want converted to cash or that might be very difficult to liquidate. Very often shares in a closely held corporation fit into this general description. A note of caution might be advisable. If it is planned to pay death taxes and expenses of administration through redemptions of such shares by the company under the

Sec. 2501 protection of Section 303, be sure that enough shares will remain in the estate to meet the Code requirements.

Attention should also be accorded Section 1015(d) of the Code which provides that gift taxes paid on the transfer of property may be added to the basis of the property with the limitation that the increased basis may not exceed the fair market value at the date of the gift. All other things being equal, it would appear desirable to select property for gift purposes with a cost basis to the donor that is low enough to permit the gift tax paid to be added to that cost by the donee so the gift tax might possibly be partially recovered through reduced capital gains taxes at some future date.

Another consideration in selecting property to be given away is the income needed by the potential donor. Many people with substantial property have an after-tax income insufficient for their needs. In such a case the property to be given away should be the least productive of income. For example, paid-up life insurance policies or investments that produce a low rate of fully taxable income might be likely prospects for gifts.

Basic to any gift problem is the consideration that gifts should be integrated with the overall plan of the donor for dealing with his property and should not be isolated, spur-of-the-moment actions.

Sec. 2512 Valuation of Closely Held Stock for Gift Tax Purposes

The effect of a public offering price and an illustration of a needless penalty.

Two individuals owned all the stock of a medium-sized electronics corporation. Three months prior to "going public," the individuals each made gifts of 16,000 shares of stock to their children. The stock had a book value of less than $2 per share but was valued at $4 per share for gift tax purposes. The initial public offering price was $9.50 per share (20 per cent of the outstanding stock of the company was sold) and the stock rose to $31 per share within a year.

The examining agent insisted that because of the close proximity of dates the stock should be valued for gift tax purposes at $9.50 per share. After several informal conferences, a $6 per share valuation, reflecting the "nonmarketability discount," was agreed upon. It was possible to rely somewhat on the dictum in the 1961 Tax Court Memorandum decision, *Bruce Berckmans,* and also on the fact that the investment letters which the two shareholders had executed (at the time the stock went public) limited the amount of their holdings which they could sell within a reasonable period after the underwriting. In other words, just because 20 per cent of the company's stock was marketed for $9.50 per share, it did not mean that the balance of the stock "closely" retained was worth the same amount. *Sec. 2512*

Because of the $4 per share original valuation which they placed on their stock, gift tax returns were not filed. The total value placed on the gifts by the donors was more than the annual exclusion but less than the specific exemption. When it was called to the taxpayer's attention that gift tax returns were required to be filed even though no tax was due, delinquent returns were filed five months after the due date. The IRS has imposed the 25 per cent delinquency penalty on the tax resulting from the increased value, and would not accept as "reasonable cause" the fact that the original valuation placed on the gift did not result in a tax liability, because the value used exceeded the annual exclusion. The agent stated that this matter was specifically set out in their internal manual.

Split Gifts Can Be a Disadvantage

Sec. 2513

Contemplation of death holding is of no avail to surviving spouse.

Ordinarily, split gift tax returns of husband and wife, like split income tax returns, are tax savers. Like everything else in taxation, there are exceptions galore.

Tread cautiously about split returns, when the one making the gift (we'll say it is the husband) is not likely to survive three years. The gift is then presumptively made in contemplation of death and may be subject to estate tax, with a credit for the gift tax paid. The credit includes the wife's tax attributable to the husband's gift. However, the part reported in the wife's gift tax return still stands for the purpose of figuring her rate

Sec. 2513 brackets on subsequent gifts. The net result is that her lifetime exemption is used and her gift tax brackets have been unnecessarily hiked (*Ingalls* v. *Comm'r* (C.A.-4, 1964).

If the wife applies her $30,000 lifetime exemption against the gift, the exemption is gone forever. One way to play safe is for the wife to apply the exemption to the gifts she herself makes, rather than to any portion of the husband's gifts.

Gift Tax—Reportable Gifts

If the gift exceeds $3,000, a return is due.

There appears to be considerable misunderstanding regarding the requirements for filing a gift tax return where a gift in excess of $3,000, but not more than $6,000, has been made by a married individual to a person other than his spouse. The regulations (Section 25.6019-2) require a return to be filed in such a case, even though the $3,000 exclusion which is available to each spouse will result in no taxable gift for the year.

