1958

Working with the Revenue code - 1958

James J. Mahon Jr.

WORKING WITH THE REVENUE CODE -

Working With The Revenue Code –1958

Edited by
James J. Mahon, Jr., CPA

Working With The Revenue Code–1958

Selected Comments from
THE JOURNAL OF ACCOUNTANCY'S *Tax Clinic*
July 1954 to July 1958

Edited by
JAMES J. MAHON, JR., CPA
Lybrand, Ross Bros. & Montgomery

AMERICAN INSTITUTE OF
CERTIFIED PUBLIC ACCOUNTANTS
270 MADISON AVENUE, NEW YORK 16, N. Y.

Library of Congress catalog card number: 57-27090

CONTENTS

PERSONAL EXEMPTIONS AND DEPENDENTS

Page

DEDUCTIONS

Page

CORPORATE DISTRIBUTIONS AND ADJUSTMENTS (Subchapter C)

Dividends and Other Distributions

Liquidations

EXEMPT ORGANIZATIONS (Subchapter F)

TAXES ON FOREIGN INCOME (Subchapter N)

NONTAXABLE EXCHANGES AND BASIS

(Subchapter O)

Page

CAPITAL GAINS AND LOSSES (Subchapter P)

Page

ELECTION TO BE TAXED AS A CORPORATION

(Subchapter R)

TAX ON SELF-EMPLOYMENT INCOME

(Chapter 2)

WITHHOLDING OF TAX ON TAX-FREE COVENANT BONDS (Chapter 3)

PROCEDURE AND ADMINISTRATION

(Subtitle F)

INTRODUCTION

Working with the Revenue Code—1958 is the fourth edition of the annual volume to appear since the adoption of the 1954 Internal Revenue Code. It has grown from 72 pages in the first edition to its current 272 pages. The basis of the book, however, remains the same—practical ideas based on actual tax problems. Experienced accounting practitioners discuss problems which have arisen under the Code and explain how they have handled these specific tax questions.

This volume has been compiled as a careful, up-to-date selection of material which has appeared in *The Journal of Accountancy's* "Tax Clinic" since July 1954. Some of the items which have appeared in the Tax Clinic are now of routine interest only and have not been included. Many items required revision in the light of subsequent developments. In addition, a current (August 1958) italicized commentary precedes many of the items where final regulations have not been issued, where the Internal Revenue Service has modified its position, or where recent developments may effect the item's conclusion.

There is, further, revised or additional editorial comment on items which have been affected by the Technical Amendments Act of 1958 and Small Business Tax Revision Act of 1958.

To increase the book's usefulness as a reference, the material has been arranged in Code section order. Every item appears under the Code section number to which it *principally* relates. If an item relates to more than one section, it is so listed under all sections in the table of contents.

The wide acceptance of the previous editions has been most gratifying and, it is hoped, the current volume will be a useful addition to the tax library. It should be stressed, however, that this book is not designed to replace the exhaustive tax services available, but rather to supplement them as a reference work.

As I have said before, neither the current volume, nor the monthly *Journal* column which provides the raw material, would be possible without the generosity and co-operation of countless contributors. I am especially indebted to my partner Richard T.

Farrand, CPA, and also Kenneth J. Mutzel, CPA, and Harry J. Spellman, CPA, of Lybrand, Ross Bros. & Montgomery, Philadelphia, for their help in the editing and production of the current edition. Thanks are due as well to the New York University Annual Institute on Federal Taxation, the Tax Executives Institute, the American Institute of Certified Public Accountants, and other organizations from whose conferences and seminars certain material was drawn as basis for discussion.

I must further acknowledge my deep gratitude to the contributing editors of the "Tax Clinic." Their aid in preparing material from their own experience has broadened the column's coverage in *The Journal of Accountancy* and should increase the usefulness of *Working with the Revenue Code—1958*. As long as these and other unnamed contributors continue to share their valuable experience, all those engaged in accounting and tax practice are the beneficiaries. My thanks therefore to the following: Jerome C. Bachrach, Bachrach, Sanderbeck & Co., Pittsburgh, Pa.; Russell S. Bock, Ernst & Ernst, Los Angeles, Calif.; William K. Carson, Touche, Niven, Bailey & Smart, N.Y.C.; Thomas J. Graves, Haskins & Sells, N.Y.C.; Thomas J. Green, Peat, Marwick, Mitchell & Co., N.Y.C.; Crawford C. Halsey, Pogson, Peloubet & Co., N.Y.C.; Leslie Mills, Price Waterhouse & Co., N.Y.C.; J. S. Seidman, Seidman & Seidman, N.Y.C.; T. T. Shaw, Arthur Young & Company, N.Y.C.; Michael J. Sporrer, Arthur Andersen & Co., Chicago, Ill.; Troy G. Thurston, Geo. S. Olive & Co., Indianapolis, Ind.; Virgil S. Tilly, W. O. Ligon & Company, Tulsa, Okla.; William H. Westphal, A. M. Pullen & Co., Greensboro, N.C.

JAMES J. MAHON, JR., CPA
Editor, "Tax Clinic"

September 1, 1958

COMPUTATION OF TAX

Determination of Earned Income from Self-Employment

Sec. 37

Knowledge of a tax concept of the 1930's is helpful in interpreting present law.

The determination of earned income may be important either in order to be able to qualify for the retirement income credit or to compute the amount of retirement credit under Section 37. VIRGIL S. TILLY, CPA, W. O. Ligon & Company, Tulsa, finds that some revenue agents are inclined to consider earned income as synonymous with income from self-employment. Such is not always the case.

Many years ago, the individual was entitled to an earned income credit in determining his final income tax for the year. Also, earned income in foreign countries has been exempt from income tax under certain circumstances, and the determination of the portion of self-employment income that constitutes earned income must then be made.

It is well established that all of the earnings from a profession, such as public accounting and the practice of law and medicine, whether operated as a sole proprietorship or as a partnership, constitute earned income even though capital may be a factor in producing the income. However, if self-employment income is from types of businesses such as realty, oil operations, merchandising, brokerage, contracting, etc., and both services and capital are employed, with capital deemed to be a *material* factor, only a portion of the income from self-employment may be designated as earned income. Under the 1954 Internal Revenue Code, the proportion which is to be so designated cannot exceed 30 per

Sec. 37 cent of the total self-employment income, in accordance with Section 911(b).

Rent *v.* Income from Farming Operations

The classification of such income may have important tax effects.

Whether income from a farm is "rent" as contrasted with business income from operation of the farm can be important from a tax viewpoint.

TROY G. THURSTON, CPA, and WILLIAM J. CARON, CPA, Geo. S. Olive & Co., Indianapolis, note that for certain classes of tax-exempt organizations, income from operation of a farm constitutes unrelated business income, whereas rent may be received without threat to the tax-exempt status of the organization (Sec. 512(b)(3)).

Similarly, for the purpose of the retirement income credit, rent qualifies as retirement income, whereas income from operation of a farm does not qualify unless there is material participation in such operation as owner-lessor (or sublessor) in a landlord-tenant relationship. However, 30 per cent of such income from operation of a farm, whether or not there is material participation as owner-lessor, is regarded as earned income and can operate to reduce the retirement income credit otherwise allowable.

Finally, rent (including rent paid in the form of crop shares) is not subject to self-employment tax, whereas net income from operation of a farm, including material participation by an owner-lessor, is regarded as earned income and can operate to reduce the retirement income credit otherwise allowable.

If a farm is merely rented to an operating lessee, the income to the owner undoubtedly constitutes rent. Likewise, where the contract calls for a profit-sharing arrangement between the owner and the tenant, the determination is the same. But where an absentee owner retains control over the type of operation and the kind of crops that are to be produced, it would appear that there is the material participation subjecting the income so derived to the self-employment tax.

This type of problem—i.e., whether the contract between the owner and tenant is a lease calling for rentals to be paid the former—must be determined by reference to the facts in each case.

Retirement Income Credit In Community Property States

Income earned by one spouse in a community-property state also qualifies the other for the credit.

Section 37 of the Code provides that an individual who has received earned income in excess of $600 in each of any ten calendar years before the taxable year may claim a retirement income credit.

In most situations, where only the husband has been employed, this means that only the husband may claim a retirement income credit. However, T. T. SHAW of Arthur Young & Company, New York City, points out that in any situation where a couple resided in a community-property state, one-half of the earned income received by either spouse while residing in the community-property state is allocable to the other spouse (Regulations 1.37-2(a)).

Thus, if a couple resided in California for ten years or more, and the husband earned at least $1,200 in each of those ten years, then both the husband and the wife would be eligible to claim a retirement income credit.

It would seem immaterial whether the couple continue to reside in the community-property state in the year for which the credit is claimed.

GROSS INCOME

Sec. 61

The Present Status of Payments to Employee's Widow

The nontaxability of such payments has "firmed up" for years prior to 1954 and the Service has recently announced its agreement (TIR-87, 8-25-58). However, doubt is still cast on post-1953 payments by the Rodner *decision.*

The tax treatment of certain amounts paid by an employer to the widow of a deceased employee or officer has been uncertain because of conflicts in court and Treasury views. The 1954 Code

Sec. 61 did not remove this uncertainty. J. S. SEIDMAN, CPA, of Seidman & Seidman, New York City, furnishes the following succinct summary of the current law:

The income tax status of payments voluntarily made by an employer to the widow of an executive is in a state of confusion, by reason of a change of position initiated by the government in 1950 (I.T. 4027, 1950–2 C.B. 9).

Where the payments to a widow are *by reason of contract obligations* with the executive, the tax effect is clear: The amounts, if reasonable, are deductible by the company (*Seavey & Florsheim Brokerage Co.,* 41 B.T.A. 198, (A)). The deceased's estate has to include the future payments as part of the estate for estate tax purposes (*Est. of A. W. Davis,* T.C. Memo, 1952). The widow has to include the amounts as taxable income when paid her (*Florsheim* v. *U.S.,* 156 F.2d 105). She can take as a deduction in her income tax return a pro-rata part of the estate tax applying to the amount that she receives (1954 I.R.C. 691).

Where the payments to a widow are not as a result of contractual obligation, but are *voluntary,* the rule up to 1950 was that for a limited period, deduction could be taken by the company, and the widow did not have to report the amounts as income (Reg. 118, Sec. 39.23(a)-9, *I. Putnam, Inc.,* 15 T.C. 86(A), and I.T. 3329, 1939-2 C.B. 153). In 1950, the government ruled that the widow would thereafter have to report the amounts as taxable income, because they were payments for services rendered by the deceased executive (I.T. 4027, *supra*).

Since 1950, court decisions have been confusing and in opposition. In general they indicate that, if a payment by a company is intended to be for services, the widow is taxable and, if the amount is reasonable, the company has a deduction. If the payment is intended as a gift, the widow is not taxable (*Hahn,* T.C. Memo, 1954), and after the "limited period" the company does not have a deduction (*Philadelphia-Baltimore Stock Exchange* 19 T.C. 355).

All of the very recent decisions hold that payments to employees' widows were tax-free as gifts (even though in some cases the employee had been an officer or stockholder) and that the corporation had claimed a deduction for the payments in its tax return. (*Hellstrom,* 24 T.C. 916; *Bankston* v. *United States,* C.A.–6, 5-5-58 affirming USDC, WD Tenn., 3-29-57; *Helman,* T.C. Memo 4-30-57; *Rodner* v. *United States,* 149 Fed. Supp. 233; and others.) These cases all involved pre-1954 taxable years.

However, the opinion in the *Rodner* case casts grave doubt on the tax-free status of such payments in years after 1953 for the reason that 1954 Code Section 101(b), by exempting the first $5,000 of employees' death benefits, may be construed as rendering taxable all payments in excess of such amount. *Sec. 61*

Treasury Checking Controlled Payments by Corporations

This four-year-old policy of concurrent examination of officers' returns with corporation returns is "crescending."

I.R. Mimeograph No. 54-72 (May 28, 1954) provides for the examination of the returns of officers and certain employees of corporations, *particularly those corporations whose stock is closely held,* at the same time that the corporate returns are examined.

The purpose of these simultaneous examinations is to detect more easily and efficiently any deduction by the corporation of expenses which constitute personal expenses of the officers and employees and, conversely, those which are not corporate expenses.

CRAWFORD C. HALSEY, CPA, Pogson, Peloubet & Company, New York City, believes that the language of the Mimeograph indicates a "tough" attitude by the Treasury. He observes that while it is not mentioned in the Mimeograph, the Treasury probably intends, upon the disallowance of a corporate deduction as being a personal expense of the individual, to claim that in the case of a stockholder the payment is a dividend. If this is upheld, the corporation would lose the deduction but the officer or employee would still be taxable on the full amount received.

In the case of nonstockholders, the Treasury could take the position that the amount disallowed constitutes additional compensation to the officer or employee. This would mean that although the corporation may still be entitled to the deduction as compensation, the officer or employee would be taxed on the reimbursement as compensation, but could not deduct the expenses which are held to be personal rather than business expense.

The Mimeograph also states that if the relationships between affiliated corporations, partnerships, trusts or estates or individuals and a closely held corporation are such that the personal expenses of the individuals could be "foisted" (that is the word used) on these affiliated corporations, etc., the returns of the affili-

Sec. 61 ated corporations, etc., should also be included in the simultaneous examination.

Mr. Halsey urges that the importance of the Mimeograph be pointed out to all accounting clients where the above relationships exist.

Tax-Free Interest Included in Life Insurance Proceeds

Possible election by insurance beneficiaries may render interest exempt which would otherwise be taxable.

Under provisions of the 1954 Code, the spouse of a decedent is entitled to an annual exclusion from taxable income of $1,000 for the interest increment included in installment payments received from an insurance policy on the life of the deceased spouse. This provision is applicable only if the insured died on or after August 17, 1954.

However, under provisions of the prior Code, *any* beneficiary was entitled to exclude *all* such interest from taxable income, whether received in a single sum or in installments. Where an option was exercised, by either the insured or the beneficiary, to receive the proceeds of a policy in installments, and installments are now being received, the interest included therein is still excludable if death of the insured occurred prior to August 17, 1954.

The decision in *Jones* v. *Comm'r*, 222 F.2d 891 seems to indicate that a beneficiary of a life insurance policy can, at this time, change a previously made election as to the method of receiving the proceeds therefrom and be entitled to the full interest exclusion if the insured died prior to August 17, 1954. The decision indicates this to be permissible even though there was no contract right in the policy to elect an installment option.

Thus, for example, where proceeds of a policy have been left with the insurer under an agreement to pay interest thereon (such interest being fully taxable), some insurance companies will now permit a change of election by the beneficiary to the installment payment method so that interest may be received tax free. Of course, other courts may not agree with the *Jones* decision and not all insurance companies may allow a change of election, but this opportunity to receive tax-free interest may be well worth investigating.

What Is Precise Definition Of Gross Income?

A concise summary on an old but fundamental concept.

From Troy G. Thurston: The term "gross income" as used in the Internal Revenue Code and regulations is not precisely defined. In fact, the term is used in its own definition in Section 61(a) where gross income is stated to include, among other items, "(2) Gross income derived from business." The regulations at Section 1.61-3 amplify the definition by providing as follows:

"(a) In general. In a manufacturing, merchandising, or mining business, 'gross income' means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. Gross income is determined without subtraction of depletion allowances based on a percentage of income, and without subtraction of selling expenses, losses, or other items not ordinarily used in computing cost of goods sold. The cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer."

The above definition appears to apply to all sections of the Internal Revenue Code except where otherwise stated, as in Section 6501(e)(1)(A), relating to periods of limitations on assessment and collection if the taxpayer omits an amount in excess of 25 per cent of the gross income stated in the return. It is there provided that there is to be no deduction for cost of goods sold.

While the proper determination of gross income may be vital under Section 6012, relating to requirements for filing individual returns, and under Section 542, relating to personal holding companies, neither the individual nor the corporation income tax returns are arranged to point up the taxpayer's gross income.

Although the definition relative to deducting cost of goods sold is set forth in the regulations, as shown in *John H. Gooch,* 21 T.C. 481, and 14 T.C.M. 1282, there still appears to be some question as to what businesses can be considered to fall under this definition and thereby be entitled to deduct cost of goods sold in arriving at gross income. In the *Gooch* case, the taxpayer was not permitted to deduct farm expenses where the farm income was classified as rent, though received on a crop-sharing basis. However, in *Rives,* 8 T.C.M. 1094, the Tax Court held that bicycle repairs of a news and delivery boy could be deducted in arriving at gross income as he was recognized as being an independent contractor.

Sec. 61 Under this general problem, it is interesting to note the opinion of the Seventh Circuit in the case of *John H. Gooch* v. *Comm'r* (January 24, 1957), in which it is stated that "from these sections of the Act, the distinction between gross income and net income is made crystal-clear."

Sec. 71 When Are Insurance Policies Said To Be Assigned?

Future property settlements should take cognizance of this revenue ruling's emphasis on form rather than substance.

JOHN E. BROWN, CPA, of Brown & Councilor, Phoenix, Arizona, writes that Revenue Ruling 57-125, recently issued by the Internal Revenue Service, appears to be "strained."

This ruling says that where a property settlement incorporated in a divorce decree requires the husband to continue in full force and effect certain insurance policies on his life—to pay all premiums on such insurance, to keep them in good standing, not to make any loans against them and not to change the beneficiaries, so that the wife would remain the first beneficiary—he did not assign the policies in such a manner as to divest himself of their ownership and control and therefore the premium payments made by the husband on such policies would not qualify as alimony payments under Sections 71 and 215. The Service's conclusion is based upon the assumption that any action which is taken by the taxpayer with respect to the policies would have to be recognized by the insurer, and that the only restraint would be the risk of punitive action by the court against the husband for disobedience of its decree (sic).

Mr. Brown questions whether a bare legal right can be said to constitute "ownership and control," when as a practical matter, its exercise would be punishable as contempt of court.

Sec. 72 Tax Consideration in Annuity Refund Feature

How to compare costs and yields of policies with and without refund provisions.

TROY G. THURSTON, CPA, Geo. S. Olive & Co., Indianapolis, states that in purchasing a life annuity it is important to consider the effect of the federal income tax on the comparative net yields of annuities without refund features and annuities having refund features. In the following example (Figure I) the total of the annual payments under the refund annuity is lower than the total under the annuity without refund—while the taxable amount is higher. Sec. 72

Figure I

Annuity for male, aged 60:	Life Annuity Without Refund	Life Annuity With Installment Refund
Investment	$50,000.00	$50,000.00
		19%
Allocated to refund		9,500.00
Investment in contract	50,000.00	40,500.00
Monthly payment	287.50	254.50
Total of annual payments	3,450.00	3,054.00
Expected return—18.2	62,790.00	55,582.80
Exclusion ratio	.796	.729
Exclusion	2,746.20	2,226.37
Taxable amount	703.80	827.63
Net proceeds after tax at assumed effective tax rate of 50%	3,098.10	2,640.18
Net annual yield on total investment	.062	.053
Years to recover investment out of proceeds after tax at assumed rate	16.14	18.94
Years guaranteed		16.37

Due to the adverse tax effect of the refund feature, the annual yield of the ordinary annuity in this example is about 15 per cent higher than the yield under the refund annuity, although the total of the annual payments is only slightly over 11 per cent higher than the total under the latter type.

If the annuitant survives fourteen and a half years, approximately his life expectancy, the net recovery under the annuity with refund in the above example will equal or exceed the net realization under the annuity without refund in the event the an-

Sec. 72 nuitant's death occurs at about the middle of the sixteenth year of the annuity. In the event of the annuitant's death before receipt of the guaranteed sum, the tax-free receipt of the amounts paid to the contingent beneficiary becomes an important factor. (Sec. 72(e) (2), I.R.C.)

The adverse tax effect of the refund feature increases as the tax rate increases and decreases with a reduced effective tax rate.

Sec. 105

Health Plan for Retiring Employees Is Deductible

This is a very interesting way of accelerating deductions and providing another fringe benefit.

From J. S. SEIDMAN: A ruling has been issued by the government allowing deductibility for payments made into a fund that will buy Blue Cross and Blue Shield policies for all retired individuals who were under the company's pension plan. The arrangement calls for payments into the fund starting five years before retirement and ending at the time of retirement. The amount of the payment is on an actuarial basis. The government has ruled that such an amount is deductible. The ruling does not say whether the fund itself will be tax exempt on the amount of the policies, although it should qualify as sick and accident pay.

Employees' Nontaxable Sick Pay: 1954 Code Section 105

A tool for making the required computations where employer pays no part of employees' accident or health insurance premiums.

Reproduced below is a simple form prepared by RAYMOND E. GRAICHEN, CPA, Lybrand, Ross Bros. & Montgomery, Philadelphia, for the computation of the nontaxable portion of salaries and wages paid to an employee for the period of an illness or injury. This form may be used by employers who have a salary or wage continuation plan but who do not pay any part of the employees' accident or health insurance.

COMPUTATION OF THE NONTAXABLE PORTION OF SALARIES AND WAGES PAID TO AN EMPLOYEE FOR THE PERIOD OF AN ILLNESS OR INJURY

	For a period of more than 7 consecutive days, during which the employee, if hospitalized, was hospitalized for less than one full day.	*For a day or a period of consecutive days, during which the employee was hospitalized for at least one full day.*	*Personal Injury*
1. Period of the employee's illness or injury (dates inclusive)	______	______	______
2. Number of consecutive calendar dates in such period	______	______	______
3. Period for which the employee's salary or wage was paid (dates inclusive)	______	______	______
4. Number of regular work days in such period	______	______	______
5. Number of days in a regular work week	______	XXX	XXX
6. Number of days which are eligible for salary or wage gross income exclusion (Line 4 minus line 5)	______	______	______
7. Daily salary or wage rate based on a regular work week ($___ per week divided by Line 5)	$______	$______	$______
8. Daily total gross income exclusion on a work week basis ($100.00 divided by Line 5)	$______	$______	$______
9. Daily rate of tax-exempt salary or wages for any work day falling in any seven-day week (since the beginning of the employee's illness or injury) (Line 7 or line 8, whichever is lesser)	$______	$______	$______
AMOUNT OF TAX-EXEMPT SALARY OR WAGES PAID TO THE EMPLOYEE:			
Line 6 (___ days) multiplied by Line 9 ($___ per day) =	$______	$______	$______

Sec. 105 Qualifications for Sick Pay Are Technical

This item is from the American Institute's 1955 Annual Meeting. Unfortunately, the subsequently issued regulations, Section 1.105-4(5), confirm the harshness of the opinions there expressed. "Thus, if an employee returns to his usual place or places of employment and performs any services for his employer, he has returned to work. . . ."

An employee sick at home for six days drags himself into the office on the seventh day to clear up some urgent work. Then he returns to bed for another week or two.

Query: When does the up-to-$100-per-week exemption start to apply to his compensation under Section 105(d)—after the seventh day of his illness or after the fourteenth?

Consensus of panel: After the fourteenth day. However, if the office had sent his work home to him, the exempt period would have started after the seventh day!

Another observation: In order to constitute a waiver of the seven-day waiting period, it is necessary to be hospitalized for at least one day. A physician's office or the patient's home will not qualify as a "hospital" even though an operation may be performed there.

Still another observation: A retroactive wage adjustment covering an employee's sick period probably could qualify as exempt sick pay.

PERSONAL EXEMPTIONS AND DEPENDENTS

Sec. 151-2 About Dependents: Claiming For Exemption or Deduction

The decisions in Turnipseed *and* Drewsbury *have been formalized in Code amendments made by the 1958 Technical Amendments Act.*

What is a dependent? The question hardly seems to pose any great problem. But read a paragraph from a booklet entitled *1956 Computax.* The booklet is distributed by the Trust Department of the Continental Illinois National Bank and Trust Company of Chicago. According to Jacob Goldberg, CPA, Chicago, it points up an error which seems to be more widespread than one ought to expect, both among practitioners and among students.

"To qualify as a dependent 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 the following relationship to him." (A list of qualifying relationships follows.)

Reference to Section 152(a) of the Internal Revenue Code reveals that only (c) and (d) above are necessary to qualify an individual as a dependent, while (a) and (b) are additional qualifications which must be met if the taxpayer is to claim an *exemption* for the dependent.

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 (Section 213(a)). Medical expenses paid for a dependent are deductible even though an exemption may not be claimed for that dependent.

There have been several novel court decisions construing the dependency provision which are commented upon by JAMES E. GELBERT, CPA, Lybrand, Ross Bros. & Montgomery, Pittsburgh. For example, Mr. Gelbert notes that 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. The reason given for the disallowance was that the taxpayer's actions were deemed to be contrary to public policy. A concurring opinion sustained the disallowance on the theory that the support furnished constituted remuneration for services rendered.

In *Richard Farnsworth,* 25 T.C. 108, a case involving the 1939

Sec. 151-2 Code, the taxpayer was denied a credit 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 eighteen 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 fifty 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 recently 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 fifty 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. The status as a student continues throughout the year (Rev. Rul. 56-399).

Recently issued Revenue Ruling 58-67 provides that the term "support" includes church contributions but does not include federal, state and city income taxes and social security taxes paid by the dependent from his own income.

Finally, a taxpayer may not claim his wife as an exemption and also claim a dependency deduction for her on the ground that she qualifies as a dependent under Code Section 152 (a)(9). The Court of Claims denied that Congress intended to give husbands a double break. (*Drewsbury,* Ct. Claims.)

DEDUCTIONS

Sec. 162 Can't Walk Away from Travel Expense Reimbursement

(From the American Institute's 1955 Annual Meeting.)

An employee or, indeed, a partner or officer, may be entitled to reimbursement from his firm for travel expenses. However, suppose that he fails to claim them from the employer—may he deduct such expenses in his own return as expenses incurred in earning income? Sec. 162

Consensus: No. He will be deemed to have constructively received reimbursement. That is, he can't just "walk away" from the reimbursement.

An "alert": One should collect from his employer all expense reimbursements to which he is entitled. Bearing the expenses himself will not entitle an employee to a tax deduction therefor (*Podems,* 24 T.C. 3).

Deduction for Professional Overhead Expense Policies

Practicing CPAs may be personally interested in this type of insurance policy.

HARRY S. GROSS, CPA, Philadelphia, has called attention to Revenue Ruling 55-264, which permits as a business deduction the premium payments on a fairly new type of insurance policy.

Such a policy is issued for the purpose of reimbursing the holders thereof for business overhead expenses incurred by them during prolonged periods of disability due to injury or sickness. Expenses include rent, electricity, heat, water, laundry, depreciation, employees' salaries, and such other fixed expenses as are normal and customary. Of course, the proceeds of such insurance are includable in taxable income.

The individual practitioner might find this type of insurance very comforting to have. He would be entitled to a deduction for premiums paid, and the insurance would provide coverage for many items of expense that ordinarily continue during a prolonged disability due to injury or sickness.

Proposed Deduction for Wives' Travel Expenses

Perhaps the announcement by the Service of a tougher policy on wives' expenses (Rev. Rul. 56-168, I.R.B. 56-17)—and the Tax Court's recent decisions (Cornelius Vanderbilt, Jr., *16 T.C.M. 1081; and* Alex Silverman, et ux, *CA: 8, 4-16-58 affirming 28 T.C. 106)—will propel this problem right into Congress' lap.*

Some Congressman, sometime, will endear himself to millions

Sec. 162 of American women voters—by successfully sponsoring an amendment to the Internal Revenue Code making clearly deductible for income tax purposes a wife's away-from-home expenses while she is accompanying her husband on a business trip or to a business convention.

Such a provision probably would not be terribly costly, revenuewise. And it needn't be too complicated—it simply might provide that the wife's expenses shall be deductible to the same extent as are the husband's.

This obviously desirable type of amendment probably would be hailed by many and diverse groups—not only the grateful wives and husbands who would directly benefit from such legislation, but also railroads, airlines and hotels, whose revenues would be bound to increase.

Indeed the advocates of such legislation might receive unexpected backing from the churches or social welfare groups, who may find moral and social appeal in this encouragement to husband-wife companionship.

Vacation Pay Agreements Should Be Checked Now

The presently accepted basis for accrual per I.T. 3956 has been further extended by Congress to years ending on or before December 31, 1960 (Sec. 97, 1958 Technical Amendments Act).

Taxpayers accruing vacation pay where there is not complete vesting at the year's end are in danger of losing their accrual unless their plans are amended. Consideration should be given to the danger now, while 1958 and 1959 union negotiations are in progress. However, accruals based upon union contracts in effect as of June 30, 1957, which expire after December 31, 1958, will not be disturbed until 90 days after such expirations.

It is understood that the Service will construe the meaning of "vesting" narrowly, i.e., there must be an absolute assurance that the employee will receive his vacation pay, even though he should die, resign or be discharged prior to the scheduled date of his vacation. A written contract is not necessary in this regard, as long as there is a firm company policy to that effect. It was stated that the vesting of vacation pay does not constitute a change of accounting method, so that permission of the Commissioner will not be required in this respect.

It is reported that in several cases taxpayers have attempted to change from the cash to the accrual basis with respect to vacation pay and to take advantage of the rule of I.T. 3956, during the period of suspension of the effective date of Revenue Ruling 54-608. It is also reported that it was never the intention of the Service to allow a change of this character; rather, the suspension of the effective date of Revenue Ruling 54-608 was made simply to preserve the status quo of those corporations which had previously been on the accrual method.

There is some hope among certain groups that the presently accepted basis for accrual (per I.T. 3956) will be extended or that new tax legislation will re-enact Code Section 462 with certain restrictions. Such hopes should not, however, deter taxpayers from serious consideration of the matter now.

A Suggested Policy for Employees' Vacation Pay

One way of meeting the deadline referred to in the item entitled "Vacation Pay Agreements Should Be Checked Now."

From T. T. Shaw: Revenue Ruling 58-18 holds that where a liability for vacation pay is vested, a deduction in the amount of this liability is allowable even though the liability is not based upon a written contract.

Many clients do not wish to incur such a liability because they feel that certain employees who resign or are discharged may not deserve vacation pay. In most cases, however, certain classes of employees are unlikely to leave. Employees with many years of service would usually receive their vacation pay even though their employment were terminated.

Employers might adopt a policy whereby only certain classes of employees would receive a vested right to vacation pay. Classification might be based on (1) length of service, (2) nature of duties, (3) amount of compensation.

Notice to the employees to be covered under the new policy would, of course, be necessary.

Sec. 162 In this manner, at least a portion of all vacation pay could be accrued. In the year of change, this portion would result in a double deduction and, in effect, permanent deferment of the tax on this amount.

Furthermore, since the establishment of a vacation pay liability for the first time amounts to a change in the method of operation rather than a change in the method of accounting, permission would not be required for the adoption of the accrual method of deducting the vacation pay.

Unrestricted Stock Options For Company Executives

An addition to the yearly audit program?

From J. S. SEIDMAN: When a company gives its executives an unrestricted stock option, there is income to the executive and a like amount of deduction to the company. 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.

The Tax Status of Carpet Leasing Arrangements

While the item concerns itself with carpeting it might well be applied to any leased personal property.

From JEROME C. BACHRACH: A frequently recurring question involves the tax status of carpet leasing arrangements. In brief, a floor-covering company installs wall-to-wall carpeting in a customer's place of business. A lease is drawn under which the customer promises to pay a scheduled series of rents for a certain number of years. Often the first year's rent is the largest and the rental payments decline each year thereafter. The total rental payments approximate the normal retail price of the carpeting plus a reasonable finance charge. The seller may discount the rental agreements with a bank. At the end of the rental term the seller has a legal right to take back the merchandise. The customer never acquires legal title to the carpeting nor does he have any option to purchase it.

The principal question is whether under these facts the customer is permitted to deduct the rentals called for under his lease. Or does the government instead consider that he is really buying carpeting rather than renting it? (In the latter case he would be entitled only to depreciation.)

There is also a second question. Even if the arrangement is considered to be a true lease, will the customer be entitled to deduct currently all of his rentals, or only a portion of them?

Certain courts, particularly a Court of Appeals, may well take a rather lenient attitude towards such lease arrangements. However, favorable court decisions can be obtained only by litigation which clients naturally wish to avoid. Accordingly it is the rules which the revenue agents and their supervisors are applying which should be considered.

The Service applies an economic test, rather than a legal one. It is almost sure to find a purchase if the "lease" provides for part of the "rents" to be applied against a specific purchase price, or if it gives the customer a purchase option which is abnormally small either in relation to the expected value of the property, or in relation to the total rental payments. But even without these factors a purported rental arrangement may still be considered really a purchase. What else then does the Internal Revenue Service look for? Here are the principal items:

1. Do the agreed rents for any year materially exceed the fair rental value of the carpeting for that year?

2. Does the lease call for rents about equal to the cash price of the carpeting plus a reasonable interest or finance charge?

3. Finally, and probably most important, what is the true intent of the parties? In other words, notwithstanding all the signed and sealed legal papers, is it really intended that the customer will continue to have possession and use of the carpeting for its entire useful life?

Some feel that the Service also takes a dim view of assigning "leases" to banks or finance companies. According to certain revenue people this makes the transaction resemble a conditional sale even more.

Even if the Service concedes that the arrangement is a rental one, too high rentals in the early years may still be attacked as being in part a prepaying of rentals for later years. For example, if the customer pays $900 of rents in the first year on a $3,000 purchase, and the government took the position that $600 was a fair first-year rental, they would require the customer to capitalize the extra $300 as a prepayment. He could only deduct it in later years when actual payments were smaller than the government considered reasonable. To meet this argument the customer should be able to show how carpet values are really measured. What per cent of the fair market value of carpeting is really lost in the first year? What is its true useful life? These are matters in which carpet dealers are naturally much more expert than are CPAs.

Suppose it can be proved that the annual loss in value of new carpeting during its early years *is* greater than can be written off through using an accelerated depreciation method. In this case a schedule of rentals need not be absolutely limited to what may be claimed through depreciation. The special depreciation methods set up in the 1954 Code are merely arbitrary conventions and do not purport to correspond with actual losses in useful value.

Still it is evident, as a practical matter, that the larger the proportion of total rents that is claimed in the early years, the more likely the whole plan is to be challenged.

As indicated above, if the customer has a "lease" running for the full estimated useful life of the carpeting, the Internal Revenue Service *is* likely to find a purchase agreement. But suppose an arrangement is set up under which the customer does *not* have a guaranteed right (even though he may well think he has every practical assurance) of continuing to use the carpeting for its whole estimated useful life. He has instead only a yearly lease with no guarantees of renewals. In other words, the seller has the choice of leaving his carpeting with the customer for the rents specified in the agreement, or of taking it back at the end of any year. Suppose also that the annual rental payment in each year does not exceed the loss of value that the carpeting really suffers during that year.

These factors would make it considerably more difficult for the Service to find that the customer had made a purchase. However, even here, considering the difficulty and expense of repossessing wall-to-wall carpeting, the government might still try to hold that the true intent of the parties was to make a sale. A realistic conclusion has to be that in any case where a client's rental deduction for wall-to-wall carpeting substantially exceeds a reasonable depreciation allowance, a challenge from a revenue agent may be expected. *Sec. 162*

New Ruling Affects Improvements On Leased Property

The enactment of new Code section 178 in the exact form discussed in this item (Sec. 15(a) of 1958 Technical Amendments Act) increases the significance of the questions raised.

Some interesting questions are raised by a recent revenue ruling and the related section of the Technical Amendments Act of 1957 (HR 8381), reported favorably to the Senate Finance Committee by the House of Representatives.

Treasury regulations under the 1939 Code and the 1954 Code hold that, where a lessee makes improvements on leased property, he generally is permitted amortization or depreciation over the length of the lease period or the life of the improvement, whichever is shorter. These regulations provide that options permitting the lessee to renew the lease *shall not* be taken into account unless the facts show with reasonable certainty that the lease *will* be renewed.

Section 14 of HR 8381 provides (by way of a new Section 178 of the Code) that optional renewal periods *shall* be taken into account unless the *lessee* establishes that it is more probable the lease *will not* be renewed than that it will be so renewed. This section also provides that, if the lessee and lessor are related persons (as specified in Section 267(b) and (c) of the 1954 Code, except that the family is to include only one's spouse, ancestors, and lineal descendants and control is to mean ownership of eighty per cent or more rather than fifty per cent or more), the cost of any improvement made by the lessee on the leased property may be recovered *only* over the useful life of the improvement.

But Revenue Ruling 57-361 provides that where a lease "*can* be renewed beyond its stated term by a lessee, due to circumstances such as, for example, stock ownership in a corporate lessee by the landowners and their families, the entire useful life of such busi-

Sec. 162 ness improvements made by the lessee is the proper period for determining allowable depreciation deductions, rather than any shorter period which may be stated as the term or renewal term of the lease, since the ultimate term of the lease is indefinite in such circumstances." (Italics supplied.) By using as the criterion the fact that a lease *can* be renewed, instead of questioning whether it *will* be renewed, this revenue ruling appears to change the basic rules established by Section 39.23(a)-10(b) of the regulations under the 1939 Code and Section 1.162-11(b)(1) of the regulations under the 1954 Code. Moreover, the revenue ruling sets no limits on the identity of ownership required (cf. the eighty-per-cent control required by the proposed new Section 178 of the Code).

It is interesting to speculate on the significance of the proposed new Section 178(a) of the Code. While the existing regulations require that the facts must show with reasonable certainty that a lease *will* be extended before the renewal periods may be taken into account, the burden of proof in proceedings before the Tax Court is, of course, always on the taxpayer. Will the situation really be changed by a Code provision requiring the lessee to establish the probability that the lease *will not* be extended? Or is this merely public Congressional approval of the existing "show me" policy of the Internal Revenue Service in this area?

Of even greater interest is the possible collateral effect of taking into account renewal periods where the lease term, so extended, is equal to or greater than the life of the improvement. In such a case the declining-balance or sum-of-the-years'-digits methods of depreciation ostensibly will be available to the taxpayer. But the regulations provide that stepped-up depreciation must be computed in the return for the taxable year in which the property may first be depreciated. Absent such an election, the Internal Revenue Service takes the position that straight-line depreciation must be used unless and until the Commissioner grants permission to change. What, then, is the position of a lessee who begins amortizing the cost of an improvement over the ten-year period of his lease, only to find, when his return is examined, that he must consider the lease term to be forty years, including renewal periods, and that the twenty-five-year life of the improvement now governs? Is he limited to straight-line depreciation unless and until the Commissioner grants permission to change? It would appear that there is an analogy in the regulations which permit an election of depreciation methods when the Service, after examination of a return, requires capitalization of an item which the taxpayer had expensed. In the case of our hypothetical lessee, the Service would be requiring depreciation instead of amortization, and a postfiling election should be permitted. *Sec. 162*

Nondeductibility of Local "Special Assessments" *Sec. 164*

However, looking behind an ostensible "special assessment" may reveal a deductible tax.

Section 164(b)(5) of the 1954 Code clearly provides (as did its predecessor Section 23(c)(1)(E) of the 1939 Code) that "taxes assessed against local benefits of a kind tending to increase the value of the property assessed" are not deductible. Such taxes are generally referred to as special assessments or betterments. The 1939 Code provided one statutory exception which is continued in the 1954 Code. Any portion of such taxes which can be shown to be "properly allocable to maintenance or interest charges" of the taxing jurisdiction are deductible.

The 1954 Code added a second statutory exception. This permits the deduction of special assessments if the taxing district covers the whole of at least one county with at least a thousand persons subject to the levy and if the assessments are annual at uniform rates and based on the regular assessed values of real property.

Quite apart from these two statutory exceptions, HERMAN STEUTZER, JR., CPA, Lybrand, Ross Bros. & Montgomery, Boston, suggests that taxpayers should not completely despair of obtaining a deduction for an item which bears the label "special assessment or betterment." Sometimes such a label is erroneously placed on an item which in reality is a tax. (See OD 928, 1919 Cum. Bull. 112.) In addition, the deduction of true special assessments has been allowed where they were levied against personal property which did not permanently increase in value. (See G.C.M. 821, 1926-2 Cum. Bull. 38.) This principle permits the deduction of special assessments which are levied against taxable machinery in a plant as distinguished from the plant and the land upon which it stands.

Beyond these possibilities the deduction of special assessments has not met with any particular success. Attempts to depreciate a

Sec. 164 special assessment over the life of the improvement itself have been denied because the taxpayer had no title to the improvement. (*Hubbell Son & Co.* v. *Burnet*, 51 F.2d 644 (8th Cir., 1931), *cert. denied* 284 U.S. 664.) This case also produced a change of heart on the part of the Treasury in another respect. Formerly, when a special assessment was levied on depreciable property, the taxpayer was permitted to add it to the basis of the property and depreciate it as part of the total basis over the life of the property. (G.C.M. 5589, Cum. Bull. VIII-1, 83.) Although the *Hubbell* case did not deal with this particular treatment, the Treasury felt that the principle applied, and thus in G.C.M. 9461, Cum. Bull. 1931-1, 120, it revoked G.C.M. 5589.

Time of Deductibility of Additional State Taxes

This recent Revenue Ruling amplifies the Treasury's 1947 views in G.C.M. 25298.

Paul D. Yager, CPA, Lybrand, Ross Bros. & Montgomery, Washington, D.C., believes that most taxpayers view with approval the provisions of Revenue Ruling 57-105, 1957-11, I.R.B., page 31, which provide that additional state taxes accrue and are allowable as deductions when the taxpayer acknowledges his liability to the state. Suppose a taxpayer files a state tax return and pays the tax shown to be due thereon. Suppose that several years later state officials review the return and propose a deficiency to which the taxpayer agrees. Is there a taxpayer familiar with this problem who has not had arguments with federal revenue agents as to the time of deductibility of the state tax deficiency? Is it deductible in the year in which the state proposes the deficiency or, because the taxpayer did not object to the assessment, is it deductible in the prior year to which it applies, that year being perhaps closed for federal purposes by the statute of limitations?

It is doctrine that contested items become deductible only upon the termination of the contest. Consequently, many taxpayers have followed the practice of going through the formality of filing protests and demanding hearings on proposed state tax deficiencies solely for the purpose of creating a recorded "contest" so that the Internal Revenue Service cannot logically argue that the tax accrued in the prior year.

Such "contests" will no longer be necessary in view of the holding of Revenue Ruling 57-105 that a taxpayer who files a state tax return and pays the tax shown due thereon is, in effect, denying any additional liability so that any state tax deficiency for that year to which the taxpayer later agrees will be deductible for federal tax purposes in the later year. *Sec. 164*

In the event of an increase in the amount of such tax, the new ruling provides that tax liability for taxable years ended prior to May 1, 1957 shall not be adjusted to apply the terms of the Ruling unless such adjustment is requested by the taxpayer "in a timely claim for refund." It is understood that it is not the intention of the Service to require that a formal claim for refund be filed in all cases where the taxpayer wishes to apply the ruling to a prior year. This may be done by an informal adjustment, if the return for the year is open and under audit.

Making the Most of a Bad Business Debt

Sec. 166

Proposed regulations, Section 1.166-7(d), and Sec. 8 of the 1958 Technical Amendments Act have resolved this doubt in favor of the House and Senate Committee Reports' version: i.e., a business bad debt is one created in connection with the taxpayer's trade or business.

THEODORE PROPP, CPA, and a member of the New York Bar, in discussing bad debts said this: Section 166(d)(2) of the 1954 Code expands the definition of a business debt to include one which is created or acquired "in connection with *a* taxpayer's trade or business." The House and Senate Committee Reports refer to the provision as though it read "*the* taxpayer's trade or business." Mr. Propp suggested that this conflict of language should be resolved in favor of the statute so that a transferee of a business-acquired debt may treat it as a business debt regardless of the business or nonbusiness circumstances of his own acquisition.

Another of Mr. Propp's pointers dealt with *Industrial Trust Co.* v. *Comm'r,* 206 F.2d 229 (1st Cir. 1953), which suggests that the timing of a bad-debt deduction may be controlled by the timing of foreclosure on collateral which was pledged to secure payment of the debt. He warned against loans which are contingently

Sec. 166 repayable, and noted that the contingency will ordinarily deprive the creditor of a bad-debt deduction.

Sec. 167 Application of New Depreciation Methods to Successor Owners

(From 1955 New York University Tax Institute.)

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 continue the use of the new methods where they had been applied by the transferor.

The point has been made that 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.

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.

KENNETH MUTZEL, CPA, Lybrand, Ross Bros. & Montgomery, Philadelphia: 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 for 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, rather than for depreciation.

This latter aspect has been of growing concern to the Internal Revenue Service; and in a series of recent rulings (Rev. Rul. 55-540, Rev. Rul. 55-541, Rev. Rul. 55-542) the Service has 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 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 declining-balance method of depreciation had been adopted (at 200 per cent of the straight-line rate). Figure I indicates the annual deduction for federal income tax purposes under that method and under the lease amortization schedule.

As disclosed by the above 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?

Mr. Mutzel believes that it certainly should. Revenue rulings are not one-way streets and in the case of this particular ruling, Sec. 167 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.

Figure I

$5,000 Annual Addition

DECLINING-BALANCE DEPRECIATION

Year of Purchase	*1956*	*1957*	*1958*	*1959*	*1960*
1956	$2 500	$1 250	$ 625	$ 125	
1957		2 500	1 250	625	$ 125
1958			2 500	1 250	625
1959				2 500	1 250
1960					2 500
	$2 500	$3 750	$4 375	$4 500	$4 500

LEASE AMORTIZATION

Year of Purchase	*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

Depreciation—Salvage Value

(From Tax Executives Institute's 1956 Annual Meeting.)

Salvage value may be recognized in the rate of depreciation only under the straight-line method. Thus, an asset with a normal life of ten years and a ten per cent salvage value may be depreciated at an annual rate of nine per cent against original cost. However, under the sum-of-the-years-digits method, salvage value must first be deducted from cost before applying the annual fraction. Under the declining-balance method, cost is used as a basis for annual depreciation without reduction for salvage value. Under all methods, however, total depreciation is limited to cost less salvage. *Sec. 167*

The Service does not feel that the useful life and salvage concepts of the new regulations require any departure from normal practice in the case of most taxpayers. This is based upon the premise that most taxpayers depreciate an asset over the full span of its useful life before disposing of it and that they will continue to do so. Although the life of an asset, as reflected in Bulletin F, has generally been its inherent useful life, the asset's economic usefulness to a particular taxpayer has long been recognized in depreciation policies.

Some Points in Depreciation Regulations

If the very recent decision in Hertz Corporation v. United States, *U.S.D.C. Delaware, 7-17-58, is upheld on appeal, and there seems very little question but that an appeal will be made, the declining "tail" would include an element of salvage and overrule the regulations with respect to point 2 below.*

The regulations on depreciation, issued June 12, 1956, show themselves to be a most commendable job. They are practical, clear, and complete. Among the principal questions they answer are these:

1. Fast depreciation may be elected with reference to property located on leased ground, provided the life of the property is shorter than the term of the lease. When the lease is shorter than the life of the asset, the cost is recoverable through amortization.
2. Salvage value must be taken into account in the declining balance method—not in fixing the life or the rate, but as a limitation on total depreciation. Thus, the declining "tail" which is characteristic of this method must stop declining when salvage value is reached.
3. The sum-of-the-years-digits method *can* be applied to group or composite accounts. A practical method for such application is described in detail.
4. Useful life *to the taxpayer* is emphasized as the criterion for establishing the rate.