Some persons feel that reporting such gifts is unreasonable and unnecessary. However, the regulations provide that after a notice of deficiency has been sent to either spouse the consent to divide gifts for the taxable year may not thereafter be signified. The results can be costly. Don't be half safe—file!

EXCISE TAXES (Subtitle D)

Sec. 4243

Excise Tax on Club Dues Exemption For Capital Improvements Program

Step to take to make sure of the exemption.

The regulations under Section 4243 of the Internal Revenue Code provide generally for exemption from the 20 per cent dues tax for club dues, assessments, etc., used by a social, athletic or sporting club for capital improvements or additions to facilities —provided such receipts are *earmarked* by the club at the time of receipt. The National Office of the IRS interprets the earmarking provision of the regulations as requiring that the funds be designated for a *specific, presently authorized* expansion program, rather than a general one. Examples are the building of a pool or acquisition of furnishings and fixtures (such as furniture, drapes, or carpeting) for a recently enlarged dining room. For an acceptable method of earmarking, see proposed Regs. Section 49.4243-2(b).

The Service holds that the money *cannot be earmarked for improvements to be made in the future* where the type of improvements has not been decided upon. Validly earmarked sums must be expended by the club within three years from the date collected. If not so expended, the tax will become payable immediately after the expiration of the three-year period. The tax in such a situation is imposed on the club rather than on the member who originally made the payment.

Club Dues Exemption for Capital Improvements

The exemption extends to dues for the purpose of paying principal and interest on improvement loans.

Several years ago a country club levied a special assessment on its members and used the funds for capital improvements. Under Section 4243(b) of the Code, no excise tax was due on such assessments. Additional funds were borrowed from an insurance company to help finance the capital improvements. In the following years, part of the annual dues was earmarked and used either for additional capital improvements or to apply on the loan. The club wants to liquidate the balance of the loan in the coming year. In order to do this, it is proposed that two-thirds of the annual dues be allocated to capital improvements, be billed as such to members and thus not be subject to the 20 per cent excise tax. This will leave an insufficient amount of cash to meet operating expenses and it will be necessary to borrow funds to maintain operations. It has been suggested by some that if borrowings are made to cover operating expenses, the dues allocated to capital improvements might be treated as

Sec. 4243 being for operating expenses and thus subjected to excise tax.

The proposal was discussed informally with Service representatives who indicated that there is nothing wrong with the plan. It is important that the part of the dues which is intended to pay off the loan obtained for capital improvements is so used. It was suggested that a separate bank account be used for capital improvements. It was also pointed out that the entire annual dues per member could be used to pay off the capital improvement loan if the club wanted to do so and notified its members. In such case none of the dues would be taxable. The important thing is to be sure that the amounts are used only for the exempt purpose. The fact that money will have to be borrowed to meet operating expenses has no effect on the exempt status of the dues if they are used for exempt purposes. Revenue Ruling 60-315 covers the subject of repayment of loans, the proceeds of which were used for capital improvements. See also proposed Regs. Section 49.4243-2(b) with respect to the payment of principal and interest on such loans.

PROCEDURE AND ADMINISTRATION
(Subtitle F)

Sec. 6109 Identification Numbers for Minors' Bank Accounts and Securities

A complete discussion of the person to whom income is to be taxed in certain situations, particularly as it affects the problem of whose number is to be used.

Taxpayers are being asked by payers of dividends and interest to submit their "taxpayer identifying numbers" so that information returns (Form 1099) can identify the recipients by numbers as well as names. All of this, of course, results from the use of automatic data processing to match payments with the income tax returns of the recipients. Presumably, if a particular payment of income which is identified by the payer under a certain taxpayer number does not show up in the tax return of the holder of that number, the Service's ADP machines will grind out an automatic invitation to a Revenue Agent's examination.

To encourage thrift on the part of a child or to build up a college education fund, parents and grandparents frequently open up savings accounts or transfer securities for the benefit of minors. Most of such donors undoubtedly believe that the ensuing interest or dividend income is taxable, if at all, only to the minor, and in the past probably have not been including such income in their own returns. Unfortunately, depending upon the manner in which the ownership of the savings account, bond, or stock certificate is expressed, the income may be that of the adult donor.