Sec. 167

New Depreciation Methods on Items Capitalized by Revenue Agent

(From American Institute's 1955 Tax Conference for Business Executives—confirmed by Section 1.167(a)-10(a) of regulations.)

Under what circumstances will a taxpayer be entitled to one of the new depreciation methods where an Internal Revenue agent capitalizes items which were expensed by the taxpayer in the year which is under examination?

(a) If the particular item falls within a class for which the taxpayer elected a new method, the taxpayer will be entitled to use the same method for the item capitalized.

(b) If the particular item is a repair of an item for which the taxpayer had elected a new method, the taxpayer would again be entitled to use the same method for the item capitalized.

(c) If the item capitalized falls within a class for which an election was not made, the taxpayer will not be entitled to use of a new method.

It would appear that the taxpayer might protect himself by a blanket election, although there is a difference of opinion as to the measure of protection this election would afford.

When Is New Property Not New For Accelerated Depreciation?

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

From THOMAS J. GRAVES, Haskins & Sells, Washington, D.C.: All may not be as it seems if a taxpayer assumes that equipment he plans to purchase may be depreciated under one of the 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. *Sec. 167*

Problems in Electing Rapid Depreciation

To avoid possible loss of "fast" depreciation, election should be made in year of acquisition.

From LESLIE MILLS, CPA, Price Waterhouse & Co., New York City: The regulations under Section 167 do much to answer some of the problems which taxpayers might encounter in making a valid election of one of the accelerated depreciation methods provided by the 1954 Code. For example, Section 1.167(a)-10(a) indicates the general circumstances under which a taxpayer will be entitled to one of the new depreciation methods where an item which was expensed by the taxpayer is subsequently capitalized following an examination. In addition, the regulations at Section 1.167(a)-10(b) also provide for the use of certain "averaging conventions" where the effect of such a convention does not distort the depreciation allowance. It should be noted, however, that the averaging convention is specifically permitted by the regulations only in the case of multiple-asset accounts. This leaves open the question of whether the use of an averaging convention which is not one of those enumerated in the regulations or the use of an averaging convention for item accounts will protect the taxpayer.

For example, assume the taxpayer follows the convention for multiple-asset accounts of not claiming any depreciation in the year of acquisition, but claiming a full year's depreciation on any assets which might be retired during the year. Under such circumstances there may be a question as to whether the taxpayer would be entitled to one of the rapid depreciation methods by reason of the requirement that the desired method must be elected in the first taxable year "in which the property may first be

Sec. 167 depreciated by him." It would seem that the taxpayer who makes his election in the year of acquisition would be fully protected.

Depreciation Disallowance Equals Salvage Value

There is no question but that salvage values are undergoing much greater scrutiny since the advent of fast depreciation.

From T. T. SHAW: In several recent examinations of tax returns by the Internal Revenue Service, the agent has disallowed depreciation on items disposed of in the year under examination where the sales price exceeded the adjusted basis of the asset as of the beginning of the taxable year. The agents appear to be operating under a standard set of instructions with respect to this type of situation. The result, of course, is to increase the taxpayer's tax liability by the difference between the ordinary tax rate and the capital gain rate. In effect, the agent is treating the actual sales price as salvage value for the purpose of computing depreciation in the year of sale. So far, there has been no suggestion that the depreciation should be revised for years prior to the year of sale.

The depreciation regulations state that salvage value is determined at the time of acquisition of the asset and is not to be changed after determination merely because of changes in price levels. Assuming a reasonable estimate of salvage value is made at the time of acquisition, gains on disposition should be recognized as resulting from appreciation due to price level increases, such gains being truly capital in nature.

Revision of Bulletin F

(From Tax Executives Institute's 1957 Annual Conference.)

The revision of Bulletin F is already well under way. This statement by an official of the Service appears to be an answer to those industry representatives who had recommended that Bulletin F be abolished in its entirety. It was stated, however, that a wealth of material had been submitted on the subject of lives and rates of depreciable property which had been extremely helpful in the revision of Bulletin F.

You Still Can Give And Make Money

Benefits of giving appreciated property to charity are retained in 1954 Code.

VIRGIL S. TILLY, CPA, W. O. Ligon & Company, Tulsa, Oklahoma, notes that the "painless" method of giving to charity which was often publicized in the past is still available under 1954 Code Section 170.

For the individual, charitable contributions are now deductible to the extent of 20 per cent of adjusted gross income. An additional 10 per cent is allowable if the contribution is made to a church, educational organization, or hospital, as referred to in Code Section 170(b).

For example, let us assume all the following conditions are present:

1. That you have $100,000 adjusted gross income;
2. That you are married with no dependents;
3. That you have securities that cost $10,000, but are worth $30,000;
4. That you make a gift of the securities, without previous commitment for the gift.

Here is what happens:

	Your federal income tax	
	If you give the securities	If you don't —
Amount of federal income tax	$32,040	$52,056

Amount of tax saving—$20,016

In other words, at a cost to you of only $4,984 (which you wouldn't have unless you sold the securities), the fine work of the charitable organization, the church, school or hospital is benefited to the extent of $30,000.

Tax Court Decision on Donations of "Air Space"

The right to build has a donative value.

Another pioneering type of decision has been handed down by the Tax Court. In *Mattie Fair* v. *Comm'r,* 27 T.C. 866, the Court has looked with favor upon the allowability of contributions of "air space" to qualified charitable organizations.

Petitioners in the *Fair* case owned a two-story building and the ground upon which it was built. Originally built in 1942, the building was constructed so as to provide for additional stories, should the need therefor arise. The building was leased to outside interests from the time of its construction. During 1948, without disturbing the existing lease, a contribution was made by the petitioners of a portion of the existing two stories (enough for a lobby and elevators) and rights to the space *above* the building in which to construct additional stories. These rights were contributed to a tax-exempt foundation which undertook to construct five additional stories at its own expense and for its own use.

Based upon independent appraisals which quoted values for both the existing building space and the "air space" contributed, a deduction was claimed in petitioners' tax returns, subject, of course, to the applicable limitations. The Commissioner sought: (1) to disallow the deductions entirely, on the grounds that the rights contributed had no value; and (2) in the alternative, assuming that value did exist, to reduce the remaining adjusted basis of the then-existing building by an amount equal to the contribution.

Both assertions were denied. As to (1), the Court, weighing evidence which included expert testimony of independent appraisers, concluded that "We have no reason to question the . . . value given by the appraisal committee to the space above the . . . building."

As to (2), the Court, in effect, would not decide, because "We do not think the issue has been presented in such a manner as to require us to rule upon it." This leaves the question of basis reduction undecided by the Tax Court as to its merits.

In the light of the foregoing, it would appear that deductions for contributions of air space, *if value can be proven,* have Tax Court sanction. The question of the effect of such a contribution upon any existing basis for the property involved, however, is indeed unsettled, and should be carefully considered as to its possible effect on depreciation deductions in any case where such a contribution is contemplated.

Provisions for Unlimited Deduction for Contributions

Tax benefits provided for by strict Code provision (which was slightly relaxed by Section 10 of 1958 Technical Amendments Act) are also obtainable by simply forming a reversionary trust.

There has been provision in the Internal Revenue Code (Sec. 120, 1939 Code and Sec. 170(b)(1)(C), 1954 Code) for many years under which an individual might obtain an "unlimited" deduction for contributions in his federal income tax return. However, the rules are of such stricture that perhaps less than half a dozen individuals have been able to qualify.

RAYMOND E. GRAICHEN, CPA, Lybrand, Ross Bros. & Montgomery, Philadelphia, observes that prior to 1954 an individual was entitled to an unlimited contributions deduction only if for the taxable year and *each* of the ten preceding years the total of his contributions and income taxes exceeded 90 per cent of his net income computed without any deduction for contributions. Consequently, if an individual was to qualify he was required for ten consecutive years to pay more than 90 per cent of his annual income to recognized tax-exempt organizations and the U. S. Treasury *without* the benefit for those years of a contributions deduction any greater than was permitted under the general rules (15 per cent of adjusted gross income prior to 1952, 20 per cent for 1952 and 1953, and 30 per cent since 1953).

Congress relaxed the rules slightly during 1954 by providing that for years after 1953 an individual will qualify if the 90 per cent requirement is satisfied in *eight* rather than ten of the ten preceding years, and during 1956 Congress went on to amend the law retroactively to provide that the eight out of ten would apply to pre-1954 years as well, thus opening the way for a few individuals to claim refunds. However, under the retroactive amendment, there is nothing to be gained by the individual except the gratification inherent in making contributions since the amendment also provides that the Internal Revenue Service may make a refund only if the individual agrees that upon receipt of the refund he will forthwith contribute it to recognized tax-exempt organizations. The eight-year "sweating out" period, together with the many uncertainties which attend such a long period, have discouraged or made it impossible for individuals who might otherwise be interested in the unlimited contributions deduction.

Fortunately, recent clarification of rules relating to trusts has

Sec. 170 opened new avenues by way of which an individual may obtain the same effect as an unlimited contributions deduction *with no prerequisite waiting or qualifying period whatsoever.* These rules which may well render obsolete the statutory provision relating to the unlimited contributions deduction for individuals are:

1. A grantor of a trust who has a reversionary interest shall not be taxable on trust income to the extent that it is irrevocably payable for two consecutive years to specifically designated churches, schools or hospitals (Sec. 673(b));

2. A grantor of a trust who has a reversionary interest shall not be taxable on trust income if reversion to him cannot occur within ten years (Sec. 673(a)); and

3. Such trust may deduct *without limitation* any part of its gross income which under the terms of the trust is paid or permanently set aside for tax-exempt organizations to which contributions would be deductible (Sec. 642(c)).

Under these rules an individual, by the simple expedient of forming a reversionary trust, may obtain the same effect as an unlimited contributions deduction without any trying waiting period since, first, the income attributable to the property transferred to the trust would be that of the trust and not the individual, and secondly, the trust would *immediately* obtain a deduction *without limitation* for contributions made from its income and thus have no tax to pay. If the individual is willing to restrict the trust's contributions to churches, schools, and hospitals, he need relinquish his principal only for two years. During this period he would still be entitled to a contributions deduction in his individual return equal to 20 per cent of his adjusted gross income for contributions to organizations other than churches, schools, and hospitals.

If, on the other hand, an individual desires to have an unlimited deduction with respect to contributions to organizations other than churches, schools, or hospitals, then it would be necessary to form a ten-year trust. However, this would be preferable to *waiting at least eight years* during which only a part of the individual's contributions would be deductible by him in his return. The ten-year trust would be entitled *immediately* to an unlimited contributions deduction. No gift tax is payable in the setting up of these types of trusts, and the individual is not, of course, entitled to a contributions deduction in his personal return for the present value of the income or the principal paid into the trust.

The advantage of a trust as the vehicle for unlimited contributions is illustrated in Figure I. *Sec. 170*

Figure I

	No Trust	*With Trust*	
	Individual Joint Return	*Individual Joint Return*	*Trust Return (Stocks and Bonds Paid in)*
Salary	$50,000	$50,000	
Dividends	75,000	20,000	$55,000
Interest	25,000		25,000
Adjusted gross income	150,000	70,000	80,000
Contributions of $80,000	45,000(a)		80,000(b)
Other deductions	5,000	5,000	
	50,000	5,000	80,000
Taxable income	100,000	65,000	none
Income tax	51,000	29,000	none
Nondeductible contributions	35,000(a)	none	
	86,000	29,000	
Income remaining after income taxes and contributions	$14,000(a)	$36,000(b)	

(a) This would be *required* for *eight* years if the individual wished to qualify for unlimited contributions deduction.

(b) Remaining after-tax and contribution income rises $22,000 per year ($176,000 for eight years) and unlimited deduction *immediately* available to trust.

Charitable Contributions In Unissued Stock

P.S. What's that again about corporate stock not being property?

From T. T. Shaw: An interesting question is whether a corporation can contribute its own unissued stock to a charitable organi-

Sec. 170 zation and obtain a charitable contribution deduction for such contribution. It is reported that the Internal Revenue Service's policy seems to be to deny the deduction. The denial of the deduction is based on the theory that while the shareholders' equity is diluted no *property* is given away (sic).

There appear to be no cases on this point although unissued stock has been used to pay corporate expenses and a deduction has been allowed for these expenses incurred.

Contributions in Trust and the Additional 10 Per Cent Deduction

Strict adherence to Code-ordained form is required to qualify these payments for deduction.

Per TROY G. THURSTON, CPA, Geo. S. Olive & Co., Indianapolis: It is to be noted that the additional 10 per cent of adjusted gross income allowed individuals for contributions to churches, hospitals and schools is not allowable for gifts in trust for such organizations. Such contributions, to be eligible for the additional deduction authorized by Section 170(b)(1)(A), must be made *directly* to organizations of the type specified therein.

Where a pledge has been made to a trust or foundation for the benefit of organizations of the requisite type, deductions under the extra 10 per cent feature may nevertheless be obtained if payment is made directly to the organization. Recognition by the trust that such direct payment satisfies the prior pledge to the trust leaves the payment in its true status as a contribution to the charitable organization. For example, a payment to a hospital qualifies for the extra deduction even though a hospital foundation, to which a pledge has been made, allows full credit against such pledge by reason of the direct payment to the hospital. Official sanction for this procedure has been given in Revenue Ruling 55-1, C.B. 1955-1, page 26.

Charitable Gift *v.* Charitable Bequest

The income tax savings from the former make it worthy of consideration.

Per TROY G. THURSTON, CPA, Geo. S. Olive & Co., Indianapolis: One who contemplates a bequest or gift of real estate to a charitable organization will ordinarily have taxable income which reaches a tax rate higher than the estate tax bracket which will apply to his estate. This is particularly true where the marital deduction may be applicable in computing the estate tax. *Sec. 170*

In such circumstances it is immediately apparent that the individual will realize greater tax savings by lifetime gifts which are deductible in computing taxable income instead of providing an equivalent benefit by a bequest under his will. If the property to be given has a value substantially in excess of the amount which can be utilized as a deduction in a return for a single year, it will be well to spread the gift over a period of years.

If the gift plan involves a series of conveyances of fractional interests, designed to keep within the allowable deduction limit each year, the gift plan may be supplemented by a codicil to the donor's will to assure the ultimate realization of the property by the intended donee organization in the event of the donor's death prior to completion of the series of gifts. The same effect could be accomplished by conveyance to a revocable trust with an appropriate exempt organization designated as the contingent beneficiary. This method would make it unnecessary to disturb the donor's will. Also, the grantor might transfer the property directly to the donee and reserve an absolute power of revocation of fractional interests until a specified date for each such interest, such right to expire in the event of the donor's death.

A lifetime gift is effective not only for saving of income taxes but avoids death taxes as effectively as a charitable bequest of the same property.

Reversed Position on Charitable Contributions of Inventory Items

An important concession by the Service after many years of limiting such deductions to "cost."

Final regulations covering contributions depart from a previous Treasury position with respect to the amount of deduction allowable where a donor makes his gift in property of an inventory nature. For example, an automobile dealer purchases an auto at a cost of $1,500. His list price is $2,000, but he is currently offering and selling such cars for $1,750. He is approached by a charitable organization for a donation and fulfills the request by assigning ownership of one of the autos in his inventory.

Sec. 170

In the past, the Revenue Service has insisted that his deduction be limited to the cost to the donor—in this case, $1,500. Now, however, the allowable amount (subject to the percentage requirements of the law) would be $1,750. This policy conforms the procedure with respect to inventory items to that long recognized in the case of *non*inventory items, such as securities, realty or art objects, which have been used so often as gifts where they had appreciated in value over the donors' basis.

The new approach to inventory gifts can result in a net cash profit. In the example given, a ninety-per-cent-surtax-bracket taxpayer would reduce his tax by $1,575 (ninety per cent of $1,750), an amount $75 more than his cash cost of the auto.

However, a word of caution—the fair market value to be used is the fair market value on the market in which the taxpayer customarily trades. Thus, a taxpayer selling in the wholesale market is *not* permitted to determine fair market value by reference to the retail market.

Contributions of Mortgaged Property to Charity

As of publication date, the expected ruling referred to in the last paragraph had still not materialized. Incidentally, along the same line, Section 12 of 1958 Technical Amendments Act now prevents a double deduction where cash-basis taxpayer prepays interest on a loan secured by property which he donates to charity.

A taxpayer purchased property for $20,000. It is now worth $100,000. He placed an $80,000 mortgage on the property. Subsequently he donated the property to a charitable organization which assumed the $80,000 liability. Was any income realized by the taxpayer, when the charitable organization assumed the liability or when it paid off the liability? If there is a gain is it capital gain or ordinary gain?

Service representatives have informally indicated their belief that he *does* realize income. However, they felt that there is a problem as to whether the gain was ordinary or capital. Two rulings which were issued in 1954 and 1955 on the surface appear to be inconsistent. One ruling holds such a gain to be ordinary income and the other ruling holds it to be capital gain.

The Service people also indicated that there might be some problem as to whether the gain is realized at the time the charity assumes the obligation or at the time the charity pays off the obligation. Sec. 170

The Treasury is understood to be re-examining its position with respect to contributions of mortgaged property and is expected to issue a ruling on this subject.

Research and Development Costs: Expense or Capitalize?

Sec. 174

Summary of factors that should influence taxpayer's election.

Crawford C. Halsey, CPA, Pogson, Peloubet & Company, New York City, calls attention to a few important situations which are brought out by the regulations under Section 174.

1. Section 174 gives a taxpayer the choice of two methods for treating these expenditures. He may adopt (this apparently is the same as elect) the method of deducting *all* research and experimental expenditures in the first year beginning after December 31, 1953, and ending after August 16, 1954, in which such expenditures are incurred. Or he may elect in such first year (or any later year provided the method of treatment as expenses had not been adopted previously) to treat such expenses as *deferred* expenses to be amortized over a period of not less than sixty months beginning with the month, generally, in which the taxpayer first puts the resulting property to an income-producing use.

If the method to deduct these expenditures currently is adopted the first year, *all* such expenditures incurred in subsequent years, except those pertaining to projects as to which the Commissioner's permission to defer has been obtained, must be deducted currently. Consistency as to the treatment of expenditures on the same project must be maintained throughout, regardless of the method adopted or elected, although in a later year the taxpayer may, with the consent of the Commissioner, change the method to be used in respect of expenditures for that and subsequent years.

What happens if a taxpayer fails to adopt or elect either of the methods permitted under Section 174? The regulations state:

"Research or experimental expenditures which are neither treated as expenses nor deferred and amortized under Section 174 must be charged to capital account."

The taxpayer then would be required to follow the methods used prior to the enactment of the 1954 Code. These are, in gen-

Sec. 174 eral, the capitalization of all such expenditures followed by: (a) depreciation or amortization of these amounts over the life of the resulting property or some other arbitrary period; and (b) write-off of the unamortized cost of unproductive projects when they are abandoned. The difficulties and uncertainties inherent in these methods are well known; in general, it might be wise to adopt or elect one of the Section 174 methods.

2. If the taxpayer has elected to deduct research and experimental expenses currently, such amounts remain as deductions forever, even though valuable property may result therefrom in later years. However, if the election to defer them is made and valuable property having a determinable useful life results from the deferred expenditures, the unamortized balance of the deferred expenditures must be written off over the life of such property.

Sec. 212 Deductibility of Attorneys' Fees in Divorce Proceedings

Financial complications of divorce may *give rise to tax deduction.*

Ordinarily, legal expenses incurred in divorce proceedings are personal expenses and hence are not deductible except to the extent that they result in the receipt of taxable income (alimony). However, the portion of such expenses incurred in resisting property settlements and bearing a reasonable and proximate relation to the management of property held for the production of income, has been held by some courts of appeal to be deductible.

The Sixth Circuit (*Bowers* v. *Comm'r,* 243 F.2d 904) recently held that a stockholder-officer was entitled to deduct a portion of the legal fees incurred in a divorce proceeding resulting in a property settlement. The rationale appears to have been that when the controversy between the spouses does not involve solely the amount of the property settlement but also the manner in which it should be made, legal fees incurred in protecting the husband's earning capacity are deductible. Thus, in *Bowers,* the wife demanded a part of the husband's dominant stock interest in a corporation, control over which would affect the husband's general income-earning capacity.

Both the Treasury and the Tax Court disagree with these decisions. They maintain that legal expenses incurred in resisting a spouse's monetary demands incident to a divorce are purely personal in nature under any circumstances. Sec. 212

The possibility exists that the Treasury may change its view if a sufficient number of courts of appeal hold contrary to its position. Accordingly, affected taxpayers should protect themselves where feasible by the filing of refund claims.

Payments to a Divorced Spouse May Qualify as a Section 212 Deduction

See item entitled "Deductibility of Attorney's Fees in Divorce Proceedings" (page 42) for possible judicial authority for the opinion here expressed.

From T. T. SHAW: A taxpayer who owns commercial rental property had to pay additional sums to his divorced wife in order to obtain a renewal lease from his tenant at a higher rental. At the time of his divorce, many years earlier, the taxpayer secured his obligation to make monthly alimony payments by delivering a mortgage on this property to his wife. When the original term of the lease expired, the lessee was willing to renew for another twenty-year term with a monthly rental increase only if the wife's mortgage was subordinated to the new lease.

The wife, before consenting to a subordination agreement, exacted from the taxpayer a promise to pay an additional monthly sum of $200 out of the rentals to be received. Her attorney also insisted that this new obligation be cast in the form of a noninterest-bearing note for $13,600 representing sixty-eight monthly installments of $200 each. Therefore, these payments could not qualify as alimony under Section 215, taxable to the wife and deductible by her husband.

It would seem that taxpayer might successfully contend that the payments are deductible expenses which were incurred for the production of income under Section 212.

Medical and Living Expenses— Important Tax Aspects

Sec. 213

Apropos of this subject, Revenue Ruling 58-280 further liberalized the medical expense deduction by allowing all costs, including living expenses, of maintaining a handicapped child in an institution; and the 1958 Technical Amendments Act has increased the deduction "ceiling" to $15,000 for persons 65 or over.

Revenue Ruling 54-343 (Cum. Bull. 1954-2, 318) holds that

Sec. 213 medical and hospital bills and living expenses paid by a taxpayer for an adult offspring, for no consideration other than the taxpayer's love and affection, constitute gifts for federal gift tax purposes. A like rule would apply where the payments are for the benefit of parents, grandchildren or other relatives. A gift tax return is required where gifts in excess of $3,000 are made to any donee in a calendar year.

If the payor has a legal liability under state law for support, Revenue Ruling 54-343 would not apply. The question as to the existence of legal liability should be referred to legal counsel.

No published rulings have been found on the question of who the donee is in connection with such a gift. For example, payments for the benefit of a grandchild may conceivably constitute a gift to the child's father, to his mother, or equally to both. Where the amounts involved warrant it, the Service's views should be obtained.

Whether or not payments of medical expenses constitute gifts, a deduction as medical expense for federal income tax purposes is allowable to the payor under Section 213(a) if the individual for whom the payments are made is a dependent as defined in Section 152. Payments of medical and living expenses should be included in determining the compliance with the over fifty per cent support test relative to qualification as a dependent. (In this connection, it should be remembered that medical expenses paid for a dependent are deductible even though an exemption may not be claimed for that dependent. *See*: "About Dependents: Claiming for Exemption or Deduction," page 12.

There is no requirement that the payor be legally liable for payment of medical expenses in order for him to be entitled to the deduction for income tax purposes.

Transportation Expenses Incurred In Connection with Medical Care

One instance of where in-town transportation expenses may be deductible.

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 may include in-town transportation. *Sec. 213*

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 deduction for the cost of such transportation.

Working Daughters Are Also Entitled to "Sitter" Deduction *Sec. 214*

Expenses of caring for physically or mentally incapacitated adult are deductible as well as child care cost.

ELLIOTT C. SEROTTA, CPA, Bell and Serotta, Augusta, Georgia, reminds us that Code Section 214 not only applies to the cost of "baby sitters" but also to amounts paid "mother sitters."

Because it grants a deduction for certain expenses of caring for small children, the provision has been widely acclaimed as a boon to working mothers. However, it also may be useful to working daughters, because it permits a deduction for expenses of caring for a physically or mentally incapacitated adult dependent.

Thus, under Section 214, the working school teacher may be entitled to deduct up to $600 of the cost of a sitter for her mother who is laid up with a broken leg.

Timing of Alimony Payment Helpful in Tax Return *Sec. 215*

Of importance to estranged husbands.

From J. S. SEIDMAN: Where a financial agreement is made between husband and wife and the likelihood is that they will be divorced in the ensuing year, it is an advantage to the husband to defer the starting of all alimony payments until the ensuing year and get the benefit of the joint return in the current year. In that way, there is both the joint return advantage and the advantage of the full deduction for alimony. If payments are made in the year while they are still married, then there is a loss of benefit from one or the other.

Sec. 216 Stock Tax Basis in Co-operative Apartment Corporation

The growing number of co-operative apartments, particularly in large cities, expands the importance of these rules.

Owners of co-operative apartments ordinarily make monthly payments to the co-operative corporation, covering interest, taxes and operating expenses. In addition, the monthly charges may include an amount allocable to amortization of mortgage indebtedness.

The Service has ruled that such charges for debt retirement represent additional cost of the stock to the "tenant-stockholders" provided the corporation credits such charges to its "paid-in surplus" account on its books (I.T. 1469, Cum. Bull. 1-2, p. 191).

In all cases where taxpayers own co-operative apartments and are being assessed for debt retirement, they would be well advised to ascertain from the corporation that such amounts are being credited to paid-in surplus.

And whenever a client sells stock in a co-operative apartment corporation, the CPA should ascertain that the tax basis of the stock has been adjusted in accordance with I.T. 1469.

Sec. 246 Quirk in Limitation On Dividend Deduction

It is now apparent that draftsmen 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.

For taxable years commencing after 1953, 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:

	1956
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% 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 to taxable income in computing a net operating loss. Here is another possibility of converting taxable income into loss.

Sec. 267 Bonds Held by Related Taxpayer Under Section 267

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

HENRY J. SEBASTIAN, CPA, San Antonio, Texas, wonders if CPAs are always careful enough in checking the application of Section 267, relating to the disallowance of a deduction for specified items between related taxpayers under certain conditions.

For example, if an accrual-basis corporation accrues interest at the end of its taxable year payable to a specified taxpayer 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 interest is not deductible by the corporation *at any time* unless the related taxpayer has a taxable year ending from three to eleven months after the close of the corporation's taxable year and receives payment before the close of that taxable year.

The specific situation Mr. Sebastian has in mind, 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 Internal Revenue Service 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.

It would apparently require an amendment of the Code to exempt accrued bond interest from the provisions of Section 267, since the only case Mr. Sebastian can find touching on the question implies agreement with I.T. 3319, *supra* (*Birch Ranch Oil Co.*, 3 T.C.M. 378; affirmed 9th Cir. (152 F.2d); *cert. denied* 328 U.S. 863.

CORPORATE DISTRIBUTIONS AND ADJUSTMENTS (Subchapter C)

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

Stock Purchase Agreement Indirectly Funded by Insurance

Sec. 301

This issue has just about completely crystallized in favor of the taxpayer by the subsequent reversal of Sanders *by the Tenth Circuit Court of Appeals.*

Thanks to MAX MYERS, CPA, for the following:

Oreste Casale 247 F.2d 440 (CA 2d Circuit) has cleared the air of much of the confusion appearing in recent discussions of the controlled corporation plan for stock purchase agreements funded by life insurance. This decision, reversing the Tax Court, is well worth reading, because it hews to the line and clearly restates recognized Internal Revenue taxation principles.

The rationale of this and other recent cases seems: A life insurance conduit may not be run *uninterrupted* through a corporation to a stockholder or natural beneficiary. The conduit must be either perforated or partly broken if successful tax results are to be obtained.

In *Casale* the petitioner was the president and principal stockholder of a New York corporation organized in 1946. He owned 98 per cent of its outstanding stock. The corporation was an operating company which had never paid any dividends to its stockholders, either in cash or stock. About two years after its organization, a meeting of the corporation's board of directors passed a resolution authorizing the corporation to enter into a contract with the petitioner to pay him monthly income upon his reaching the age 65, or on his prior death to pay a stated sum to his

Sec. 301 nominees or his estate. On the same date, the corporation did enter into a deferred compensation agreement, insuring the petitioner's life for the benefit of the corporation.

The corporation declared itself to be the owner of the policy and possessed the right to assign the policy; to change its beneficiary; to receive dividends as declared by the insurer, and the right to borrow on the policy up to the amount of its loan value. By retaining these rights, it may be seen that the corporation did not assign the policy or its proceeds to any specific use. The corporation paid the annual premium during each of the next three years, but did not claim a deduction for the premiums; rather, they were charged against earned surplus. The policy was reflected as an asset of the corporation on its books.

The Commissioner asserted that the premium paid for the year 1950 (the last year involved) by the corporation was "the equivalent of a distribution of a dividend and is therefore included in . . . gross income." The Tax Court upheld the Commissioner having reached the conclusion that ". . . the corporation was no more than a conduit running from the insurer to petitioner, or his beneficiaries, with respect to any payments which might come due under the insurance contract."

In overruling the Tax Court, the Second Circuit makes a very important observation, which will be applicable to most all cases in this field. It points out ". . . if the corporation should become insolvent, its contractual obligation remains in force. But this is a far cry from saying that during insolvency payments are to continue." (Payments under the deferred compensation agreement.) "The policy is a corporation asset in every sense of the word; as the Tax Court found, the corporation paid the premiums and possessed the right to assign the policy; . . . In the event of insolvency, corporate creditors would be able to reach the policy as they might any other asset. *Lincoln National Life Insurance Company* v. *Scales,* 62 F.2d 582 (CA 5th Circuit). Taxpayer would at most have an unsecured claim under this contract and would share pro rata, or he might even be subordinated to the claims of other creditors. See *Pepper* v. *Litton,* 308 U.S. 209." This seemed to adequately interrupt the "conduit" to the satisfaction of the Second Circuit, for the Court used these facts in striking back at the Tax Court's attempted disregard of the corporate entity.

The Court's closing paragraph, however, states the "package" which really clears the air on stock purchase agreement planning. It says:

"We have seen that taxpayer has received no *immediate* personal benefit from the corporate purchase of the policy. We have been cited to no case or legislative provision which supports the proposition that the entity of a corporation which is *actively* engaged in a commercial enterprise may be disregarded for tax purposes *merely* because it is wholly owned or controlled by a single person." [Emphasis supplied.]

The stock purchase agreement plans generally used are only one step away from the deferred compensation plan in *Casale;* so that these principles are valid for most of those plans. Other recent decisions in the stock purchase plan field cover exceptional fact circumstances not comparable to those in *Casale.*

The *Prunier* decision (CA-1 11/8/57 248 F.2d 818) 28 T.C. 10, recently reversed by the First Circuit Court of Appeals, and *Sanders* (CA-10 3/20/58) 149 Fed. Supp. 942 (DC Utah) case, both of recent origin and both looked upon with despair by many tax men until *Prunier* was reversed, may be clearly distinguished in the Tax Court decisions.

The real argument in *Prunier* is on the facts, not the principles. And the fatal flaw, as far as the Tax Court was concerned, appears in the naming of an individual stockholder as the beneficiary of a policy on the life of another stockholder. This device does not allow for an interruption in the "conduit." In finding against the taxpayers in this case, the Tax Court majority found as follows:

"The corporation was neither the beneficial owner nor the beneficiary of the insurance policies on the lives of Joseph and Henry involved here." (Joseph and Henry were the two dominant shareholders.)

In addition to finding that the corporation was not the beneficiary or owner of the policies, the Tax Court found that the two dominant stockholders were. It used this language:

". . . At the close of 1950 we are of the opinion that Joseph and Henry each had interests in the policies of insurance on their lives that were of such magnitude and of such value as to constitute them direct or indirect beneficiaries of the policies."

Under these findings, the Tax Court decision was correct. But so is the First Circuit case on its changed finding of fact.

The First Circuit in reversing held as follows:

"The corporation would have been held to be the beneficial owner of the eight insurance policies under controlling Massachusetts law and thus could have obtained the help of a court

Sec. 301 of equity to recover the proceeds of the insurance policies if one of the brothers had died in 1950."

These principles may be illustrated: A funnel (beneficiary) on top of a hose may be firmly fixed a foot or so below a hydrant (corporation) which when turned on will gush water (benefits) which will almost *certainly* fall into the funnel. By traveling through the air, the water is rendered pure (tax free). An element of risk is introduced because a storm *may* come before the water falls into the funnel and may blow the water wide of its mark. This is the tax-free situation.

If the hose is attached directly to the faucet, the water is not purified by the free fall and remains impure (taxable).

From this we can see that when a stock purchase agreement plan follows the principles restated by the Circuit Court of Appeals in *Casale* and the open conduit principles implied by the finding of fact language in *Prunier,* success should be assured in subsequent income tax litigation.

Sec. 302 Gain or Loss to Individual Shareholders In Corporate Liquidations

Summary of 1954 Code provisions.

As under the 1939 Code, distributions to shareholders in complete liquidations or in bona fide partial liquidations are still treated as sales or exchanges (Sec. 331). Thus, any gain or loss of the shareholder generally is subject to the capital gain or loss provisions.

Distributions in partial liquidation are still complicated, however, by the possibility that they may be essentially equivalent to the distribution of a taxable dividend (as under 1939 Code Sec. 115(g)). The principle of "genuine contraction" of corporate business required in *Flanagan* v. *Helvering,* 116 F.2d 937, has been introduced into the definition of a partial liquidation. Thus, the statute is now clear that where two or more businesses have been conducted by a corporation, and one is to be discontinued, the distribution of those assets or proceeds from liquidation thereof constitutes genuine contraction and therefore a partial liquidation (Sec. 346).

Of course, a subsidiary company still can be partially liquidated by its parent without disastrous tax consequences.

Using Corporate Funds To Finance Sale of Stock

A practical method of disposing of stock of closely held corporation via the capital gains route. Not affected by Zipp *and* Holsey *decisions. (See item entitled "What to Do When a Stockholder Leaves the Company" p. 55.)*

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 caused the corporation to redeem part of her stock; concurrently, she sold the balance to a third party. She treated her aggregate profit as a capital gain.

However, the Treasury asserted an ordinary dividends tax on the proceeds of the stock redeemed on the grounds 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 C.B. 223). That section provides *inter alia* that if a redemption 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 dividends 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 under certain conditions. What's 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.

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

Sec. 302

Qualifying a Stock Redemption As Substantially Disproportionate

This example by the Congressional committee should not be taken too literally!

The Congressional committee reports on the Internal Revenue Code of 1954, commenting upon the "substantially disproportionate" redemption provisions of Section 302, use an example to show the effect of a series of redemptions on such distributions.

The first part of the example states:

"A corporation has, as its sole capitalization, 100 shares of common stock outstanding. Shareholder A owns 55 shares and shareholder B 45 shares. Shareholders A and B are unrelated. In 1955, pursuant to a plan, the corporation redeems 12 shares of the stock of shareholder A and none from shareholder B. Such redemption standing alone qualifies as a disproportionate redemption within the meaning of Section 302(b)(2). In 1956, pursuant to the plan, the corporation redeems 10 shares of shareholder B's stock and none from shareholder A. This redemption, standing alone, would also have qualified as a disproportionate redemption within the meaning of Section 302(b)(2) . . ."

Section 302(b)(2) provides that a distribution is substantially disproportionate if the ratio which the voting stock of the corporation owned by the shareholder immediately *after* the redemption bears to all of the voting stock of the corporation at such time is less than 80 per cent of the ratio which the voting stock of the corporation owned by the shareholder immediately *before* the redemption bears to all of the voting stock of the corporation at that time. In addition, the shareholder, immediately after the redemption, must own less than 50 per cent of the total combined voting power of all classes of stock entitled to vote. Regulations Section 1.302-3(a)(3) provides that these percentage tests are to be applied only with respect to stock issued and outstanding in the hands of the shareholders.

Shareholder A in the cited example, immediately after the redemption, owned 43 shares, or 48.8 per cent of the total remaining 88 shares outstanding. Prior to the redemption he owned 55 per cent. To meet the 80 per cent test in Section 302(b)(2), shareholder A, immediately after the redemption, should own less than 44 per cent of the remaining shares. Thus, a minimum of 20 shares should have been redeemed.

Similarly, prior to the redemption of his stock, B owned 45 shares out of the 88 outstanding shares, or 51.2 per cent. After the redemption, he owned 35 shares of the remaining 78, or 44.9 per cent. In order to meet the requirements of the 80 per cent rule, he should own less than 40.96 per cent. Assuming 20 shares owned by A had been redeemed, rather than the 12 shares in the cited example, a minimum of 17 shares of B's stock should have been redeemed. *Sec. 302*

Of course, the redemptions illustrated comprise a series; therefore, neither would actually qualify as being substantially disproportionate. Therefore, one should not be misled by the committee's example.

What to Do When a Stockholder Leaves the Company

Despite the fate of the Holsey *case and its companion the* Zipp *case, (U.S. Court of Appeals, 6th Circuit, Nos. 13374-75 5/21/58, Affirming 28 T.C. 314) the Service will still rule favorably on a pure* Zenz *v.* Quinlivan *213 F.2d 914 type of transaction.* *(See item entitled "Using Corporate Funds to Finance Sale of Stock" p. 53.)*

Per WILLIAM H. WESTPHAL: Partners may not be able to agree, but they can always terminate the partnership with each going his way without serious tax consequences. There is no danger to the remaining partner because of the withdrawal of the other partner. The same is not true if a similar disagreement occurs in a closely held corporation, particularly where there are only two stockholders. Here it would seem that the acquisition of the other interest or the elimination of the withdrawing stockholder is surrounded by hazards.

In the average case, the stockholder who chooses to continue the operation of the business is likely to have insufficient funds outside of the corporation to make it possible for him to purchase the withdrawing stockholder's share. On the other hand, the corporation may have the necessary funds or if it does not possess them may borrow them and repay the loan out of earnings, while the individual stockholder could never accumulate enough income free of taxes to liquidate such a loan. Obviously, therefore the indicated approach is the complete retirement of the withdrawing stockholder's stock by the corporation or its acquisition for the treasury. Ordinarily, such a termination of a shareholder's interest should qualify under Section 302(b)(3) of the 1954 Internal Revenue Code and permit the capital gain treatment.

If stockholders face this problem, consideration must be given to the case of *Joseph R. Holsey*, 28 T.C. No. 107 (1957). Here it appears that the remaining stockholder had entered into an option to purchase the stock of a withdrawing stockholder and transferred the option to the corporation. It was exercised by the corporation to which it was thus transferred. The Court took the position that the substance of the transaction was the payment of a dividend to the remaining stockholder in an amount sufficient to permit the exercise of a valuable option. Thus, the payment to the retiring stockholder was treated as a dividend to the one remaining. This line of reasoning might be applied when a contract to purchase stock has resulted from the negotiations between the individual stockholders and the stock is later retired by the corporation.

The earlier decisions on this question are in conflict. The case of *Earl F. Tucker* decided by the Eighth Circuit Court of Appeals (226 F.2d 177 (1955)) was decided for the taxpayer, while that of *Frank P. Holloway*, decided by the Sixth Circuit Court of Appeals (203 F.2d 566 (1953)) is against the taxpayer.

Therefore, the area that once seemed clear and safe is beginning to drift into a twilight zone. Nevertheless, it is believed that a valid acquisition of stock for the treasury may result in capital gain to the stockholder who thus terminates his interest without giving rise to taxable income to the remaining shareholder. Great care, however, must be exercised to avoid the creation of anything resembling a contract between the individual stockholders or the issuance of any option to the remaining stockholder. The resolutions of the corporation should be clear and definite concerning the redemption of all the stock of the retiring stockholder in a partial liquidation of the company. If firm understandings have been reached between the individuals, it may be well to abandon the whole matter or consider it at a later date on the basis of the corporation's purchasing the retiring stockholder's share for the treasury.

The corporation may borrow the funds if it is necessary, but it would seem desirable that there be no endorsement of its obligation by the remaining stockholder or any action that might be construed to indicate that the individual stockholder, and not the corporation, actually borrowed the money. It is suggested that if there is a shortage of cash, the stock be purchased by payment of part of the consideration in cash with the issuance of serial notes or debentures of the corporation for the remainder. It is believed that this will result in capital gain to the retiring stockholder if all of his stock is thus redeemed; also he may be able to report this gain on the installment basis if no more than 30 per cent of the redemption price is received in cash in the year of this partial liquidation. *Sec. 302*

Date of Redemption of Stock to Pay Estate Taxes Governs

Sec. 303

Sec. 206(a) of the 1958 Small Business Tax Revision Act cross refers to Section 303 in permitting certain estate tax payments to be made over 10 years.

1954 Code Section 303 permits an estate to redeem stock to pay death taxes without the hazard of a dividends tax. It is more liberal than its 1939 Code predecessor, Section 115(g)(3)—it permits redemptions to pay *deficiencies* in estate tax.

B died in 1953. The estate tax was paid in 1954. Suppose a deficiency in estate tax is asserted in 1956. Can the benefits of *new* Section 303 be depended upon to obviate dividend treatment?

Answer: Yes. More liberal treatment depends upon the date of redemption—not the date of death.

Making Gifts Not Always Advantageous

An example of where ideal estate planning from the tax savings viewpoint may be imprudent from an economic viewpoint. (See item entitled "Estate Planning: A Capsule Review" p. 204.)

From J. S. SEIDMAN: While it is true that gifts can reduce estate taxes, there is also a disadvantage in making gifts in that they "under-cut" the amount of stock that can be redeemed on a capital gain basis under Section 303. That section is a protection up to the amount of the estate tax (and some other items). The lower the estate tax, the lower the amount of protection. In those situations, therefore, where getting money out of the

Sec. 303 company is more important than the tax factor, caution about gifts and estate tax savings is in order.

Sec. 304

Section 304 as Estate Planning Aid

Estate tax funds may be raised safely by selling corporate stock to related corporation.

JAMES E. GELBERT, CPA, Lybrand, Ross Bros. & Montgomery, Pittsburgh, points out that 1954 Code Section 304(a) can be an important estate planning aid where the decedent had stock investments in more than one corporation.

That section was primarily aimed at tax avoidance. Under prior law, stockholders could avoid the risk of the proceeds of a stock redemption being treated as an ordinary dividend under old Section 115(g) by simply *selling* such stock to a related corporation in a capital gain transaction. Code Section 304(a) (in conjunction with Section 302(b)(1)) closed this loophole.

However, Section 304(a) also can be applied advantageously. It permits a corporation to purchase the stock of a related corporation with the proceeds being treated as a distribution in redemption of the acquiring company's stock *for the purposes of Section 303* which permits redemptions to be taxed as capital gains provided the funds are used to pay estate and inheritance taxes as well as funeral and administrative expenses of the estate.

For example, Taxpayer A owns 51 per cent of Corporation A and 100 per cent of Corporation B. At the time of death, the stock of Corporation A qualifies under Section 303(b)(2), as the value exceeds 50 per cent of the taxable estate. The stock of Corporation B does not qualify since the value is neither 35 per cent of the gross estate nor 50 per cent of the taxable estate.

Ordinarily, under Section 303 alone, it would be the stock of Corporation A that would have to be redeemed to safely provide funds to pay the death taxes. This would result in control of that corporation passing to outsiders. However, if 49 per cent or less of the value of Corporation B's stock will provide sufficient funds, Corporation A can purchase that stock from the estate under Section 304 without risk of a dividends tax. Thus control of neither corporation would pass from the estate.

Stock Dividends Can Create Gift Tax Liability

A trap to be avoided by closely held family corporations.

Stock dividends are generally nontaxable for income tax purposes (Sec. 305).

However, assume that the common stock of a closely held family corporation is owned by the father and the preferred stock is owned by his sons. The issuance of a common stock dividend to both classes of stockholders will increase the son's and decrease the father's proportionate ownership.

Result (if donative intent is present): A possible taxable gift from father to sons.

Stock Dividends *v.* Recapitalization

Subsequently issued regulations, Section 1.368-2(3), confirm this by providing that "if such an exchange is made solely *for the purpose of effecting the payment of dividends for the current and immediately preceding taxable years upon the preferred stock exchanged, an amount equal to the value of the stock issued in lieu of such dividends shall be treated . . . as a (dividend)."*

Stock dividends specifically are made taxable under the Code if they are made in discharge of preferred dividends in arrears for the current or preceding taxable year (Sec. 305(b)(1)).

However, couldn't the same effect be achieved tax free by issuing stock for preferred dividend arrearages in a recapitalization, i.e., a tax-free reorganization under Section 368(a)(1)(E)?

Consensus of a Tax Institute panel: Possibly not—if the preferred dividends are in arrears for only a year or two. However, if the arrearage covers, say, five or six years, the issuance of stock therefor probably would constitute a bona fide tax-free recapitalization.

Expenses Incurred in Payment of Unusual Stock Dividends

A developing line of court authorities tends to sustain this position.

Corporation X has declared cash dividends for a substantial

Sec. 305 number of years. Due to a shortage of cash funds, which was expected to exist only for one year, the corporation decided to issue a stock dividend payable in unissued capital stock. The question of the deductibility of the transfer agent's fees and other similar expenses incurred in connection with the payment of the unusual stock dividend was raised with the Internal Revenue Service.

Service representatives informally advise that although ordinarily expenses incurred by a corporation in issuing capital stock are deemed capital in nature and are therefore nondeductible, in this case, due to the unusual nature of the stock dividends, it was felt that the expenses would be deductible.

Expenses incurred in listing the stock on the stock exchange are capital in nature, and therefore nondeductible.

Tax-Free Discharge of Preferred Stock Arrearages?

Whether Step 3 herein (the continuing preference dividend for the second preceding year) can remain nontaxable is the principal question raised by this item.

Section 305 of the 1954 Code was intended to dispel much of the confusion which had previously attended the tax status of stock dividends. To a large extent, that objective has been accomplished. As is usually the case, however, the statutory cure has raised a number of troublesome "after-effects" which are presently coming to light.

Browsing through current tax literature discloses that a number of writers have discussed at some length certain problems arising in connection with distributions which may, at the election of a shareholder, be received in stock or property. This type of distribution constitutes the first exception to the general rule of nontaxability applicable to stock dividends. Section 305(b)(1), which makes stock dividends taxable to the extent that they are "made in discharge of preference dividends" for the current or preceding taxable year of the corporation, has, in contrast, received only summary treatment. One writer has noted that the latter exception "seems to have given rise to no particular problems of interpretation or application."

A question may be presented, however, as to whether the express language of Section 305(b)(1) of the Code may not permit the discharge of preference dividends in such a manner that its penalty effect may be avoided. Consider the following:

1. Corporation X is five years in arrears on its 5 per cent cumulative preferred stock dividends.
2. A stock dividend of common stock is declared which is expressly stated by corporate resolution to be made in discharge of dividends owing for the three earlier years.
3. Each year thereafter, Corporation X declares a preference dividend for the second preceding year.
4. If desired, preferred stock could be utilized rather than common stock, apparently with no change in the tax effect.