There are many ways in which property can be held for the benefit of a minor: (1) he can hold it outright in his own name; (2) he can be a joint owner of property with an adult; (3) he can be named a beneficiary to take title upon the death of another person; (4) he can be the beneficiary of an informal trust sometimes loosely called a "revocable trust"; (5) he can be the beneficiary of a formal trust created under a written trust agreement; (6) he can be the beneficial owner of property held in the name of a legal guardian; (7) he can be the beneficiary of a custodianship arrangement under either the Model Gifts of Securities to Minors Act or the Uniform Gifts to Minors Act. Each will be considered.

1. In most states a minor can have a savings account in a savings and loan association in his sole name and will be irrevocably bound by his action in withdrawing money or giving a release. Naturally, such a minor should have reached the age of reason (usually seven) and should be able to sign his own name. Where an account in a bank or savings and loan association is in the sole name of a minor, any interest or dividend income should be his alone and the social security number of the minor should be furnished.

Placing securities in the sole name of a child will create problems if later on it becomes advisable to dispose of them by sale or in a merger. Nevertheless, it will happen that a parent or grandparent will transfer securities into the sole name of a minor. In such an instance, care should be taken to effectuate a completed gift;[1] otherwise any dividend income will be taxable to the donor.

Where securities are registered in the sole name of a minor, his account number should be furnished. If the securities are in the name of an adult under a designation such as "John Parent as natural guardian for Joseph Minor," the regulations seem to permit furnishing the minor's account number.[2] If the securities are registered in the name of an adult alone without any designation of him acting as an agent, the adult's number should be furnished.[3] Then that adult should disclose that he is only a nominee of the minor by filing information return Form 1087 on or before each February 28 following the close of each calendar year in which dividends are received.[4]

2. In most states it is possible for an adult and a minor to own a bank account, securities or other property as tenants in common or as joint tenants with right of survivorship. In addition, U.S. savings bonds can be jointly owned without any such designation of a particular type of tenancy.

The creation of a joint bank account in joint tenancy with right of survivorship does not give rise to gift tax liability with respect to the person making the entire deposit, until the other joint owner actually withdraws funds.[5] Similarly, if the joint account is opened in alternative names, such as "John Parent or William Minor," or in any other manner under which the donor can regain the entire fund without the donee's consent, there is no gift subject to gift tax until the donee makes a withdrawal.[6] Consistently, with respect to any of these types of bank accounts, any interest or dividend income is taxable to the joint owner who provided the funds.[7] Equally consistent is

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[1] For the requirements of a completed gift see *Estate of Lorenzo W. Swope*, 41 B.T.A. 213. In determining whether each requirement has been effectuated, state law controls. Completed gifts were found in: *James T. Pettus, et al.*, 45 B.T.A. 855 (Acq.) (Missouri); *P. Miller Trust*, 7 T.C. 1245 (Acq.) (Oregon); *Emil Frank*, 27 B.T.A. 1158 (Acq.) (Ohio); *Herbert L. Dillon*, 32 B.T.A. 1254 (Acq.) (New York). To the contrary: *Weil* v. *Comm'r*, 82 F. 2d 561, 17 AFTR 666 (5th Cir. 1936), affirming 31 B.T.A. 899, cert. denied 299 U.S. 552 (Alabama). Also see Mertens, *Law of Federal Income Taxation*, Sec. 7.12.

[2] Regs. Sec. 1.6109-1(b)(1)(iii), last sentence.

[3] Regs. Sec. 1.6109-1(b)(2)(i) – an interpretation of the last sentence.

[4] Regs. Sec. 1.6042-2(a)(1)(ii) and (c).

[5] Regs. Sec. 25.2511-1(h)(4).

the requirement that the amount on deposit must be included in the taxable gross estate of a joint owner upon his death to the extent of his contribution to the bank deposit.[8] Sec. 6109

The regulations require that the identifying account number of the parent be furnished,[9] and such identification of the taxpayer seems correct.

In the case of U.S. savings bonds, the purchase by a parent and registration in both his name and that of his minor child as co-owners under a designation such as "John Parent or William Minor" will not constitute a taxable gift to the child unless and until the child surrenders the bonds for cash.[10] Interest income on the bond will be taxed in full to the parent because he supplied the full consideration.[11] Finally, of course, the value of the bond will be included in the parent's estate if he predeceases his child. The identifying number of the parent is the right one to use.[12]

When securities are held in the names of a minor and an adult as joint tenants with right of survivorship, the tax consequences will be different from those in the case of a joint bank account. It will be held that a completed gift to the extent of one-half the value has been made where the adult provides the purchase price or contributes the property and where under applicable state law either party may "sever his interest" such as by conveying an undivided one-half to another.[13] Then, the income would be taxable one-half to each joint tenant, provided that under local law each joint tenant is entitled to his or her share of the dividends.[14] From the standpoint of the estate tax, however, the full value of the property would fall in the adult's taxable estate if he died first.[15]

The regulations[16] call for the account number of the parent joint tenant to be furnished. This could lead to trouble.

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6 Regs. Sec. 25.2511-1(h)(4); Mertens, *Law of Federal Gift and Estate Taxation*, Sec. 34.61.
7 *K. M. Emmons*, 20 T.C.M. 1513.
8 IRC Sec. 2040; *Estate of M. A. Doyle*, 32 T.C. 1209 (1959).
9 Regs. Sec. 1.6109-1(b)(2)(iii); Rev. Rul. 64-122, IRB 1964-17.
10 Regs. Sec. 25.2511-1(h)(4).
11 I.T. 3301, 1939-2 C.B. 75; Rev. Rul. 54-143, 1954-1 C.B. 12.
12 Regs. Sec. 1.6109-1(b)(2)(iii).
13 Regs. Sec. 25.2511-1(h)(5); Mertens, *Law of Federal Gift and Estate Taxation*, Sec. 34.61.
14 *Haynes*, 7 B.T.A. 465 (Acq.); I.T. 3754, 1945 C.B. 143; Regs. Sec. 1.34-1(d) pertaining to dividends-received credit and exclusion.
15 IRC Sec. 2040.
16 Regs. Sec. 1.6109-1(b)(2)(vi), Example (9).

Sec. 6109 As to securities held as tenants in common, there seems to be no clear-cut rule. Some authorities seem to support the proposition that if a valid completed gift is made of an undivided one-half interest, then only one-half of subsequent dividends will be taxed to the donor.[17] Where a parent purchases securities, has them issued in his name and the name of a minor child as tenants in common, and otherwise completes the gift of an undivided interest, such gift is subject to gift tax.[18] Upon death of the donor, only his undivided one-half interest is subject to Federal estate tax.

The regulations[19] again call for the social security account number of the parent only. The IRS computers, therefore, may cause a revenue agent to closely scrutinize any claim that only one-half of the dividend income on shares of stock owned as tenants in common is taxable to the parent donor.

3. In some instances a minor can be designated as a beneficiary to take title on death of a parent owner of property. For example, a U.S. savings bond can be registered in the name of the parent who purchases it with a provision that upon his death the proceeds shall be payable to his son. In this case the interest income is taxable to the father; no gift is considered to have occurred; and the father's identification number is required.

4. Many states permit savings accounts to be opened in the name of one person as trustee for another, such as "John Parent as trustee for Mary Jones, a minor," but without any formal trust instrument being executed. The trustee can revoke the arrangement at any time and may freely deposit in and withdraw from the account. On death of the trustee, the balance in the account becomes the property of the minor beneficiary. Trusts of this nature are sometimes called revocable trusts.

In each instance, state law and the facts will determine whether a completed gift has been made giving rise to gift tax, but the general rule seems to be that for gift tax purposes

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[17] *Walter F. Henningsen*, 30 B.T.A. 301 (Oregon); Mertens, *Law of Federal Income Taxation*, Sec. 17.02 and 17.03.

[18] Mertens, *Law of Federal Gift and Estate Taxation*, Sec. 36.07.