Whether or not the above plan would be successful depends initially on the ability of a corporation to designate particular years' arrearages which are discharged by the stock dividend. The language used in Section 305(b)(1) would appear to indicate that a corporate choice exists as to which arrearages are being discharged. The regulations offer nothing which will clarify the point. In other parts of the Code, notably Section 316 defining the term "dividend," there is express language precluding a choice by the distributor as to the year's income which is being distributed. Also, it may be noted that the regulations permit the same end to be accomplished through a recapitalization unless the *sole purpose* of the transaction is to effect the payment of dividends for the current and immediately preceding taxable years (Regulations, Section 1.368-2(e)(5).). Furthermore, additional common stock resulting from the recapitalization route would not constitute Section 306 stock, as it would be if received as a tax-free stock dividend.

Against the above points operating in favor of the device, certain negative factors must be considered. First, the present rule is a liberalization of Section 305(c)(1)(A) of H.R. 8300 (March 9, 1954) which provided that all stock dividends in discharge of current dividends or arrearages were to be taxable. Under the 1939 Code, this type of transaction could have been taxable. (*Koshland* v. *Helvering*, 298 U.S. 441.) Also, the general rule that exempting provisions are to be construed against the taxpayer where ambiguity exists would point toward taxability.

Sec. 306

Section 306 Stock May Include Common Stock

Where common stock is received in exchange for previously outstanding "Section 306 preferred," the common will inherit the "stigma."

"Section 306" stock which is tainted with the likelihood that its sale will result in ordinary income to its owner, rather than capital gain, may include common stock. So observed JAMES E. GELBERT, CPA, Lybrand, Ross Bros. & Montgomery, Pittsburgh. Mr. Gelbert noted that Section 306 is commonly deemed applicable only to preferred stock. However, he pointed out that under some circumstances (e.g., where common stock of another company is received in exchange for previously outstanding Section 306 preferred stock), the common shares will inherit the "stigma." (Reg. Sec. 1.306-3(d)).

Section 306 Is Not So Onerous In Certain Corporate Mergers

This thoughtful summary throws much light on a somewhat abstruse subject.

From WILLIAM K. CARSON: Section 306 is one of those little-understood but greatly feared sections of the 1954 I.R.C. Careful examination of the Code, regulations and some recent revenue rulings show that not all dispositions of Section 306 stock are to be feared as resulting in adverse tax consequences to a taxpayer, particularly where the Section 306 stock was received in connection with a merger.

Congress in enacting Section 306 attempted to plug a loophole in the tax laws known as the "preferred stock bail-out." Under the bail-out scheme, a corporation would issue a stock dividend of preferred stock to the holders of its common stock. The dividend stock would then be sold and, as held in *Chamberlin* v. *Comm'r*, 207 F.2d 462 (1953), this series of transactions gave rise to only a capital gains tax to the shareholders at the time of sale.

Section 306 eliminates the tax advantages of the "stock bail-out" by designating certain types of nontaxable stock dividends as

"Section 306 stock" and taxing as ordinary income the amount received by the shareholder on the sale or redemption of such tainted stock. Preferred stock received tax free in exchange for common stock in a merger or other type of corporate reorganization is also included in the term "Section 306 stock," but only to the extent that the effect of the transaction was substantially the same as the receipt of a stock dividend.

It is the erroneous impression of many that all preferred stock received as a dividend or in a reorganization falls within the purview of Section 306. However, the Code provides many circumstances in which gain on disposition of preferred stock will not be treated as ordinary income.

Section 306(b)(4) provides that the treatment normally applied to Section 306 stock will not be applied if it can be established to the satisfaction of the Commissioner that the issuance of the Section 306 stock and its disposition were "not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax." The regulations offer very little help in ascertaining the interpretation which the Commissioner will place on this section.

The Senate Finance Committee Report (S. Rep. No. 1622, 83rd Cong., 2nd Sess. 243,244 (1954)) states that subparagraph (b)(4) "is intended to apply to the case of dividends and isolated dispositions of Section 306 stock by minority shareholders who do not in the aggregate have control of the distributing corporation. In such a case it would seem to your committee to be inappropriate to impute to such shareholders an intention to remove corporate earnings at the tax rates applicable only to capital gains."

Three recent Revenue Rulings have somewhat clarified the position of the Internal Revenue Service on Section 306 as applied to preferred stock received along with common stock in a merger or similar type tax-free reorganization.

Revenue Ruling 56-116, I.R.B. 1956-13, deals with a statutory merger of two corporations where shares of common and preferred stock in the surviving corporation were to be received in exchange for the surrender of common stock in the corporation absorbed. The common stock of both corporations was widely held. After the merger the total per cent of common stock of the surviving corporation held by the shareholders of the absorbed corporation was less than 20 per cent. The management of the surviving corporation had no intention of redeeming

Sec. 306 any of the preferred stock which would be issued in the merger, except as required under a sinking fund agreement.

In Revenue Ruling 57-103, I.R.B. 1957-11, a publicly held corporation acquired all the assets of a closely held corporation which had only common stock outstanding, in return for preferred and common stock constituting 5 per cent of the acquiring corporation's outstanding stock.

The third revenue ruling pertinent to this question (R.R. 57-212, I.R.B. 1957-21), deals with the tax-free merger of two large publicly owned corporations. The preferred stock issued was subject to sinking fund provisions under which 3 per cent of the outstanding preferred shares are to be redeemed or purchased in the open market annually.

The Internal Revenue Service in each of the above three rulings held that the preferred stock issued was Section 306 stock. Thus, it would seem that wherever preferred and common stocks are issued in a merger, the Service believes the effect of the transaction is the same as the receipt of a stock dividend. However, the Service also held that the exception provided by Section 306 (b)(4), applied to the proceeds of the disposition of the preferred stock issued in the mergers, unless such dispositions were in anticipation of a redemption after the issuance of the stock. The operation of the sinking fund in some of the plans did not make the exception inapplicable.

In the first two rulings, no indication is given of the treatment to be accorded to stock redeemed by the company, or sold by the shareholder in anticipation of a redemption. But in the third ruling, it was held that the redemption through the sinking fund was not involved in a tax-avoidance plan and did not give rise to ordinary income.

Thus, the issuance and later disposition of the preferred stock was held in all three cases not to be in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax within the meaning of Section 306(b)(4).

The following conclusions can be drawn from the abovementioned revenue rulings:

1. Where a shareholder receives both preferred and common stock in a merger, the preferred is Section 306 stock.

2. If, after the merger, less than 20 per cent of the stock of the continuing company would be owned by those receiving common and preferred stock, the Service would probably rule that Section 306 treatment would not apply on a sale of the pre-

ferred unless the sale was in anticipation of redemption. It seems quite important that one of the parties to the merger be widely and publicly held and preferably a listed company. *Sec. 306*

3. Retirement of preferred stock through a sinking fund providing for annual retirement of 3 per cent of the preferred stock issue will not of itself cause the proceeds to be taxed as ordinary income.

Since the problem is still in the "twilight zone" even after these revenue rulings, it is advisable in moot cases to discuss the matter with the Service. However, the Service will probably not advise on redemptions or sales in anticipation thereof until it knows the terms of the redemption.

Effect of Distributions in Kind On Earnings and Profits

Sec. 312

A conflict between Congressional intent and initial Treasury interpretation has been resolved in the final regulations.

Whether Congress did or did not jettison the pre-1954 Code *Hirshon-Godley* principle has been a question. The principle relates to the effect on corporate earnings or profits and the taxability to stockholders of distributions of property appreciated in value. It was established in *Comm'r* v. *Fannie Hirshon Trust,* 213 F.2d 523, and *Comm'r* v. *Estate of Ida S. Godley,* 213 F.2d 529. Here is an example:

Factors	
Earnings and profits	\$75
Fair market value of distributed property	\$50
Adjusted basis of distributed property	\$35

The amount taxable to the recipient is \$50—the entire fair market value of the property, since the earnings and profits of \$75 were sufficient to absorb a charge for the entire adjusted basis of the property; i.e., \$35.

Even if the fair market value of the property were \$1,000 or \$10,000, the entire value would be taxable as a dividend to the recipient under this rule so long as the earnings and profits exceeded the adjusted basis. However, remove \$75 of earnings or profits and *none* of the distribution would be taxable as a divi-

Sec. 312 dend! Or increase the basis to $150 and only *one-half* of the distribution would be so taxable. Thus:

Earnings and profits	$ 75	Zero	$ 75
Fair market value of distributed property	1,000	1,000	1,000
Adjusted basis of distributed property	35	35	150
Amount taxable to the recipient as a dividend	1,000	Zero (presumably)	500

The 1954 Code's provisions are very specific and precise with reference to the effect of distributions in kind on earnings and profits (Sec. 312(a)). But the relationship between earnings and profits and the amount of taxable dividend apparently is not yet completely spelled out in the Code itself. However, Congress obviously intended to change the *Hirshon-Godley* rule as indicated by the following extract from the Finance Committee's report:

"... This rule is applicable whether the property has appreciated or depreciated in value. Thus, if property with a value of $100 is distributed but if there are only $75 of earnings and profits from which the distribution can be made, the taxable amount will be only $75. If the property cost the corporation only $50, however, its earnings and profits will be reduced only by $50, and $25 will remain in its earnings and profits account."

Here is an example of the application of the new rule:

Factors	
Earnings and profits	$75
Fair market value of distributed property	$50
Adjusted basis of distributed property	$35

The amount taxable to the recipient as a dividend is $50, the entire fair market value of the property, since it is less than the earnings and profits of $75.

However, if the fair market value of the property were $1,000 or $10,000, the amount taxable to the recipient as a dividend *would be only $75,* the amount of earnings and profits! Indeed, eliminate the $75 of earnings and profits and *none* of the distribution would be taxable as a dividend. Or increase the basis to $150 and the taxable portion of the distribution would still be limited to the amount of earnings and profits. Thus:

Earnings and profits	$ 75	Zero	$ 75	*Sec. 312*
Fair market value of distributed property	1,000	1,000	1,000	
Adjusted basis of distributed property	35	35	150	
Amount of taxable dividend	75	Zero	75	

It is apparent that a change was intended by the new Code and despite some earlier leaning to the contrary, the Treasury has adopted it in the final regulations issued under Subchapter C (Sec. 1.312-1). What's more, the 1939 Code has since been amended retroactively to eliminate the *Hirshon-Godley* rule.

Determining When A Distribution Is Made

Sec. 316

The increasing use of "fast" depreciation or amortization is spawning more tax-free dividends—hence the importance of this item.

The list of corporations making capital distributions rather than dividend distributions is growing considerably, the standout industry group being the public utilities. Public utilities are declaring dividends by reference to book profits, which generally are much greater than tax profits for the reason that accelerated depreciation and emergency facility amortization being claimed for tax purposes are not being booked.

There appears to be feeling among some distributing corporations that a dividend distribution is out of earnings and profits of the year in which the dividend is *declared,* regardless of the fact that the payment date occurs in the subsequent year. A word of caution here is appropriate. Regardless of the accounting propriety of accruing dividends and charging surplus in the year in which declared, a distribution is a matter of statutory concept and is one of those instances where the statute diverges from generally accepted accounting principles.

The Supreme Court has ruled that the statute creates a conclusive presumption that "distributions" during a year are from earnings and profits determined as of the close of that year without reduction for the amount of the distributions and without regard to the date on which the distributions were made during the year. (*Edwards* v. *Douglas,* 269 U.S. 204; also see *Harder* v. *Irwin,* 285 F. 402.) The Tax Court discussed the subject in

Sec. 316 *J. Barstow Smull,* 17 T.C. 1393. This rule prevails even though the directors of a corporation express or intend a different source for the distribution (*Leland* v. *Comm'r,* 50 F.2d 523; *Lawrence* v. *Comm'r,* 143 F.2d 456).

In view of the foregoing, there remains only the question of determining precisely *when* a distribution is considered as having been *made,* the possible dates being either the declaration date, the record date or the date on which the distributions are payable and paid. This point has also been considered by the Supreme Court (*Mason* v. *Routzahn,* 275 U.S. 175, Cum. Bull. 1928-VII-1, p. 195) which held that ". . . the date of payment, not the date of the declaration of the dividend is the date of distribution. . . ." This rule was reiterated and discussed in the land-mark case, *American Light & Traction Company* (CA 7, 156 F.2d 398), in which the Court established a single rule for taxation of dividends to recipients which is that regardless of a taxpayer's accounting method, a dividend is taxable income for the year in which received. Thus, a distribution is made at the time it is paid even though indeed for accounting purposes it was properly accrued and charged to surplus in a different year.

The cases of *Comm'r* v. *Goldwyn* (175 F.2d 64) and *Roe, et al* (192 F.2d 398) are misleading. True, in these cases the date of declaration was held to be the distribution date; however, the thread of the fabric in both cases was that the dividends were available to the stockholders upon demand at that date. Therefore, the constructive receipt principle was definitely in the foreground, and under this circumstance, the decisions were not necessarily inconsistent with *Mason* v. *Routzahn* (*supra*).

Clincher—the Internal Revenue Service is one hundred per cent behind the position that a distribution occurs at the time it is paid.

Sec. 331 Installment Liquidation of Corporation

A step-by-step illustration of the proper tax treatment of liquidating distributions with authorities therefor.

From TROY G. THURSTON: There is considerable misunderstanding of the tax treatment to the stockholder in a corporate liquidation where it is necessary or advisable to make installment distributions to the shareholders instead of a single distribution. The applicable income tax procedure for the shareholders may be illustrated by the following example of a shareholder receiving four equal distributions of $75 each on a share of stock having a basis of $125, in a complete liquidation of a corporation:

Basis	$125.00
Distribution No. 1, December, 1957— applied against basis	75.00
Remaining basis	50.00
Distribution No. 2, July, 1958	75.00
Recovery in excess of basis, constituting capital gains	25.00
Distribution No. 3, December, 1958	75.00
Distribution No. 4, January, 1959	75.00

Thus the capital gain of $175 would be accountable in three calendar years as follows:

Year 1957	None
Year 1958	$100.00
Year 1959	75.00

The statutory warrant for this procedure is found in Section 301 of the Internal Revenue Code considered in connection with Section 302. Section 302(a) provides that "If a corporation redeems its stock . . . and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock." The relevant portion of Section 301 is subsection 301(c)(2) which provides—"That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock." Further clarification is found in Section 346 defining partial liquidation. The governing authority was more clearly shown in Section 115(d) of the 1939 Code.

For additional references, see O.D. 343, Cum. Bull. 1919, p. 80; O.D. 461, Cum. Bull. June, 1920, p. 85; *Ludorff* et al., 40 B.T.A. 32; *Smith* v. *Westover*, D.C. Calif., affirmed 173 F.2d 90; and *Arthur Letts, Jr.*, 30 B.T.A. 800.

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

LIQUIDATIONS

Sec. 332 **Complete Liquidations Of Subsidiaries**

Summary of Code provisions.

The tax-free liquidation of "wholly owned" (80 per cent) subsidiary companies (1939 Code Sec. 112(b)(6)) was reinstated in the 1954 Code in practically its old form and wording. Moreover, a new provision was added: no gain or loss is to be recognized to a subsidiary transferring property in satisfaction of a debt owed to the parent company (Sec. 332). This new provision is a definite and desirable overruling of *Houston Natural Gas Corp.*, 9 T.C. 570, affirmed 173 F.2d 461, and I.T. 4109, 1952, Cum. Bull. 138.

Preferred Stock Liquidation Not Tax Free

Receipt of assets, on account of preferred stock only, does not constitute tax-free liquidation.

The courts and the Internal Revenue Service have long held that a liquidation of a subsidiary corporation does not qualify as a tax-free liquidation under Section 332 of the 1954 Code (Section 112(b)(6) of the 1939 Code) unless the parent corporation receives something in exchange for its stock. Thus, where the parent corporation is likewise a creditor of the subsidiary, the subsidiary's assets first go to satisfy its debt to the parent and any remaining assets are then considered to be passed on to the parent in exchange for its stock. Unless the subsidiary's debt to the parent is fully satisfied and there are some assets remaining to go to the parent, the rule has been that the parent does not receive anything in exchange for its stock and the liquidation accordingly does not qualify as a tax-free liquidation under Section 332. Gain or loss is recognized to the parent corporation. *Sec. 332*

The Tax Court in *Spaulding Bakeries, Inc.*, 27 T.C., 684 (N.A.), (affirmed CA-2, 252 F.2d 693) recently considered the application of the above rule to a situation where the parent corporation owned all the common and preferred stock of a subsidiary corporation. On liquidation the assets of the subsidiary were not sufficient to redeem fully the preferred stock and still leave some assets to be applied in redemption of the common stock. The Tax Court pointed out that the assets of the subsidiary were not distributed in cancellation of *all* the stock of the subsidiary. The Court accordingly held that the liquidation did not fall within Section 112(b)(6) of the 1939 Code, and consequently that the parent's loss with respect to its worthless common stock was a recognizable loss under Section 23(g)(4), now Section 165(g)(3) of the 1954 Code.

The Court's decision in the *Spaulding* case was advantageous to that particular taxpayer. The decision, however, may well be disadvantageous to other taxpayers. Assume that the subsidiary corporation has a substantial net operating loss. If the liquidation qualifies as a Section 332 liquidation, the parent corporation under Section 381(a)(1) of the 1954 Code may carry forward such loss against its own income. Moreover, the twenty per cent rule provided in Section 382(b) will not be applicable in computing the amount of the carryover. If the liquidation does not qualify as a Section 332 liquidation, however, the parent probably will not be able to avail itself of the subsidiary's net operating losses.

Loss Carryover of Foreign Subsidiary Not Available to Parent

Refutes a view expressed in the 1957 Edition, page 76, "Can Section 381 Loss Carryover Apply to Foreign Corporations?"

It has been learned that the Internal Revenue Service in Washington takes the position that, although a foreign subsidiary may be liquidated under Section 332 so that Section 381 will apply, no net operating loss carryover from the foreign subsidiary to the U. S. parent will be allowable because any losses

Sec. 332 incurred by such a foreign subsidiary will normally consist of deductions attributable to gross income from sources outside the U. S. and therefore would not be "allowable deductions." Since no "net operating loss" will exist in the foreign subsidiary, no carryover is available to the parent.

Sec. 334 Acquisition and Liquidation of Subsidiary—Basis of Property

Description of "Kimbell-Diamond" Code provision.

The 1954 Code basis provisions governing liquidations contain a highly desirable change.

Where the liquidation of a subsidiary occurs within two years after the purchase of its stock by the parent, the consideration paid for the stock by the parent becomes the basis of such assets to the parent (Sec. 334). Thus, the principle in *Kimbell-Diamond Milling Co.*, 14 T.C. 74, affirmed 187 F.2d 718, is expressed in the statute.

Stepped-up bases now appear to be not only possible, but controllable; so do stepped-down bases.

When Must "Kimbell-Diamond" Liquidations Be Completed?

The final regulations do not appear to refute the opinion herein reached.

HARRY JANIN, CPA, Eisner & Lubin, New York City, has submitted this observation:

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 "dignity" 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 only a plan of liquidation need be adopted, then 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 liquidations 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.

Points to Consider Where Purchase Of Corporation Followed by Liquidation

Careful attention must be given to the new general rule set forth in Regulations 1:334-1(c)(3) as amended where stock is acquired through a series of purchases.

Section 334(b)(2) may give a stepped-up basis where Corporation A buys 80 per cent of the stock of Corporation B within a period of 12 months and a plan of liquidation is adopted by Corporation B within two years thereafter. Assume that the cost of the stock is $100,000 and the aggregate tax basis of B's assets applicable to the stock purchased is $75,000. If the provisions of Section 334(b)(2) are fulfilled, those assets will have a basis of $100,000 in A's hands after the liquidation has taken place.

Now assume that the facts are the same except that the cost of the stock is $50,000. The basis of the B assets would then be $50,000 in A's hands, unless the transaction fails to qualify under

Sec. 334 Section 334(b)(2). In that case A would take over B's $75,000 basis.

It is apparent that qualification under Section 334(b)(2) will be beneficial under some circumstances and not under others. A misunderstanding as to timing may produce the undesired result especially where the stock is acquired in a series of purchases.

As a general rule under Regulations Section 1.334-1(c)(3) in the case of a series of purchases of stock, the two year period for liquidation begins on the day following the end of a period of twelve months or less during which at least 80 per cent of the stock was acquired. This may be illustrated by the following examples in which it is assumed that each purchase in the series by A is for 20% of the stock of B:

I		II	
Acquisition Date	Two Year Period Begins	Acquisition Date	Two Year Period Begins
Apr 1, 1955		Nov 1, 1954	
Jun 30, 1955		Jun 30, 1955	
Sep 30, 1955		Sep 30, 1955	
Dec 31, 1955	Jan 1, 1956	Dec 31, 1955	
Jun 1, 1956		Jun 1, 1956	Jun 2, 1956

If in example II above the last acquisition date were August 31, 1956 rather than June 1, 1956, Section 334(b)(2) would not be applicable since 80% of the stock of B would not have been acquired by A within a period of 12 months or less.

Since this general rule was established on June 23, 1958 by amendment to previously existing regulations, an exception has been provided to cover transactions already consummated and to provide a transition period for transactions under consideration at the time the amendment was made. Thus, where a plan of liquidation is adopted on or before December 24, 1958, the above rule does not apply unless the parent corporation so elects in a statement attached to its return for the taxable year within which such plan is adopted. If the return has already been filed, a statement electing the general rule must be filed with the District Director by September 22, 1958. If an election is not made, the two year period begins on the day following the date of the last purchase in the series if at least 80 per cent of the stock is purchased during the preceding twelve months. Assuming A purchases stock of B as set forth below, the two year period begins April 2, 1956.

Stock Acquired	Acquisition Date
20%	Apr 1, 1955
20%	Jun 30, 1955
20%	Sep 30, 1955
20%	Dec 31, 1955
20%	Apr 1, 1956

Stepped-Up Basis on Liquidation of Sub-Subsidiary

It is understood that since this item first appeared the Service has "softened" its position, in that it would permit the stepped-up basis on C's assets so long as C is liquidated into B before B is liquidated into A.

Corporation A buys all the stock of Corporation B for cash of, say, $1,000,000. 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 $1,000,000. (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?

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 $1,000,000 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 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 B—or to A. And the step-up in basis which is attributable to C's assets presumably is lost to A under the Service's interpretation.

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 simply requires the selling stockholders to liquidate the subsidiary of the company whose stock is to be purchased *before* the purchase takes place.

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

Stepped-Up Asset Basis After Tax-Free Exchange?

The Treasury has unofficially indicated that it does not intend to follow the Firestone *decision under the 1954 Code. Therefore, a stepped-up basis, if obtainable at all, would require litigation.*

Generally, the recognition and basis provisions of the Internal Revenue Code are synchronized. Thus, a tax-free exchange is almost always accompanied by a carryover of basis to the transferee of the property or securities received. Conversely, a taxable transaction results in a basis of cost.

There may be one exception to this over-all symmetry. Where a corporation exchanges its voting *treasury stock* (which was previously acquired for cash) for all the stock of another corporation, the exchange is tax free as a reorganization, under Section 368 (a)(1)(B). However, the basis of the acquired company's stock in the hands of the acquiring company is not determined by reference to its basis to the acquired company's stockholders. (*The Firestone Tire & Rubber Company,* 2 T.C. 827(A)). Rather, it appears that the basis is "cost"—i.e., it would be determined by reference to the cost of the treasury shares exchanged.

If still valid, this apparent exception to the general consistency of the recognition and basis provisions would permit one company to acquire all the stock of another company without tax to the stockholders of the other company. Yet the acquiring company might obtain a stepped-up basis for the acquired company's assets under Section 334(b)(2) by liquidating the newly acquired subsidiary within two years.