[19] Regs. Sec. 1.6109-1(b)(2)(iii).

there is not a completed gift until the beneficiary actually receives the money.[20] *Sec. 6109*

In income tax cases, to the contrary, completed gifts to minor children have been found by the courts and the Internal Revenue Service to have been effected upon the transfer into accounts set up in the name of a parent as trustee for a minor, where no trust instrument was ever executed, the donor did not intend to create a trust, the funds were never used for the personal benefit of the donor, and no amounts were withdrawn for the support and maintenance of the children.[21]

With respect to identifying numbers to be furnished for the recipient of the dividend or interest income, the regulations state that (a) if under state law no valid trust is created and the donor-parent is the owner of the account, his account number should be furnished,[22] whereas (b) if under state law the so-called "trust" account is legally the property of the minor and the parents are not legally permitted to use any of the funds to satisfy their obligations to support the child, the minor child's account number should be furnished.[23] Question 18, IRS Publication No. 459, "Questions and Answers Regarding Taxpayer Identifying Numbers," states that an informal trust account of the type here discussed "ordinarily . . . is not recognized by state law as a legal or valid trust during the trustee's lifetime nor is it a valid gift to the beneficiary." It is fair to assume that if the minor's account number is furnished, the IRS will question its use and attempt to tax the parent.

5. A parent or grandparent who wishes to set property aside for the benefit of a minor child will frequently use a formal irrevocable trust agreement. The gift, estate, and income tax liability will vary depending upon the provisions of the trust

[20] Beveridge, *Law of Federal Gift Taxation,* Sec. 4.05; Mertens, *Law of Federal Gift and Estate Taxation,* Sec. 34.55 and 34.58.

[21] *Jolly's Motor Livery Company,* 16 T.C.M. 1048, 1070 – deposits in a so-called trust account for the benefit of minors in a Federal savings and loan association located in Tennessee; *Edward H. Heller,* 41 B.T.A. 1020 – deposits in so-called trust accounts for the benefit of minors in a commercial bank located in California. Rev. Rul. 55-469, 1955-2 C.B. 519 citing *Prudence Miller Trust, et al.,* cited above in footnote 1; Rev. Rul. 58-65, 1958-1 C.B. 13.

[22] Regs. Sec. 1.6109-1(b)(2)(vi), Example (4). A valid trust may be revocable or irrevocable. Solely for the purpose of determining whether the trust's identification number should be used, the maker of the trust instrument may determine if the trust is valid (Rev. Rul. 64-122, *supra*).

[23] Regs. Sec. 1.6109-1(b)(2)(vi), Example (6).

Sec. 6109 instrument and quite technical rules contained in the tax law. The trust will identify its fiduciary income tax return with its own "employer identification number" and then as to beneficiaries will show their account numbers.

6. A parent is the natural guardian of his children. He is not their legal guardian unless so appointed by a court. As a legal guardian he can unquestionably accept gifts on the part of his minor child and manage his investments, with all income being taxed to the minor. The minor's identification number is then appropriate.

7. Solely from the tax aspect the simplest and best way of transferring property to minors is under the Uniform Gifts to Minors Act (in effect in most states) or the Model Gifts of Securities to Minors Act (in effect in a few states). All of the income, estate, and gift tax results are certain.[24] The income is taxable to the minor except to the extent used to discharge a parent's support obligation, and the minor's account number is the correct one to use.[25] Being able to furnish the minor's account number will avoid future arguments with revenue agents.

With respect to joint savings accounts or informal trust accounts now existing in the names of an adult and a minor, strong consideration should be given to closing them out prior to the next interest payment date and opening up new accounts under the Uniform Gifts to Minors Act. As to securities, the same recommendation is made, but first the taxpayer's attorney should investigate the present legal rights of the minor in the securities and the proper legal method of transferring them to the parent as custodian.

Where the amounts are large, a formal trust may be more satisfactory than custodianship arrangement.

Sec. 6323 Taxation of Embezzled Funds

Robbing Peter to pay Paul.

The decision of the U. S. Supreme Court in the *James* case (366 U.S. 213) holds that embezzled funds constitute gross

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[24] Rev. Rul. 59-357, 1959-2 C.B. 212; Rev. Rul. 56-484, 1956-2 C.B. 23.
[25] Regs. Sec. 1.6109-1(b)(2)(vi), Example (5).

income to the embezzler in the year in which the funds come into his possession. The embezzler becomes entitled to a deduction for the year in which he repays the embezzled funds. There are several tax consequences. The embezzler may realize little or no benefit from any deduction for repayment, while inclusion of the embezzled funds in his taxable income may cause the amount to be subjected to a substantial tax. Furthermore, relief under Section 1341 is not available because the embezzler did not receive the income under "claim of right." *Sec. 6323*

The dissenting opinion of Justice Black in the *James* case points out that the Government's claim for taxes due from the embezzler ranks ahead of the victim's claim for recovery. To the extent that collection of tax by the Government prevents him from recovering on his claim against the embezzler, the victim suffers an evident inequity. The Government revenue benefit is limited to the excess of its collection of tax from the embezzler over the decrease in the victim's tax attributable to an increase in his deduction for the loss occasioned by the priority of the Government's lien. Under some circumstances, which evidently would be unusual, the victim of an embezzlement might establish priority for his claim by means of a judgment or a pledge antedating the Government's lien as provided in Section 6323.

Form 1139 or Form 843 — There Can Be a Difference

Sec. 6411

Here is a situation where the filing on Form 1139 may produce a larger refund than a filing on Form 843.

The change in the net operating loss carryback provisions of the Revenue Code in 1958 brought into focus a problem of which comparatively few persons may be aware.

Prior to this amendment, a net operating loss was carried back to the second preceding taxable year; however, the amendment served to change this to the third preceding taxable year when the loss arises for the calendar year 1958 or a later year. This has created some new facets to the question of whether to file a Form 1139, Application for Tentative Carryback Adjustment, Sec. 6411 to recapture the prior year tax or to file a Form 843 claim for this purpose.

A Form 1139 application must be filed within the twelve-month period following the end of the year in which the net operating loss arises and the refund resulting from the carryback will be made on the basis of the information contained in the form itself, subject, however, to the requirement that the amount thus received by the taxpayer shall be paid back if it is later proven to have been refunded through error. A claim for refund on Form 843 can be timely filed within three years from the due date of the return for the year in which the net operating loss arises, and the refund is made after field examination. Interest on the refund, in the case of either method, begins at the end of the loss year.

If the years involved are examined by the Federal Government after the refund has been allowed on the Form 1139, a complex question may arise regarding the application of the Statute of Limitations. The Government may find that it can not properly disallow any part of the net operating loss carryback, but that there are some errors in the earlier year to which the carryback is taken. This earlier year would ordinarily be barred by the Statute of Limitations because of the passage of the three-year period. Can these changes in this third preceding year be made to recover the refund which grew out of the net operating loss carryback? The answer is "no," unless a consent had been signed extending the Statute of Limitations for that year. Any changes must necessarily be limited to the loss year itself (see *Leuthesser* v. *Comm'r,* 18 T.C. 1112, and *Bouchey* v. *Comm'r,* 19 T.C. 1078).

If the three-year period from the due date of the return covering the loss year has not elapsed, a deficiency may be asserted by the Government to the extent based upon adjustments made to the loss year and the Government may recover any excessive refund to such extent. It may not give effect to any adjustments applicable to the statute-barred year to which the loss was carried.

For example, let us assume that a net operating loss carryback from the year 1964 in the amount of $50,000 is claimed against the year 1961. A Form 1139 is filed, the refund is made and upon later examination it develops that the loss for 1964 should be $25,000 instead of $50,000. Also, it appears that the income for 1961, now barred by the Statute, should be $125,000 instead of $100,000. Under these circumstances, the IRS can disallow $25,000 of the net operating loss and assert the resulting tax as a deficiency. It cannot offset the remainder of this loss by the increase in income of $25,000 in 1961. *Sec. 6411*

A different position could be taken by the Treasury if a Form 843 claim had been filed. The earlier year would be examined to determine the amount of refund allowable from the net operating loss carryback. The claim would be offset by any adjustments that would serve to increase the income of the year to which the loss is carried. In making the change, the Government would rely upon the decisions of the Second Circuit Court of Appeals in the cases of *Comm'r* v. *Maurice H. Van Bergh,* 209 F.2d 23 (1953), and *Phoenix Coal Company* v. *Comm'r,* 231 F.2d 420 (1956). Following the example in the preceding paragraph, the $25,000 increase in the 1961 income, while it would not be added to assert a deficiency in tax, would be used to offset the claim based on the loss carryback. In addition, the $25,000 adjustment in the 1964 loss would be made.