Section 334(b)(2) permits a stepped-up basis where the acquired company's stock was "purchased." A purchase is defined as any acquisition of stock . . . "if the basis of the stock in the hands of the acquiring company is not determined by reference to its basis in the hands of previous owner." Since the *Firestone* case provides for basis of cost to any shares acquired by the exchange of treasury shares (as contrasted with "issuing previously unissued shares") such an acquisition, even though tax free to the transferor's stockholders, may constitute a "purchase" under Section 334(b)(2) and the stepped-up asset basis would then obtain upon liquidation. *Sec. 334*

IRS Position Regarding Liquidation or Reorganization

Reincorporation may destroy step-up in basis of assets.

It has been learned that the Internal Revenue Service will adhere to its position that liquidation of a subsidiary followed by reincorporation of any substantial part of the assets in liquidation will be ignored as a liquidation and treated instead as a reorganization. In any event, the provisions of Section 334(b)(2) will be deemed inapplicable. This view seems to be concurred in by the Chief Counsel's office. In a particular case the Service reached this conclusion despite the fact that the reincorporation was required because of creditor action and was not the result of a voluntary plan of the acquiring company.

Avoiding Corporate Tax by Distributing Receivables *Sec. 336*

(From American Institute's 1955 Annual Meeting)

A possible oversight in the drafting of the 1954 Code results in the following apparent loophole:

A corporation reporting on the cash basis would pay income tax on accounts receivable only as they are collected. However, if the corporation distributes ordinary accounts receivable to its stockholders in liquidation, the result will be that corporate income tax will be avoided on such uncollected income.

Section 336 provides that, except for installment obligations, no gain or loss is recognized to the corporation on the distribution of property in partial or complete liquidation.

Sec. 337 Avoiding Double Tax on Liquidating Sale by Corporation

*Description of anti-*Court Holding Company *Code provision. Sec. 19 of the 1958 Technical Amendments Act has now slightly broadened this provision by according relief from double tax to less-than-20% minority stockholders in a subsidiary, 80% or more owned by a parent corporation.*

A definitive rule is provided in the 1954 Code to eliminate the uncertainties that formerly arose in the *Comm'r* v. *Court Holding Company,* 324 U.S. 331; *U.S.* v. *Cumberland Public Service Co.,* 338 U.S. 451; area.

The statute (Sec. 337) provides that gain or loss will not be recognized to a corporation upon the sale of its assets (except for certain inventory and installment gains) while it is in the process of liquidation. Thus, the "double tax"—the tax on the corporation and on the stockholder—on certain sales of corporate assets followed by liquidation is alleviated.

Like the *Kimbell-Diamond Milling* provision heretofore discussed, the *Court Holding-Cumberland* section *also* can work both ways. It may be beneficial to taxpayers in its nonrecognition of gains, or it may be detrimental in its nonrecognition of losses.

"Court Holding" Principle Is Not Entirely Dead

Double capital gains tax may still obtain in partial liquidations.

Comm'r v. *Court Holding Company,* 324 U.S. 331, held that a "double tax"—a tax both on the corporation and on the stockholders—obtained in certain sales of corporate assets followed by 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 gains) if fully forthwith liquidated.

However, the pertinent observation has been made that *Court Holding* 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 12-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 certain property 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 to 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 may 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 corporation is specifically empowered by the shareholders to act as their agent 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.

Avoidance of State Income Tax On Sale of Corporate Assets

The failure to consider state income taxes in planning a transaction often results in unanticipated liabilities therefor. For example, the acceleration of income to utilize an otherwise lapsing operating loss carryover, may produce taxable income in states that do not recognize loss carryovers—e.g. Pennsylvania.

Some states have adopted the provisions of Internal Revenue

Sec. 337 Code Section 337 which eliminate tax to the corporation on the sale of its assets followed by its complete liquidation within a twelve-month period.

In such states that have not gone along with this 1954 change in the Code, it would appear more economical state-taxwise to liquidate the corporation *before* the sale in order to avoid state tax as well as federal tax at the corporation level. As long as the property is sold within the twelve-month period it would appear that any attribution of gain to the corporation would still be obviated by Section 337.

When Is a Real-Estate Sale a "Sale" for Section 337 Purposes?

Care should be exercised in "timing" real estate transfers lest Section 337 benefits be lost.

To eliminate the taxable gain at the corporate level on the sale of certain assets of a corporation coincident with its liquidation, Code Section 337 requires that a "plan of dissolution" be adopted *prior* to the sale date. However, the directors of a corporation contemplating such a disposition of assets might be reluctant to adopt a formal plan of dissolution until they are certain that pending negotiations will result in a definite sale. Under the circumstances, any agreement for the sale of real estate which is executed prior to adoption of the formal plan of dissolution certainly would have to be drafted carefully lest there be an immediate passage of title to the purchaser, thereby constituting a "sale."

Regulations under Section 337 appear to adopt rather general rules for determining when a sale of real estate occurs for income tax purposes. However, it is understood that the Internal Revenue Service has given more specific consideration to the problem of whether a corporation had effected a sale of real estate by entering into a standard form of sales agreement which provided, among other things, that title would be transferred at settlement date (ninety days subsequently) and that the transferor would retain possession and the burdens and benefits of ownership until such settlement date. *Sec. 337*

The Service in resolving the issue indicated that the local real property law would be controlling and that such elements as the following would be of extreme value in the determination of whether the execution of a prior sales agreement did not constitute a sale:

1. Written opinion by the corporation's legal counsel that under local law title did not pass, and/or
2. Inclusion in the sales agreement of some additional conditions preceding passage of title, such as certification by counsel for the purchaser.

Thus, it would appear that the corporation could defer its adoption of a liquidation plan until immediately prior to the settlement date and still obtain the benefits of Section 337.

Dangers in 1954 Collapsible Corporation Provisions

Sec. 341

A concise history of the practices that led to the 1954 collapsible corporation provision. Sec. 20 of the 1958 Technical Amendments Act now provides generally that where the unrealized appreciation in "ordinary income assets" does not exceed 15% of the corporation's net worth, the collapsible corporation provisions do not apply (1) to the sale of its stock, or (2) to its complete liquidation. Moreover, such a corporation may now qualify for relief under the one-month liquidation provision (Sec. 333) and the nonrecognition-of-gain-or-loss-in-connection-with-complete-liquidationprovision (Sec. 337).

Thanks to JOSEPH J. SCHWARTZ, attorney of New York City, for this pithy summary of dangers lurking in the new provisions relating to "collapsible corporations."

The collapsible problem arises when a corporation owns assets

Sec. 341 which have appreciated in value. Stockholders have usually attempted to avoid taxation both to the corporation and to themselves upon the sale of the assets by the corporation and the ultimate distribution of the proceeds, by such devices as selling or exchanging their stock in the corporation, liquidating the corporation, or distributing the appreciated assets as dividends in kind without liquidation.

The collapsible situation arose most prominently in the past in the motion picture and construction industries and with regard to "windfall" profits taken out of corporations established under Section 608 of the FHA. However, according to Mr. Schwartz, many liquidating corporations in *other* industries may find themselves "tagged" as collapsible in the future if they distribute appreciated assets.

The government met the collapsible problem rather unsuccessfully prior to 1950 by arguing *Gregory* (that the corporate entity should be disregarded), Sections 41 and 45 (allocating the corporate income to the stockholders), and Section 22(a) (charging the stockholders with compensation). Congress enacted Section 117(m) in 1950 to deal with the problem. However, that section was worded in such a way as to introduce questions of interpretation and of the subjective intent of the stockholders. No one could tell for sure what Section 117(m) meant and the courts have yet to clarify the situation. But stockholders who do not come under the specific exceptions of Section 117(m) are likely to find that to escape its consequences, if asserted by the Treasury, they had better produce strong evidence of lack of intent.

Whatever the potency of old Section 117(m), the corresponding provision of the 1954 Code, Section 341, is even more of a threat. The new Code provision tightens the restrictions on collapsible corporations by adding to "tainted assets" certain assets used in a trade or business, and by establishing a presumption against the stockholders. It is difficult to say how much weight the courts will give to such a presumption, but it certainly will help the government win the close cases. In addition, the statutory exceptions are retained and tightened in the 1954 provision, e.g., the percentage of ownership of stock necessary to bring a stockholder under the provision is reduced from 10 per cent to 5 per cent.

Mr. Schwartz's conclusions: Practically *any* corporation making liquidating distributions in kind within three years before realizing substantial profits may be vulnerable as a collapsible corporation, with its stockholders subject to tax on ordinary income rather than on capital gains. *Sec. 341*

Leasehold-Owning Corporation Collapsible Under the New Code?

As the author had hoped, the Treasury considers amortization of leaseholds to be deductible as a business expense rather than as depreciation.

HARRY JANIN, CPA, Eisner & Lubin, New York City, raises this problem: Is a corporation which purchases a leasehold collapsible? The "tainted" assets include property subject to the allowance for depreciation provided in Section 167. But is amortization of the cost of a purchased leasehold "depreciation allowed" under Section 167?

Regulations under the 1939 Code permitted a deduction of an aliquot part of the cost of a leasehold under Rentals, a subdivision of business expenses. The same section of the regulations provided that if the lessee's improvements had a useful life which was less than the term of the lease, the lessee would be permitted an annual deduction with respect to such improvements in the form of an allowance for depreciation. But if the useful life of the improvements exceeded the remaining term of the lease, the deduction would be based upon the remaining term and would be in lieu of depreciation. Under the 1939 Code, the allowance for amortization of the cost of a leasehold was contained in the regulations, Section 39.23(a)-10, whereas the allowance for depreciation was contained in Section 39.23(1)-1.

The depreciation regulations under the 1954 Code, Section 1-167(a)-4, follow the foregoing pattern and, as under the 1939 Code, do not contain any specific provision allowing amortization of the cost of a purchased leasehold. However, final regulations under Section 162, trade or business expenses, Section 1.162-11, do cover the deduction for amortization of the cost of a purchased leasehold.

Sec. 341

Does Installment Sale Eliminate Collapsible Corporation Provisions?

The answer is still in doubt. However, this may constitute a respectable defense against the invoking of the collapsible corporation provisions in a back-to-the-wall type of case.

A collapsible corporation is a corporation formed or availed of principally for constructing, producing, or purchasing property with the view of making it possible for the shareholders to sell the stock of the corporation or to liquidate the corporation before the corporation has realized a substantial part of the income to be derived from the property. Gain from sale of stock or from liquidation of a collapsible corporation is taxed to the shareholder as ordinary income rather than as capital gain as in the usual situation.

Collapsible corporation provisions do not apply, however, if the shareholder's gain is realized after the expiration of three years from the date of completion of production or purchase of the property to which gain is attributable. This provision has given rise to speculation over the status of gain from sale of stock reported on the installment basis where installments are received after the expiration of the three-year period. It has been suggested that gain attributable to installment payments received after the three-year period would be realized at that time and would not be subject to collapsible corporation rules.

The three-year provision has not been the subject of reported litigation on this point. The Code does not appear to cover the matter specifically, although the Service held in a 1951 letter to a taxpayer that use of the installment method would not free a sale from collapsible corporation rules. The question would appear to turn on interpretation of the word "realized." If it is held that gain is realized in full at the time of sale, although recognized for taxation as installments are received, the Service's position would be correct. If it is held that gain is realized only as installments are collected, which is the underlying theory of reporting income on the installment basis, gain from installments received after the three-year period would escape collapsible corporation provisions.

It is interesting to note that for equity capital purposes under the World War II Excess Profits Tax Act, the courts held that unreported profits on installment sales were not "realized."

Under all the circumstances, it does not seem safe to rely on an installment sale of stock to avoid collapsible corporation provisions, although a venturesome taxpayer would seem to have some chance of sustaining his position. *Sec. 341*

Dearth of Rulings Involving Collapsible Corporations

A hope that the Service will modify its "hands-off" policy and give taxpayers some assurance in this troubled area.

While it can be readily understood that the Service might be reluctant to issue a ruling in any instance where later events might change the importance of the facts involved, one correspondent feels that this policy may be carried to an economically unsound extreme. The situation is exemplified by reference to the policy ostensibly in existence to deny any ruling directly concerned with Section 341, the collapsible corporation provision.

The Service apparently has been unable to reach a satisfactory conclusion regarding the possible application of that provision to certain long-term real-estate developments—there being a difference of opinion as to whether the provision can be applied to a project which was begun before the enactment of the statute, as for example, a shopping section which might be disposed of after many years but before final completion of the center.

Proper, legitimate and economically necessary business deals may be held up or abandoned if the Service does not undertake to consider and rule upon the possible Section 341 application. While the Service understandably attempts to ferret out ordinary income disguised as capital gain, any extreme efforts in that direction can discourage an entire transaction and result in no tax at all. In many of these instances it is to be hoped that a reasonable determination can be made currently so that ordinary business negotiations can proceed with the seller having some idea of where he stands taxwise.

Relationship Between Section 341 and Section 302

From T. T. Shaw: A question recently arose with respect to

Sec. 341 the applicability of Section 341, 1954 IRC (collapsible corporation provisions) and Section 302(b)(2), 1954 IRC (substantially disproportionate redemption of stock). A hiatus apparently exists in the Internal Revenue Code with respect to the controlling applicability of either section when a substantially disproportionate redemption of stock occurs. The position of the Service is that Section 341 would take precedence and Section 302 (b)(2) would be inapplicable.

Collapsible Corporation Not Qualified Under Section 337

Sec. 20 of the 1958 Technical Amendments Act now enables an otherwise "collapsible corporation" to qualify for Section 337 treatment if generally the unrealized appreciation in "ordinary income assets" does not exceed 15% of the corporation's net worth, etc.

From T. T. SHAW, Arthur Young & Company, New York City: Stockholders of a "collapsible corporation" may avoid the unfavorable tax consequences inherent in such status by waiting three years following completion of the construction, manufacture or purchase of such property. The corporation's status, however, as a "collapsible corporation" remains unchanged. Therefore, the corporation (as a collapsible corporation) could never avail itself of the benefits of Section 337 to avoid the double tax upon liquidation of the corporation. The corporation could liquidate, however, in the normal course and the stockholders could subsequently sell the property and avoid the double tax.

Sec. 346 Partial Liquidations—Qualifications Ambiguous

This problem may be academic, since if the requirements of subsection (b) are satisfied, it ought to be easy to satisfy those in subsection (a)(2).

The Internal Revenue Service has recently had occasion to consider informally the relationship between Section 346(b) and Section 346(a)(2).

That is, if a distribution attributable to the termination or contraction of a business meets the requirements of paragraphs (b)(1) and (2), must it also meet the separate requirements of subsection (a)(2) that the distribution "is not essentially equivalent to a dividend," is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year? *Sec. 346*

It has been learned that the Service takes the position that Section 346(b) simply describes one instance of a distribution which is not essentially equivalent to a dividend. Therefore, even though the requirements of Section 346(b) are met, the Service will require that the distribution meet the *other* requirements, those of Section 346(a)(2), before it will treat the distribution as one in partial liquidation.

The Service maintains that Section 346(a) provides the general rules relating to partial liquidations, which must be met in *every* case, and that Section 346(b) is not an exception to the general rules but, instead, is a description of *one type* of distribution which will qualify within the general rules. Although they agree that a literal reading of Section 346 might produce a different result, they seem to feel that their interpretation is the more reasonable, at least from the standpoint of Service ruling policy. Consequently, before there can be a partial liquidation, the Service will require that there be a redemption of at least part of the stock of a corporation, and that such redemption must occur within the specified time limit.

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

CORPORATE ORGANIZATIONS AND REORGANIZATIONS

Corporate Organizations *Sec. 351*

Summary of 1954 Code provisions.

Tax-free transfers of property to controlled corporations in exchange for stock or securities (1939 Code Sec. 112(b)(5)) were modified in the 1954 Code as follows:

Sec. 351 The old requirement that the stock and securities interest of each transferor be "substantially in proportion to his interest in the property prior to the exchange" was eliminated. What a blessing! The old requirement had reached a stage of "confusion worse confounded" because of a conflict in the courts as to what it meant. Now it's out. However, its elimination is not intended to permit one stockholder (e.g., a father) to make a gift in disguise to another (his son) via the tax-free incorporation route.

Services rendered the corporation are not deemed to be "property" for which stock or securities may be issued tax free in this type of transfer. Therefore, he who receives stock or securities for services rendered will have taxable income.

The new section also permits a corporate transferor of property to distribute any stock or securities it receives to its shareholders, without breaking the "immediately after the exchange" control requirement.

Issuance of Debentures Upon Organization of a Corporation

It is understood that, in a clear-cut case of nontax avoidance, the Service will *rule on the nontaxability of Section 351 exchanges involving securities.*

If debentures (as well as stock) are issued for property by a newly organized corporation, there could be doubt as to whether the exchange is tax free.

Section 351 provides that a transfer of property to a corporation by one or more persons solely in exchange for stock *or securities* is nontaxable.

However, any securities received by a stockholder upon incorporation admittedly constitute a *potential* means of cashing in on future corporate earnings without incurring a dividends tax on the proceeds. On similar reasoning, the Supreme Court taxed as a dividend bonds issued to the stockholders in a purported tax-free recapitalization (*Bazley* v. *Comm'r,* 331 U.S. 737).

Because of the ostensible conflict, the Internal Revenue Service has been reluctant to rule on the nontaxability of Section 351 exchanges where securities are involved.

Comment: A distinction *can* be made between the *Bazley* situation and the usual Section 351 exchange. In the former, there existed a large undistributed surplus at the date of the issuance of bonds; in the latter, no surplus exists. *Sec. 351*

In any event, a bona fide all-cash organization cannot give rise to gain or loss even if securities are issued.

Preferred Stock Should Be Issued Upon Incorporation

Suggestions (1) and (2) here are being quite closely followed in practice.

Are you organizing a corporation?

(1) This may be your last chance to create "cold" preferred stock. (For the benefit of those who have not followed the recent development of the English language, "hot" preferred stock is stock which is subject to the horrible penalties prescribed in Section 306.)

(2) Rather than try for an "ultra-thin" incorporation, provide capital by having the stockholders guarantee loans from banks or other third parties.

(3) Perhaps a predecessor partnership has losses from which no carryover benefit will result. Can you make it a taxable transaction by giving boot to the transferors and get a stepped-up basis for property in the hands of the transferee corporation?

One Way for Young Partners To Buy Out a Business

The retention of preferred stock with terminal voting powers by elders furnishes a probation period.

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.

William H. Westphal, CPA, of A. M. Pullen & Company, Greensboro, N.C., reports a plan dealing with this problem, which arose incident to the acquisition of a thriving business by two young businessmen:

Sec. 351 The enterprise has been operated as a partnership by a man and his son, both of whom wish to withdraw from the business.

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 method 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 1954 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 4 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. Sec. 351

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?

FUNDS PROVIDED OUT OF EARNINGS

Obviously 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 will 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. In the alternative, 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.

The practicability of this solution seems sound.

Step-Up in Corporate Property Basis by Paying Capital Gains Tax

A method of obtaining future "ordinary" deductions.

Revenue Ruling 56-303, 1956-27 I.R.B., page 12, involves the tax effects of a transaction whereby a corporation transferred lots to a wholly owned subsidiary which it created in a transaction qualifying as nontaxable under Section 351 of the 1954 Code. In addition, however, to receiving stock of the sub, it also took short-term notes of the subsidiary. The notes were treated as "boot" under Section 351(b) and capital gain was recognized in the amount of the fair value of the short-term notes.

Since the subsidiary's basis was held to be the same as that of the transferor-parent, *increased* by the amount of gain recognized to the parent, the corporate group succeeded in raising its basis to

Sec. 351 fair market value by paying a capital gains tax, without any very real economic significance to the transaction. As a matter of fact, in the case in the ruling, the parent apparently succeeded completely in converting ordinary income to capital gain, since to the extent that the taxable gain was measured by market value, the subsidiary would realize little gain or loss when it subsequently sold the lots!

This principle apparently can be applied, for example, to fully depreciated assets, so as to acquire a new depreciation base by the payment of a capital gains tax. Service officials are understood to be unhappy over this type of transaction, but they seem to agree that it can be done, subject only to a very close scrutiny as to the adequacy of the taxpayer's business purpose.

Sec. 354 Corporate Reorganizations

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.

"COMBINING" REORGANIZATIONS

Under the 1939 Code (Sec. 112(a)(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 "whether or not such acquiring corporation had control immediately before the acquisition" (Sec. 368(a)(1)(B)).

Under the 1939 Code (Sec. 112(g)(1)(C)) a corporation also 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 a 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 (1939 Code Sec. 112(g)(1)(D)) are still tax free. 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 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 pro rata distribution of the transferee corporation's stock is not required (Sec. 368(a)(1)(D)).

Spin-offs also were liberalized by the 1954 Code. As under the 1939 Code Sec. 112(b)(11) no "exchange" is required. However, under the 1954 Code, a spin-off need not even qualify as a reorganization, since it now 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 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 such business must have been conducted at least five years before the distribution.

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.*, *Sec. 354* obligations, may be received tax free by stockholders or security holders but only to the extent 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).

Sec. 355 Partial Liquidation May Avoid Spin-Off Hazards

An alternative procedure is often safer.

Dallas Blair-Smith, CPA, Lybrand, Ross Bros. & Montgomery, New York City, notes that there are cases where tax benefits of the 1954 Code which are not obtainable under one section may be obtainable under another, if the form of the transaction, but not the purpose or result, is varied.

In Revenue Ruling 55-103 (I.R.B. 1955-9, 7), the Service ruled against the taxpayer, apparently being intent upon imposing tax on dividends rather than on capital gains. The facts were these:

Corporation X conducted a paper manufacturing business and also owned 80 per cent of Corporation Y (in the lumber business), which stock had greatly appreciated in value. X had a large earned surplus. The stockholders of X had negotiated the sale of their stock at a price which did not include the value of the Y stock; therefore they wished to spin off the Y stock tax free before selling the X stock.

The Service considered the negotiations for the sale of the X stock to be sufficient evidence that the spin-off distribution was to be used principally as a device for the distribution of earnings and profits of the distributing corporation. Therefore it ruled that the transaction did not meet the requirements of Section 355(a)(1)(B), and that Section 355 was not applicable. The ruling holds that any distribution of the Y stock would be taxed as a dividend to individual stockholders under Section 301.

On the other hand, *capital gain* treatment is available if there is a partial liquidation under Section 346, in which case Section 301 does not apply. Certainly there is a "corporate contraction" here, as the X stockholders desire to get rid of one business and retain the other. The Senate report (p. 262) adopts the "corporate contraction" theory to distinguish a distribution in partial liquidation from a dividend.

It would therefore seem that Corporation X could liquidate Y in a tax-free liquidation, after which X would be conducting two businesses which are assumed to have been conducted throughout the preceding five-year period by X and Y, respectively (see Sec. 346(b)). Now if the assets of the paper manufacturing business of X are distributed to its stockholders, in redemption of a pro rata part of their stock, and are sold by them, there ought to be a partial liquidation resulting in capital gain to the stockholders.

Of course, the stockholders would have to negotiate the sale of the assets rather than the stock, but this might be beneficial to the purchaser also, as he could, within limits, demand favorable allocation of the purchase price to the various assets acquired by him.

If X corporation had previously undertaken negotiations for the sale of its paper manufacturing assets, there would be a question under *Court Holding Company* whether that corporation is not also taxable on any gain represented by the excess of the sales price over the basis of the assets to the corporation. However, most of such gain would usually be treated as capital gain, and two capital gain taxes, one on the corporation and the other on the stockholders, might be better than a dividend tax on the stockholders.

Spinning Off Segment of "Vertical" Organization

Regulations Section 1.355-1(d), adopts the "integration" test in this type of situation. Thus, the production and fabrication of steel in this case probably would constitute inseparable components of a single trade or business.