These significant aspects of this question may justify careful consideration in making a choice of the method by which to recoup the tax of a preceding year in the event of a net operating loss carryback.

Note, however, that if the Commissioner arbitrarily disallows the Form 1139 application, there would appear to be no remedy available to the taxpayer (other than filing a Form 843), as the Regulations, Section 1.6411-3(c) provide that his action may not be challenged in any proceeding. The Code authorizes a disallowance only for errors of computation or material omissions in the Form 1139, but in actual practice the disallowance may be quite arbitrary.

Withdrawal of Claim for Refund

Sec. 6511

This does not necessarily nullify the claim.

X Corporation filed a claim for refund within the statutory period. The Internal Revenue Service considered the claim and discussed it at some length with the taxpayer. It was finally

Sec. 6511 agreed that the claim would be dropped and a withdrawal statement on FL3-42 (a form letter of the District Director) was executed by the taxpayer.

Subsequently a Court of Claims decision on an identical issue but different taxpayer was decided adversely to the Government. Interest was revived in the aforementioned claim; however, the Statute of Limitations had now run on filing a new claim.

The matter was discussed with the Office of the District Director and there was called to their attention Revenue Procedure 57-23, C.B. 57-1, 753 in which the Internal Revenue Service admitted that the Statute of Limitations does not begin to run on a properly filed claim until a denial of the claim has been sent to the taxpayer by registered mail. The District Director's Office agreed that X Corporation still has a valid and existing claim for refund which could be honored if they agree with the merits of the situation.

Sec. 6653

Negligence Penalty Is Weapon Against Abuses

It is imposed upon the entire deficiency.

In *Farwell* v. *Comm'r,* 35 T.C. 454, the Tax Court approved the imposition of the 5 per cent negligence penalty for intentional disregard of rules and regulations. Upon examination a revenue agent had disallowed an amount paid in 1952 for renegotiation of a lease. The taxpayer had deducted the same item once again in 1954 even though it had been indicated at the time of the 1952 disallowance that it would be amortized over the term of the lease. No disbursement or other event had occurred in 1954 to support the deduction.

There are two features of the negligence penalty under Section 6653(a) of the Code which should be borne in mind in relation to dubious items of income or expense. One is that after the penalty has been asserted by the Commissioner the burden is on the taxpayer to prove that he was not negligent; that is in contrast with the 50 per cent fraud penalty where the burden of proof is on the Commissioner. The other point is that the penalty applies to the entire deficiency and not merely to the item in respect of which the taxpayer was negligent. This is a potent weapon against abuses in reporting which has not been used with great frequency in the past. *Sec. 6653*

Proper Planning of Individual's Estimated Tax to Avoid Penalties

Sec. 6654

Stepping up the amount of withholding tax before year-end may solve a problem.

Penalties for underpayment of an individual's estimated income tax may be avoided by basing the current year's estimated tax on the prior year's tax. Where, however, the current year's estimated tax (based on the prior year's tax) is reduced by taking a credit for withholding tax, it is necessary to ascertain before the end of the taxable year that the credit taken for withholding tax in computing the estimated tax does not exceed the actual tax withheld. Failure to do so may result in penalties being imposed by the Service for underpayment of tax where the estimated withholding tax exceeds the actual withholding tax in the taxable year.

Section 6654(e)(2) states that an equal part of the amount withheld shall be deemed paid on each installment date for the taxable year unless the taxpayer proves otherwise, and Section 3402(i) provides that an employer may withhold an additional sum where the monies are withheld under a written agreement. Therefore, assuming the taxpayer can control the amount to be withheld, proper planning of estimated withholding tax *before* the end of the year can serve to eliminate penalties for underpayment of estimated tax for each period.

Right to Subpoena Accountant's Work Papers in Fraud Cases

Sec. 7602

Of particular interest to CPAs.

The underlying authority to subpoena records of third persons to ascertain the correct liability of the taxpayer is set forth in Section 7602 of the Internal Revenue Code. This section provides that the Commissioner may examine any books, papers, records or other data which may be relevant or material to the inquiry and may summon any person having: "possession, custody, or care of books of account containing entries relating to the business of the person liable for the tax. . . ."

Not much light is shed by the committee reports on the apparent broad scope of this section. However, the case law has extended the scope of this section to include all work papers and other confidential memoranda prepared by the taxpayer's accountant. The leading case giving the Commission unfettered power to examine the work papers of the accountant concerning a taxpayer being investigated for fraud is *Falsone* v. *U.S.*, 205 F.2d 734 (5th Cir. 1953) certiorari denied, 346 U.S. 864. In this case the accountant's assertion that his work papers were subject to the confidential privilege between accountant and attorney (pursuant to the law of that state) was rejected by the Court. The Court held that the Commissioner's subpoena powers are "inquisitorial" in character and similar to the power vested in Federal grand juries.

The implied holding in that case is also that the accountant can be compelled to be a witness against the taxpayer who hired him. There is one faint ray of hope in an otherwise tragic dilemma of the taxpayer in such a situation. This is a holding in the case of *Application of J. M. House,* 144 F. Supp. 95, in which a California District Court ruled that an accountant's work papers in the hands of an attorney were no longer his property but that of the client, and the client could, therefore, claim the privilege against self-incrimination. This decision is contrary to numerous other decisions, however, and a New Jersey District Court in *Thomas Boccuto,* 179 F. Supp. 886, refused to follow it. In addition, in *Gariepy* v. *United States,* 189 F.2d 459 (6th Cir. 1951) it was intimated that even if the accountant were in the employ of an attorney, the privileged status would be denied. However, in *U.S.* v. *Kovel* (decided December 1961), the Second Circuit held that the privilege status would apply to an accountant in the employ of an attorney. The *Kovel* case is discussed in the following item.

It would seem that this doctrine can become an increasingly potent weapon in the hands of the Intelligence Division, and although it has been criticized by most authorities in the field, it would seem that only a Supreme Court decision can finally settle this matter.

The Accountant in Relation to the Attorney-Client Privilege

An enlightening decision of the Second Circuit Court.

Does the duty of confidentiality, the attorney-client privilege, attach to the accountant who works for and with a lawyer so that the lawyer may be able to represent his client more effectively? Should the accountant be forced to testify to the communications made to him by the client in circumstances where he is working as the agent for the lawyer? The Court of Appeals for the Second Circuit in a definitive decision (*United States* v. *Louis Kovel,* 296 F.2d 918(CA-2, 1961) said that the duty of confidentiality under these circumstances attaches to the accountant and he cannot be compelled to testify. The Court analogized the accountant's role to the case where the attorney sends a client speaking a foreign language to an interpreter to make a literal translation of the client's story. Judge Friendly, speaking for the Court, said:

"Accounting concepts are a foreign language to some lawyers in almost all cases, and to almost all lawyers in some cases."

The Court recognized that in order to enable lawyers to do competent work in the twentieth century they have to employ experts because our society is so complicated that no one, much less lawyers, can handle technical and sometimes scientific facts without assistance. Particularly in tax matters, lawyers must have accounting information which neither the lawyer nor the client is professionally equipped to obtain.

In its opinion, the Court went further than the issues before it and extended the privilege to accountants who are associated with lawyers as independent contractors. The specific facts before the Court concerned an accountant who was a full-time employee of a law firm. He had formerly been in the Internal Revenue Service and was neither a certified public accountant nor a lawyer, but he was privy to a number of confidential communications by the client to the law firm. He was called before the grand jury and asked questions which he declined to answer on the ground that the answers were within the scope of the attorney-client privilege. He was then taken before the Court and upon his further refusal the Court found him in contempt and sentenced him to prison. It was within the framework of these facts that the Second Circuit disapproved the apparently con-

Sec. 7602 trary decision in *Himmelfarb* v. *United States,* 175 F.2d 924 (9th Cir. 1949), vacated the judgment as to the defendant and enunciated the rule set forth above.

While the case *per se* dealt solely with income tax matters, the question there presented has a lasting important impact upon the legal and ethical standards governing the responsibility of lawyers and to a great extent the people who work with them. The attempt to whittle away the right of the public to speak confidentially in relations with lawyers, standing for hundreds of years, has been rebuffed, because society today requires lawyers to use expert assistance.

Court Cases Cited

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