A corporation engaged in brewing malt beverages and manufacturing pretzels is clearly engaged in two separate trades or businesses. Thus, one could be "spun off" tax free under Section 355.

However, it is not so clear that a segment of a vertical organization would constitute a separate trade or business. For example, a company produces its own steel and fabricates it into usable shapes. Is the production of steel a "separate trade or business" or is it an inseparable component of an integrated business? If it is the former, it can be spun off tax free. If it is the latter, it can't.

Obviously, such a determination is difficult and restraint must be exercised. Otherwise, says one Service official, "It might be argued that a pair of pliers constitutes two separate trades or businesses!"

When Is Operation of Real Estate A Separate Trade?

A pertinent discussion of real estate spin-offs.

From Leslie Mills: 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 conducted throughout the five-year period preceding its distribution.

The regulations (Section 1.355-1(c)(2)) take the point of 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 rule *for ruling purposes only* 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 will 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 would 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.

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

Also it seems that this rule 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.

Liquidating Distribution In Lieu of Ordinary Dividend

Qualification under Section 355 can convert certain "regular" distributions to shareholders into capital gains income. However, the obtaining of an advance ruling would appear prudent.

Corporation X in early 1956 realized $750,000 cash from the termination and liquidation of one of its several businesses. The terminated business had been operated for over five years. Corporation X ordinarily pays a common dividend which requires cash of $200,000 per year. For 1956 and 1957, it declares no regular dividend—instead it distributes $200,000 in *partial liquidation* in each year, the funds being obtained from the liquidation proceeds of the terminated business. The remaining proceeds of liquidation of $350,000 are retained by the company for reinvestment in the business.

Cashwise, the stockholder is in the same position as if the regu-

Sec. 355 lar dividend had been paid. But taxwise he probably is much better off. The status of the payments as proceeds of redemption—a capital gains type of income—would not seem to be impugned by the fact that the regular dividend is "passed." An otherwise valid distribution in partial liquidation of a terminated business under Section 346 is not contingent upon the corporation having first declared and paid its regular dividend. And the fact that part of the proceeds of the terminated business is retained by the corporation would not seem to damage the *bona fides* of the partial liquidation under that section so long as such distributions as *are* made, are made within two taxable years.

Sec. 368 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 was made by T. T. SHAW, CPA, Arthur Young & Company, New York City.

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 face amount of the securities received exceeds the face amount of the securities surrendered, the 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. This is different from the 1939 Code.

If this transaction were a recapitalization of one company, rather than a reorganization involving two companies, the result would be the same—stockholder A would be taxed on $1,000 boot. Under the new Code it is no longer possible to receive bonds or debentures for stock in a recapitalization without tax consequences. This too is different from prior law.

An interesting provision, new in the 1954 Code, 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.

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 232) 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.

Treatment for tax purposes as "boot" cannot be avoided by giving the boot an appearance of something different. For example, if some of the assets of a corporation are transferred to a new corporation for all of the stock of the new corporation, and the old corporation then liquidates (distributing new stock, cash and other assets not transferred), the regulations, Section 1.331-1(c), threaten to tax the "boot" as a dividend under Section 301 even though this type of transaction undoubtedly is not even a "D" type reorganization under the 1954 Code.

Sec. 368

"B" Type Reorganizations

Description of provision.

The 1954 Code reduced ownership requirements for filing consolidated returns from 95 to 80 per cent (Sec. 1504(a)). Ownership requirements necessary to qualify for the tax-free liquidation of a subsidiary remain at 80 per cent (Sec. 332(b)(1)).

Suppose that A corporation had purchased 51 per cent of all of the outstanding stock of B corporation for cash a number of years ago. Now A, who is short of cash, would like to utilize B's current operating losses to offset its profits by way of a consolidated return. Or possibly A desires to operate B as one of its divisions. Can A acquire additional shares of B's stock to meet the 80 per cent control requirements by issuance of its own voting stock without any income tax liability to B's stockholders on the exchange?

The answer to this question depends upon whether or not the "entire" controlling interest must be acquired under a single plan of reorganization. There was considerable doubt on this point under prior law (see *Comm'r* v. *Dana,* 103 F.2d 359, and *Pulfer* v. *Comm'r,* 128 F.2d 742). The 1954 Code (Sec. 368(a)(1)(B)), however, makes it clear that the issuance of stock for stock can qualify as a reorganization even though control was not acquired in a single plan of reorganization. The Code accomplishes this end by providing that in a "B" type reorganization it is the control *after* the transaction that counts.

Thus, under the 1954 Code, A corporation can issue its voting stock for the remaining stock of B corporation (or enough of B's stock to bring its ownership up to 80 per cent). No cash is required for the "purchase price," and no income tax would be payable by the "selling" shareholders of B corporation.

Indeed, A's intention to liquidate B immediately after acquiring control would not seem to impugn the nontaxability of the first step since the two steps (acquisition and liquidation), if taken together, would constitute a reorganization under Section 368(a)(1)(C).

Increasing Common Stock Interest of Corporate Officers

Reshuffling may be accomplished as tax-free recapitalization.

T. T. SHAW, CPA, Arthur Young & Company, New York City, points out that 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: *Sec. 368*

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, the new preferred stock may be "Section 306 stock." Under the Code, Section 306 stock, on later sale or redemption, with certain exceptions, gives rise to ordinary income. One exception is a later sale by the estate of a deceased stockholder, as stock passing at death loses its character as Section 306 stock. Hence, classification as Section 306 stock would not be injurious if the stock were retained until the death of the stockholder.

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

Recapitalization Followed By Sale of Part of Stock

This is supported by a private revenue ruling.

T. T. SHAW, CPA, Arthur Young & Company, New York City, forwarded this solution to a potentially perilous tax problem:

The M Corporation is the successful operator of a television station. All of 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

Sec. 368 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 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.

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 neither Class A nor Class B stock was Section 306 stock.

Substitution of Debt for Equity in Recapitalizations

(From Tax Executives Institute's 1955 Annual Conference)

Recapitalizations involving a substitution of indebtedness for equity occasionally were held to be tax free under prior law.

However, there is grave doubt that the same result can *ever* obtain under the 1954 Code's provisions—particularly since exchanging stockholders are taxable up to the fair market value of any increase in the principal amount of securities received over the principal amount of securities surrendered (Sec. 356(d)(2)(B)).

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

CARRYOVERS OF TAX ATTRIBUTES IN CORPORATE ACQUISITIONS

Carryovers in Certain Corporate Acquisitions

Sec. 381

Description of Code provision.

The principles of a long line of court decisions (*Helvering* v. *Metropolitan Edison Co.* 306 U.S., 522, *Comm'r* v. *Sansome* 60 F.2d 931, cert. den. 287 U.S. 667, *Stanton Brewery, Inc.* v. *Comm'r* 176 F.2d 573) holding that certain tax attributes carry over from one corporation to another in tax-free transfers, particularly of the merger type, are given effect and indeed expanded in the 1954 Code. Some eighteen tax attributes now carry over from corporate transferors to corporate transferees in tax-free liquidations or reorganizations except in divisive reorganizations and partial liquidations (Sec. 381).

Thus, net operating loss, capital loss, and dividend carryovers "carry over" to the successor corporation; unamortized bond discount and premiums carry over, and so do accumulated earnings and profits, elections as to methods of accounting, and other similar items.

Don't Lose a Subsidiary's Operating Loss Carryover

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

This admonition comes from GORDON J. NICHOLSON, CPA, Arthur Andersen & Co., Chicago.

Parent corporations with subsidiaries which have a continuing record of operating deficits and which are not likely to have earn-

Sec. 381 ings 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 parents' 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 carry-forward limitation.

Timing of the liquidation or merger is important because the transaction must be consummated not later than 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.

Carryover of Subsidiary's Loss To Parent in All-Cash Liquidation

(From the American Institute's 1955 Annual Meeting.)

A subsidiary company has an operating loss carryover. Suppose the subsidiary's assets are converted into cash and the subsidiary is then liquidated into the parent company. Is the subsidiary's loss carryover available to the parent under Section 381, which relates to carryovers in certain tax-free corporate acquisitions? *Sec. 381*

Consensus: Yes. Cash qualifies as "property." Therefore, the fact that the liquidation is an "all-cash" liquidation does not disqualify it as tax free under Section 332. Therefore, the subsidiary's loss carryover is available to the parent under Section 381(a)(1).

Loss Carryover of Insolvent Subsidiary

(From Tax Executives Institute's 1956 Annual Meeting.)

If a subsidiary is liquidated under Section 332, its net operating loss may be carried over to the parent, unless Section 334(b)(2) applies. In corporate mergers, however, the full amount of the carryover cannot be availed of by the acquiring corporation unless 20 per cent or more of its stock is owned after the merger by stockholders of the loss corporation. Section 382(b) imposes this limitation.

What happens upon liquidation of an *insolvent* subsidiary?

The Treasury takes the position that Section 332 does not apply, in which case the liquidation would be taxable, and loss to the parent would be recognized under Code Section 165. The nature of the loss would hinge upon the per cent of the subsidiary's shares owned by the parent. Since 332 does not apply, the parent cannot use any operating loss carryovers of the subsidiary.

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 transactions 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.

Sec. 381 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—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)).

b. 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 *a* above.

c. Immediate liquidation of acquired company—The acquired company's operating loss carryovers are forfeited. Section 381 carryovers are not applicable to taxable acquisitions. 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 for stock in *non*taxable transactions:

a. Continuation of acquired company—The acquired company's loss carryovers are fully available against its own future profits. (Same as *2a* above, except that the requirement that the acquired company may not change the nature of its trade or business is absent in this case.)

b. Consolidated return—same as *2b* above.

c. 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 (Sections 381 and 382(b)). *Sec. 381*

About the Libson Shops Case

The Service announced on August 25, 1958 that it will not invoke the Libson *case to deny a net operating loss carryover in a merger or other transaction described in Section 381(a) (TIR-89).*

In the *Libson Shops* case a surviving corporation in a merger tried to carry forward to the taxable year the losses of the merging companies which had been sustained in years prior to the merger. The businesses of the former merging companies continued to sustain losses after the merger.

Service people who attended a recent Tax Institute conference feel that the rationale of this case was that the taxpayer was attempting to push too far the doctrine of the survival of corporate existence in a merger. In the cases in which the doctrine has been applied the merging corporation had some right which would have been lost if such right were not permitted to continue to exist in the surviving corporation. Here, however, the surviving corporation was attempting to gain a right which it would not have had if the merger had not taken place. In other words, the Service's position in this regard is similar to the consolidated return regulations which provide that a loss sustained by a company prior to consolidation may only be used to offset income of that same company in consolidation.

Lifo Pitfall for Acquiring Corporations

This type of problem is usually recognized after *a merger has been consummated; whereas it probably should be considered during merger negotiations. Not yet confirmed by regulations.*

Code Section 381(c)(5) permits the carryover of inventory methods from a transferor corporation to an acquiring corporation in a tax-free reorganization. However, if a transferor cor-

Sec. 381 poration uses the Lifo method of inventory valuation but the acquiring corporation does not, and if the items in the inventories of each are substantially identical and will be co-mingled, the acquiring corporation must elect Lifo for its own inventories in order to retain the Lifo basis of the transferor's inventories.

If the acquiring corporation does not elect Lifo, *its* inventory method will prevail, with the result that the acquiring corporation will, for the year of acquisition, be required to report as taxable income the accumulated Lifo "reserve" of the transferor. The resultant tax cost thus could be substantial.

So rules the Treasury informally and it is believed that regulations (when issued) will not change this result.

Sec. 382 Special Limitation on Net Operating Loss Carryovers

Description of 1954 Code provision to discourage "trafficking" in loss corporations.

A much-publicized section of the 1954 Code precludes the use of an operating loss carryover by successor owners of a corporation in the *Alprosa Watch Corp.* (11 T.C. 240) type of transaction. Thus, the purchase of a loss corporation's controlling stock followed by a change in its type of business will tend to negate any loss carryover it may have.

This provision is designed to and probably will discourage some of the "trafficking" in loss corporations (Sec. 382).

Loss Corporation Provision May Be Defective

Postponing a change in the trade or business may preserve the loss carryover. However, caution is in order as regulations under Code Section 382 have not yet been issued or proposed.

Lawrence E. Cohn, CPA, Washington, D.C., lectured on Section 382 which is designed to discourage "trafficking" in loss corporations. He pointed out that the new provision may fail in its purpose since it does not prohibit the use of an "acquired" loss carryover by the purchasing corporation when any change in the trade or business is postponed for an "appropriate" waiting period.

However, Mr. Cohn thought that the broader Section 269, aimed at acquisitions made to evade or avoid income tax, may apply in such situations to deny any undeserved tax benefits. *Sec. 382*

Inequity in Rules Governing Loss Carryovers in Mergers?

This type of inequity should be corrected in a 1959 "technical adjustments" act.

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. 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. Under the formula in the special rule, P is treated as owning .75 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

Sec. 382 interest in S presumably would receive .25 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 x 100) of the loss carryover of S is available to P.

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.

Is it possible that relief for this situation is provided in Section 382(b)(3)? There we read that the special rule is not applicable "if the transferor corporation and the acquiring corporation are owned substantially by the same persons in the same proportion." This test should be satisfied if the transferor had been wholly owned by the acquiring corporation. Perhaps 90 per cent ownership would be enough. Then what about 80 per cent? Or 75 per cent?

Insurance of Loss Carryover by Relinquishment of Part Thereof

Watch that last paragraph! This may require litigation to settle.

Per RICHARD T. FARRAND, CPA, Lybrand, Ross Bros. & Montgomery, Philadelphia:

Code Section 381(c)(1) provides for the transfer of existing net operating loss carryovers to an acquiring corporation in certain types of reorganizations. If the shareholders (or former shareholders) of the "loss" corporation own at least 20 per cent of the "profit" corporation immediately following the reorganization, the carryovers may be available in full since the limitation imposed by Section 382(b) is not effective.

For example, assume that Corporation A, having outstanding capital stock with a fair market value of $400,000, issues additional voting stock worth $100,000 to the shareholders of Corporation B (a "loss" corporation) in exchange for all the outstanding stock of that company. The existing loss carryover in the amount of, say, $100,000 would be available to Corporation A upon liquidation of Corporation B. Sec. 382

However, if Corporation B's net assets have an adjusted basis of, say, $250,000, the entire loss carryover may be disallowed Corporation A under the provisions of Section 269. The purpose of acquisition would be particularly suspect since it would appear that a substantially disproportionate amount ($100,000 of stock) was exchanged for $250,000 of net assets plus $52,000 tax benefits to be realized from the carryovers (Sec. 269(c)).

According to the Senate Finance Committee reports on Section 382, the danger of the application of Section 269 is avoided if the limitations imposed by the former section are effective. Thus, had Corporation A's stock issued in exchange for the stock of Corporation B been limited to $93,826, 5 per cent of the carryover would have been sacrificed, since the former shareholders of Corporation B would have only a 19 per cent interest after the exchange. Thus, the relinquishing of 5 per cent of the loss would seem to constitute "insurance" for retaining the balance of the loss.

However, it is understood that the Treasury may not agree with the plain wording of the committee report that Section 269 is not applicable in a case where the limitations which are imposed by Section 382(b) obtain.

Revenue Ruling on Net Operating Loss Carryovers

Conceivably a "raided" corporation could lose its loss carryover without its management being aware of it.

Section 382(a) of the 1954 Code provides in part, that if one or more of the ten largest unrelated stockholders in a corporation own, at the end of the corporation's taxable year, a percentage of the total fair market value of the outstanding stock (other than nonvoting preferred stock) as a result of purchase, which is at least 50 percentage points more than such person or persons owned at the beginning of either such taxable year or the prior taxable year, and if the corporation has not continued to carry on a trade or business substantially the same as that conducted before the change in percentage ownership of the stock, the net operating loss carryovers shall not be allowed. Roughly, there must be a shift of control (50 per cent of the stock).

Sec. 382 In a ruling (Rev. Rul. 58-9, I.R.B. 1958-2,6) the Service held that where a corporation ceased to do business, and there was the requisite change in stock ownership, its net operating losses could not be carried forward, even though it was reactivated in the same line of business.

The report of the Senate Finance Committee states that the losses may be disallowed if: "the corporation shifts from one type of business to another, discontinues any except a minor portion of its business, changes its location, or otherwise fails to carry on substantially the same trade or business."

It is not unusual for a loss corporation to dispose of a substantial part of its business, or make such other changes as may constitute a discontinuance of a significant portion of its business. And in the case of a corporation with stock that is actively traded in, a "raiding" group may acquire 51 per cent of the stock. Accordingly, it may run afoul of Section 382.

Therefore, in the case of corporations attempting to carry forward losses where substantially the same trade or business may *not* have been carried on, appropriate inquiries should be made as to changes in stock ownership.

Disallowance of Loss Carryovers to Corporations

What a difference a day makes!

Per William K. Carson: Section 382(a) of the 1954 Internal Revenue Code involves a hidden pitfall which probably was not intended since it denies a loss carryover to which the taxpayer is equitably entitled. This section specifically denies to any corporation an operating loss arising during the period between the date of purchase of over 50 per cent of its stock and the end of the taxable year where there has been a change in business of the acquired corporation.

Let us assume the following set of facts:

On January 2, 1956, Company A purchases for cash the entire capital stock of Company B, whose taxable year is the calendar year. The latter was operating two divisions of about equal size and importance, one of which was earning large profits, the other of which was incurring identical losses, resulting in a "break-even." Officials of Company A believed that by incurring substantial expenses for advertising and other expenses they could eliminate the losses of the unprofitable division. They entered into this program and for the year 1956 the unprofitable division's losses were so high that Company B had a substantial net operating loss for the year. In 1957 it was decided that the program had been a mistake and to prevent further losses the operations of the unprofitable division were discontinued with additional losses on disposition of inventory and fixed assets. *Sec. 382*

Certainly, in equity, Company B is entitled to a carryover of its net loss incurred during 1956. And following a liquidation of B into A to which Section 334(b)(1) is applicable, A should be likewise entitled to this carryover.

But the requirements of Section 382(a) are encountered. At the end of 1957 there is a change in stock ownership of more than 50 per cent from that existing at the beginning of 1956 as a result of a purchase and the company has not continued to carry on substantially the same business it conducted before the change in stock ownership. Therefore, the loss carryover from 1956 is to be disallowed.

It is noteworthy that had the stock been purchased just one business day earlier, this result would have been avoided.

DEFERRED COMPENSATION (Subchapter D)

Benefits of Pension and Profit-Sharing Plans

Sec. 401

(From the 1955 New York University Tax Institute.)

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 paid, when presumably lower surtax rates will apply.
2. No tax on earnings of the fund, permitting a faster accumulation.

Sec. 401

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 when employer's securities are distributed.

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 it 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.

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 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 Sec. 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 either 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 on the following pages.

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 co-trustees).

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.

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; and
4. Who are not older than a stated age such as sixty-five years.

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.

Sec. 401 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 until distributed or made available to 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 shall 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 formulae 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.

Caution on Transactions Between Company And Pension or Profit-Sharing Fund

Sec. 30 of the 1958 Technical Amendments Act now permits exempt employees' trusts to invest in limited quantities of the employer's debentures if acquired in "arm's-length" transactions.

Where the pension or profit-sharing fund constructs a building and leases it to the company, it has been suggested that an advance ruling on the transaction between the fund and the company be obtained. Otherwise, if the rent is too low, it may be deemed a prohibited transaction and the fund might lose its exemption.

If the rental is too high, the amount disallowed as rent would be considered a contribution. If the company has already contributed to the maximum limit, the deduction may be lost.

A third point of caution is that the investment should be limited to real estate, and should not include machinery. Furthermore, no borrowed funds should be used to finance the construction.

Investment of Pension or Profit-Sharing Fund In Tax-Exempt Securities

(From the American Institute's 1955 Tax Conference for Business Executives.)

The question has been raised as to whether the income from investments in tax exempts by a pension or profit-sharing fund would carry over its exempt status when distributed to the employees.

The answer by one tax institute lecturer is "no."

Sec. 401 Appreciation in Value of Assets Of Profit-Sharing Trusts

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

Many employees' 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 employees' 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 decide 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 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 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?

JOHN P. HODGKIN, CPA, Price Waterhouse & Co., Philadelphia, calls attention to Revenue Ruling 56-558 (1956-2 C.B. 290), which 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 gains 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 gains 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. Mr. Hodgkin's experience in the past 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 adjust-

Sec. 401 ment 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 gains treatment. This result seems contrary to the logic used in giving capital gains 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.

Sec. 401 et seq.

Continued Pension Deduction After Termination of Plan

An observation that may be helpful some time.

The following observation was furnished by EDWARD L. GATES, CPA, Lybrand, Ross Bros. & Montgomery, Boston.

Taxpayer terminates, in a manner ruled to be nondiscriminatory, its pension plan in the eighth year of the plan, because of a change in its operations from a manufacturing company to an investment company, with a consequent dismissal of substantially all its employees. The pension plan provides for the vesting of pension benefits for all covered employees dismissed during the year of termination. Past service benefits had been funded over a ten-year period. However, because of the termination, payments for the final three years are all made in the year of termination.

Under these circumstances, the deduction for pension fund contributions for the year of termination is limited under Section 404(a)(1)(C) to ten per cent of the total cost of the past service credits plus the normal cost of current service credits. Apparently, however, the balance of the past service payments can nevertheless be deducted over subsequent years, subject to the ten per cent limitation, even though the plan had been terminated, the employees had been separated, and taxpayer's operations have been drastically changed! *Sec. 401 et seq.*

However, where the corporation dissolves, deduction of the unamortized past service cost may never be realized.

(See item entitled "Unamortized Past Pension Services Forfeited on Liquidation," page 125.)

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. PAUL F. ICERMAN, CPA, Icerman, Johnson & Hoffman, Ann Arbor, Michigan, suggests 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 55 years old. He now enters into a 10-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 65 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 to B. All income from the funds in the trust would be payable to the company in annual (or oftener) payments. On the date when B becomes 66, 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, when it would be entitled to deduct the payments annually.

The trust agreement would provide further that in the event

Sec. 401 et seq.

the company defaults on any deferred compensation payment to B under his contract, B may call upon the trustee to reimburse him. The trustee would notify the company that it had notice of default. If the default were not remedied within a suitable period, the trustee would make the payment to B, except, of course, if the default occurred on the last payment.

Mr. Icerman believes 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.

However, in view of the Treasury's long-time insistence upon the imposition of substantial conditions, this new type of plan ought to be cleared with the Treasury to assure safety in its adoption.

Corporate Directors Not Includable In Profit-Sharing Plans

It has been learned that the National Office of the Internal Revenue Service has recently issued a private ruling to the effect that corporate directors serving as members of the executive committee but not otherwise officers of the company are not "employees" and may not be included in a qualified profit-sharing plan. Their inclusion would result in the plan's failure to qualify and loss of the related tax benefits.

The private ruling is consistent with Rev. Rul. 57-246, I.R.B. 1957-23,15, which holds that compensation paid to members of an executive committee of the board of directors when serving as such and not as officers of the corporation is not "wages" subject to federal employment taxes.

Deferred Compensation Plan May Destroy Pension Plan Benefits

(From Tax Executives Institute's 1957 Annual Conference.)

Corporation executives are warned of a dilemma in which they may find themselves when in the same year they are entitled to receive deferred compensation under a deferred compensation plan and also a lump-sum distribution under a pension plan or other exempt trust. *Sec. 401 et seq.*

Some deferred compensation plans put restrictions on the right of the executive to receive his compensation which are so extensive that the executive must in fact become an employee in order to receive the deferred compensation. On the other hand, in order to obtain the special capital gains treatments accorded to lump-sum distributions from an exempt trust by Section 402, it is necessary that the employee be retired from the service of the corporation. In some cases it may be advisable to revise deferred compensation plans in order to be sure this problem does not exist.

Unamortized Past Pension Services Forfeited on Liquidation

(From American Institute's 1955 Annual Meeting.)

Organization expenses which had been properly capitalized at a company's inception are clearly deductible in the last year of its existence.

However, the unamortized payment for past pension services which is ordinarily deductible over a ten-year period *cannot* be deducted in the year of a corporation's liquidation and dissolution.

The law ought to be changed!

Possible Provisions of Stock Option Plan

Sec. 421

A checklist containing both tax and administrative considerations. (Sec. 26 of the 1958 Technical Amendments Act has "tightened up" the qualifications relating to variable price stock options.)

Over 500 companies have granted restricted stock options to executives or key employees over the past few years. By far, most of them have used the 95 per-cent-of-market-value rule rather than the 85 per cent rule. Very few have used the "variable price options" since they seem to be desirable only where very large numbers of employees are involved or stock prices are extremely volatile.

Assuming the rejection of the "variable price" principle, the following tabulation, which is a composite of several actual plans, indicates the points that should be considered for inclusion in a

Sec. 421 stock option plan. Some of the points are required to be covered by the provisions of Section 421. Others are not. Therefore the following symbols are used to designate the source of the various points:

T—Should be condition of option plan to meet tax requirements of Section 421.

ET—Not required to be condition of option plan, but required to be observed by employee to retain Section 421 tax status.

A—Administratively desirable.

I. *To Whom Option Is Granted:*
   (a) Must be employee of granting company or its subsidiary. (T)
   (b) Employee, at time option is granted, must not own directly or constructively (i.e., by attribution) more than 10 per cent of outstanding voting stock. (This limitation is waived if option price is made at least 110 per cent of fair market value on granting date provided option period does not exceed five years.) (T)
   (c) Option must be granted for a reason connected with optionee's employment. (T)

II. *Stock Subject to Option:*
   (a) Must be stock of granting company (although grant may be made to employee of subsidiary). (T)
   (b) The aggregate number of shares to be reserved for the issuance under options should be specified; also whether option stock is to include previously unissued stock or treasury stock or both. (A)
      (1) Provision should be made for increase or decrease in such number of shares after plan becomes effective by reason of subsequent changes in par value, split-up, reclassification, distribution of stock dividends, etc. (A)
      (2) Provision should be made for substitution of successor's stock in the event granting company is succeeded by another company in reorganization, merger, liquidation, etc. (A) However, in such event:
      (i) the price "spread" is to be no greater than that previously existing; i.e., it should be based on the market value of the successor's stock; and
      (ii) no additional benefits are to be granted the employee as the result thereof. (T)

III. *Terms of Exercise:*

(a) Period of Option—Period during which option may be exercised must not exceed ten years from date granted by Board of Directors. (T)

(b) Option Exercisable by Employee Only—Option must be exercised during his lifetime by employee only; he must not dispose of or transfer option except to his estate or heirs by reason of his death. (T)

(c) Employment Conditions Precedent to Exercise—Before option is exercised, employee must have been in continuous employ of company for a specified period after the date option is granted (e.g., say, two years) (A); and at time option is exercised, optionee must be employee of granting corporation or its parent or subsidiary, or must have been employee within three months prior to exercise. (T)

(1) Recognition should be extended to employment by a successor corporation acquiring the stock or properties of the granting corporation. (A)

(2) Three-month employment period waived in case of employee's death; i.e., his estate or heirs may exercise beyond three-month period. (T) However, limitation of, say, six months should be placed upon estate. (A)

(d) Holding Period of Stock—Employee must not dispose of stock acquired under the option until two years have elapsed after option was granted and six months have elapsed after stock was acquired. (ET)

(1) Employee's death will not constitute a "disposition"; i.e., two-year holding period condition waived in case of estate or heirs. (T)

(2) Holding period requirements do not apply to shares held by estate; but the estate having exercised the option must hold shares for six months to receive long-term capital gains treatment. (T)

(3) Nontaxable exchange shall not constitute a "disposition" but new stock must be held for balance of required holding period. (T)

(4) Transfer of stock into joint ownership will not constitute a "disposition," but termination of joint tenancy will be treated as a disposition of the shares to the extent not reacquired by the employee. (T)

Sec. 421 IV. *Option Price:*

Option price to be at least 85 per cent, preferably 95 per cent, of fair market value of stock on date of grant by Board of Directors or by duly authorized committee. (T) and (A)

V. *Administrative Provisions:*

(a) The selection of employees to whom options are to be granted and the number of shares to be optioned to each should be provided for.

(1) Actual names of employees may be specified in plan with number of shares to be optioned to each; or provision can be made for allocating shares to each listed employee in the ratio that his aggregate compensation (with or without bonus) bears to total compensation of members of the group; or

(2) Selection of eligible employees and allocation of shares can be vested in a Special Option Committee with varying degrees of discretion. (Under this arrangement, the options need not be granted forthwith but may be granted by the Committee as it sees fit, in the interest of providing incentive.)

(3) In any event, the aggregate number of shares that can be optioned to any one employee should be restricted—say, no more than 10 per cent of reserved stock.

(b) Company not to lend money to employee directly or indirectly.

(c) Although plan or options do not confer continuing right of employment, company should seek option consideration in form of employee's agreement to render future services. Latter can be accomplished primarily by placing annual limitation on portion exercisable for each year covered by option.

(d) Compliance with Stock Exchange and statutory requirements.

(e) Amendment and administration.

(f) Termination and cancellation.

(g) Reservation of shares.

(h) Effective date.

Joint Ownership of Restricted Stock Option Shares

Confirmed by regulations, Section 1.421-5(a)(3).

WALTER M. BURY, CPA, Ernst & Ernst, Minneapolis, submits this:

The X Company has had a restricted stock option plan for several years. Some employees have taken title to the stock in the joint name of husband and wife and some are planning to do so now because of the dividend exclusion allowed individual taxpayers.

The question is raised whether taking such stock in joint name with one's spouse or transferring it into joint ownership would constitute a "disposition" of the stock. If so, the tax benefits of the restricted stock option will dissolve.

Pursuant to Section 421(d)(4)(B) of the 1954 Code, the acquisition of a share of stock in the name of the employee and another jointly with the right of survivorship—or a subsequent transfer of a share of stock into such joint ownership—shall not be deemed a disposition. A termination of such joint tenancy shall be treated as a "disposition" by the employee occurring at the time such joint tenancy is terminated unless such employee acquires the ownership of such stock at such time.

This provision codifies Regulations 39.130A-5(3)(ii) under the 1939 Code. It should be noted that both the 1954 Code and Regulations 118 qualify joint tenancy as joint ownership *with right of survivorship.* Care should be taken when placing such stock in joint ownership that such ownership is with right of survivorship. Otherwise, anticipated tax benefits may abort.

Liability for Negligence in Failing to Claim Deduction?

It is almost impossible for a corporation to protect itself against this type of contingency.

ROBERT BUCHANAN, CPA, Lybrand, Ross Bros. & Montgomery, San Francisco, submitted this interesting item:

Sec. 421

In a struggle for control of a corporation, the minority group sought to show negligence on the part of the management on grounds of failing to claim a deduction for the corporation for income tax purposes as compensation of officers. It was there alleged that certain officers had *disposed* of their "restricted option" stock in the corporation within six months of acquisition under a restricted stock option, as provided by Section 421(f) of the 1954 Internal Revenue Code. Thus, it was charged that the price "spread" represented compensation.

The officers in question had pledged their "restricted option" shares, together with other shares in the same corporation (not option stock) and other securities, with a stockbroker in the usual trading account. Therefore, the particular shares acquired under the stock option could not be identified because the option and other stock had been transferred by the broker into "street" certificates.

Section 421(d)(4)(A)(iii) provides that the term "disposition" does not include "a mere pledge or hypothecation."

The question then was whether the pledged shares had been "disposed of," where shares of the company were actually bought and sold through the brokerage account, but at all times there was on hand more than the number of shares represented by the "restricted stock option" shares.

Whether or not management is found to be negligent in this particular case, in not claiming a deduction for compensation, the problem does raise the question as to whether corporate management should keep close tabs on the status of stock acquired by employees under restricted options. If the employee does not observe the strict statutory requirements as to holding period, etc., perhaps the corporation *is* entitled to a deduction for compensation!

The Lo Bue Decision

Proposed regulations, Section 1.421-6(b)(2), reflect the Supreme Court doctrine.

A single blast by the Supreme Court (*Comm'r* v. *Lo Bue* 351 U.S. 243) recently nullified the distinction, laboriously built up by various courts over many years, between proprietary and compensatory stock options. Briefly, the lower courts had developed the rule that there was no compensation subject to tax where the essential purpose of the corporate employer, in granting the option, was to instill in selected employees a proprietary interest in its affairs.

The Tax Court and the Third Circuit had duly found the required proprietary interest in the *Lo Bue* case. But the Supreme Court concluded that: (1) a transfer of stock to an employee for less than its value must be either a gift or compensation; (2) the transaction was carried out purely for business reasons and therefore was not a gift; (3) there was no basis in Section 22(a) (1939 Code) for the "proprietary" theory; and (4) the option thus resulted in taxable compensation.

The Supreme Court noted that Treasury practice since 1923 and the 1950 legislation creating "restricted stock options" both used the difference between option price and the market value at time of exercise as the measure of compensation or gains. (As to the 1950 legislation, this may be a reference to the negative rule in Section 130A(a)(1): "No income shall result at the time of the transfer of such share to the individual upon the exercise of the option with respect to such share"—the general standard in Section 130A was the difference at the time of granting the option.) The Court concluded that the taxable gain should be measured as of the time of exercise.

As we further survey the wreckage left by this decision, do we find anything in the option field that remains whole other than the restricted stock options spelled out in Section 421? The decision itself pointed out one possibility—that the option might have a taxable value when granted if it were not hemmed in by restrictions. But these restrictions are usually essential to a grantor desirous of creating new proprietors.

If restrictions against transfer prevent an option from having value, presumably they have a similar effect on stock. There is considerable authority for the position that value in such cases is a question of fact and that the necessary facts are not too hard to establish. Does the termination of the restrictions constitute a taxable event? The answer was negative, according to private rulings which were reported to have been issued before the *Lo Bue* decision. However, it appears that the *Lo Bue* decision has induced the Service to reconsider its position, as evidenced by proposed regulations, Section 1.421-6(b)(2).

ACCOUNTING PERIODS AND METHODS

(Subchapter E)

Sec. 441 Different "Taxable Years" Created by the New Code

A change in corporate domicile does not create a new taxable year.

Richard T. Farrand, CPA, Lybrand, Ross Bros. & Montgomery, Philadelphia, submitted this:

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 Corporation Y in exchange solely for voting stock in Corporation X (a "C" type reorganization) as of September 30, 1955. Assume further that Corporation Y had an operating loss for the period January 1 to September 30, 1955, and taxable income for the period October 1 to December 31, 1955.

Under Code Section 381(b)(1), the taxable year of Corporation Y ended September 30, 1955, despite the fact that it remained in business until the end of the calendar year. It appears that a return should be filed for the short period ended September 30 and the loss for such short "taxable year" carried back to the calendar year 1953.

If, on the other hand, Corporation Y had taxable income for the period January 1 to September 30, 1955, and a loss from October 1 to December 31, it appears, according to Code Section 381, that the loss should be carried back to 1954.

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 to 1953. *Sec. 441*

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 in accordance with Code Section 381(b)(1) does not end on the date of the reorganization. Therefore, if Corporation S changed its state of incorporation, say, from Pennsylvania to Delaware, on September 30, 1955, and is a calendar-year taxpayer, a 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 1953 (of the "Pennsylvania" company) in accordance with the provisions of Code Section 381(b)(3).

Disparity of Accounting Methods For Book and Income Taxes

Sec. 446

Certainly this area will remain confused until Section 481's status is clarified. The Tax Court's decision in Patchen *has recently been reversed by the 5th Circuit (CA 7/23/58). At publication date it was not known whether this reversal would be accepted by the Treasury Department. However, the recent amendment of Section 481 made by the 1958 Technical Amendments Act (which tends to pierce the "iron curtain" referred to herein) will help to clarify the confusion existing in this area.*

Undoubtedly there are numerous taxpayers throughout the country who, as a matter of consistent practice, use a method of accounting for federal income tax purposes which differs from the method used in their books of account. As a result of the recent decision in *Joseph C. Patchen and Aleyne E. Patchen, et al.* v. *Comm'r,* 27 T.C. 592, the propriety of this practice by these taxpayers is indeed in doubt, apparently depending upon its passive acceptance by Internal Revenue Service personnel.

In the *Patchen* case the Court, sustaining the Commissioner, ruled that a partnership which maintained its books on an accrual method and reported its income for federal income tax purposes on the cash method should report its income for federal income tax purposes on the accrual method. The fact that both the cash and accrual methods would reflect clearly the partnership's income and that consistency would appear in favor of the cash

Sec. 446 method was not sufficient to overcome Section 41 of the 1939 Code—the section requiring that a taxpayer report its income in accordance with the method of accounting regularly employed in keeping its books. This same rule is contained in Section 446 of the 1954 Code.

Of course, the taxpayer in *Patchen* had made a change in the book method from cash to accrual, which no doubt precipitated the Commissioner's challenge that for federal income tax purposes a similar change should have been made. Nevertheless, the decision appears to be sufficiently broad to support any similar attack in a situation where, say, different methods of accounting for book and taxes have existed for years.

Effect on Taxpayers—How would such an enforced change affect the taxpayer? The answer, of course, would depend upon the fact situation in each case. One might naturally assume, however, that under normal conditions the change of method would not be enforced in a situation which would result in a refund of taxes to the taxpayer. Beyond the fact situation, however, lies the ever-present and ever-perplexing "iron curtain" provision of Section 481. Also, the effect of Sections 1311-1314, providing for adjustment, under certain circumstances, in otherwise barred years, would no doubt play an important part in the outcome.

Perhaps it is the very existence of these complications which will act as an "umbrella" for taxpayers in a shower of accounting change enforcements.

Unauthorized Accounting Methods Acceptable If Consistently Used

Consistently wrong methods "legalized"!

Regulations recently issued under Section 446, relating to accounting methods, provide that where a taxpayer treats a material item in a consistent manner, although contrary to the manner provided for in the regulations, such consistent treatment may nevertheless be approved for continued use by the Commissioner. In such case, the nonconforming method used by the taxpayer would constitute a method of accounting and he would not be permitted to change such method, even to a conforming method, without the prior approval of the Commissioner.

Deferral of Subscription Income

Sec. 446

Sec. 28 of the 1958 Technical Amendments Act has since added new Code Section 455 permitting accrual-basis publishers to defer subscription income.

It was announced at a recent Tax Institute conference that the Service will not follow the decision of the Court of Appeals for the Tenth Circuit for the *Beacon Publishing Company* case, which held that a publisher on the accrual basis could properly defer income arising from unearned subscriptions.

As an interesting sidelight, it was pointed out that the theory of the Service in part, at least, is that under the general rule that income and expenses must be matched, deferral is improper here since the expense to be matched against the subscription income is the cost of obtaining the subscription rather than the cost of servicing it (sic).

How Bookkeeping Entries May Create Taxable Income

Sec. 451

"Cleaning out" balance sheet accruals or liabilities can 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

Sec. 451 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.

Consistent Accounting Practice And Income Determination

Also, see item entitled "Benefits Under Section 452 Available Despite Repeal," p. 137.

JOHN E. BROWN, CPA, of Brown, Coombs & Councilor, Phoenix, wants accountants to enjoy the refreshing breeze that blows from the decision of the Ninth Circuit, (219 F.2d 862) reversing the Tax Court in *Pacific Grape Products Co.*, 17 T.C. 1097. The Tax Court had held that income from the sale of fungible goods did not accrue at the time of billing to purchasers, despite a consistent accounting practice in the entire canning industry to the contrary. Six dissenting judges of the Tax Court deplored the practice of disapproving consistent accounting systems of long standing, saying:

"Methods of keeping records do not spring in glittering perfection from unchangeable natural law but are devised to aid businessmen in maintaining sometimes intricate accounts. If reasonably adapted to that use they should not be condemned for some abstruse legal reason, but only when they fail to reflect income. There is no persuasive indication that such a condition exists here. On the contrary, a whole industry apparently has adopted the method used by petitioner."

The Circuit Court agreed with the dissenters and in its decision held:

"Not only do we have here a system of accounting which for years has been adopted and carried into effect by substantially all members of a large industry, but the system is one which appeals to us as so much in line with plain common sense that we are at a loss to understand what could have prompted the Commissioner to disapprove of it." *Sec. 451*

The legal phase of this case turned upon the passing of title. However, Mr. Brown hopes that the decision presages a general acceptance by the courts of consistent accounting practices as governing the period in which income is realized and corresponding expenses sustained.

Benefits Under Section 452 Available Despite Repeal

This item has gained stature because the Tax Court again has been overruled, this time by the Fifth Circuit, in the Schuessler *case (230 F.2d 722) involving a reserve for servicing furnaces. The Tenth Circuit's decision in* Beacon Publishing *thus is not alone. Nevertheless the Tax Court refuses to go along (see* Curtis R. Andrews, *23 T.C. 1026 and* National Bread Wrapping Machinery Company, *30 T.C. 52) and the Supreme Court has dodged the issue (see* Automobile Club of Michigan *v.* Comm'r, *353 U.S. 180). Three Supreme Court Justices dissented and agreed with* Beacon *concept! In any event publishers are now "off the hook"—Section 28 of the 1958 Technical Amendments Act permits deferral of subscription income.*

HERMAN STUETZER, JR., CPA, Lybrand, Ross Bros. & Montgomery, Boston, observes that since Congress has scuttled Section 452 of the 1954 Code—the section dealing with prepaid income—more attention will undoubtedly be paid to the decision of the Tenth Circuit Court of Appeals in the case of *Beacon Publishing Company* v. *Comm'r.*

In that case the taxpayer, a newspaper publisher, received in 1943 substantial amounts of money for prepaid subscriptions for newspapers. The prepaid subscriptions ranged in length from thirty days to five years. On its books and on its tax returns the taxpayer treated these advance payments in accordance with good accounting practice by setting them up as deferred credits and taking them into income as they were earned.

The Commissioner disputed this treatment, claiming that the

Sec. 451 advance payments should be taken into income when received, under the "claim-of-right" doctrine.

The Tax Court agreed with the Commissioner. However, on appeal the Tenth Circuit Court of Appeals reversed the Tax Court and sustained the taxpayer's treatment of the sums in question.

The interesting thing about the Circuit Court's opinion is that it contains strong language giving recognition to the generally accepted accounting treatment of prepaid income. The court distinguished the familiar claim-of-right cases, such as *North American Oil Consolidated* v. *Burnett*, 286 U.S. 417, by saying that they merely determined *whether* under certain circumstances a particular item was or was not income. The court said that the claim-of-right doctrine does not determine *when* an item should be taxed as income.

One swallow does not make a summer, but this case can be extremely important. Now that Section 452 (which, incidentally, the Court refers to as Congressional recognition of the correct way of handling deferred income) has been repealed, if other cases follow the lead of this decision, judicial authority of long standing may well be overturned.

On the other hand, if another circuit court in a similar situation takes the opposite view from that of the Tenth Circuit, the basis for an application for a writ of certiorari to the Supreme Court will have been laid. In the meantime, taxpayers may well feel justified in treating prepaid income in their returns in accordance with generally accepted accounting practices in spite of repeal of 452.

This decision is important for another reason. Actually the taxpayer had been reporting the prepaid income for years prior to 1943 in accordance with the method approved by the Commissioner. That is, it had been taking prepaid subscriptions into taxable income when they were received. In 1943, on the advice of its accountants, it changed its treatment of this income for both book and tax purposes by adopting the generally accepted accounting method discussed above. However, it did not request the permission of the Commissioner of Internal Revenue to make this change.

The Commissioner, as a second argument in the case, urged that, since permission had not been requested, the taxpayer's change was invalid. The Court said, however, that this was not a change of accounting method but merely a correction of an error. The Court stated that the taxpayer should have been reporting its prepaid income in accordance with the proper generally accepted accounting principles all the time. Therefore, the permission of the Commissioner of Internal Revenue was not necessary for the change. This portion of the opinion could be particularly important when read in connection with Section 481 of the 1954 Code dealing with changes in accounting methods.

Taxability of Balance Carried In Auto Dealer Reserves

It is to be regretted that these year-of-taxability issues persist. However, the Fifth Circuit has since reversed the Tax Court's decision in Texas Trailercoach, Inc., *thus joining the Fourth Circuit in favoring the taxpayer.*

JOHN E. BROWN, CPA, Brown, Coombs & Councilor, Phoenix, Arizona, believes that the refusal of the Tax Court to follow *Johnson* v. *Comm'r,* 233 F.2d 952 (C.A.-4) has placed automobile dealers in the well-known hollow between the devil and the deep blue sea. This was the case in which the Court of Appeals reversed the Tax Court and held that the balance carried in so-called dealers' reserves is not accruable as income. But the Court in *Albert M. Brodsky,* 27 T.C. No. 23, and *Texas Trailercoach, Inc.,* 27 T.C. No. 64, has, with due deference, disapproved the reversal.

It is common practice for an automobile dealer to sell a car on the installment basis for, say, $4,000, under a contract executed by a finance company—a finance charge of, say, $500 is added and the purchaser pays the $4,500 in equal installments over a period of months. The finance company pays the dealer 95 per cent of the purchase price, or $3,800, retaining $200, which is credited to a dealer's reserve. Upon completion of payment of the installments by the purchaser, the $200 is paid over to the dealer. The issue is whether the $200 is taxable income to the dealer when credited, or when paid. Since these reserves add up to a substantial amount of money, the year in which the income accrues is of vital importance.

The Tax Court agrees that whether the sale of the car and the financing contract be regarded as a single or separate transaction, the result must be the same (*Texas Trailercoach, Inc.,* supra). Both courts agree upon the *right* to receive as the touchstone of accrual. But the Tax Court insists that the dealer has the right to

Sec. 451 receive at the time of the sale, whereas the Court of Appeals points out that until a condition precedent is met, namely, the payment of the purchase price, the dealer has no right to receive the amount credited to the reserve.

Mr. Brown thinks the Fourth Circuit has the better view based both on logic and precedents. But the dealer who now adopts that view is apparently faced with serious problems of litigation, and the dealer who doesn't is faced with the possibility (in case the rule of the Fourth Circuit ultimately prevails) that the Internal Revenue Service may attempt to impose a "double tax" on some of the income.

The position of the Internal Revenue Service, stated in Revenue Ruling 57-2, I.R.B. 1957-1, 12, follows the Tax Court, holding that income accrues to an accrual-basis dealer at the time the reserves are created.

Sales Finance Paper Retained by Originating Dealer

An interesting argument in support of deferring a portion of the time-price differential on installment sales.

An annoying problem frequently arises during tax audits when an IRS agent examines the books of a taxpayer reporting on the accrual basis (installment-sales method not elected) who has retained installment sales contracts which were obtained in the normal course of business. The time-price differential is included in the face amount of the contract. The contracts may vary substantially as to amount, rate charged, and repayment period—a good example would be a new-car dealer selling new cars, used cars, accessories, parts, services, etc. Harold F. Wilber, CPA, Lybrand, Ross Bros. & Montgomery, Los Angeles, offers the following discussion of this problem, primarily from the standpoint of a dealer who is fortunate enough to be able to finance himself (although in practice a mixed situation usually exists, and substantial dispositions of paper to finance companies are necessary).

Suppose an agent has been led into the troubled area by noting on the company's balance sheet an item of deferred interest, unearned finance charges, or some similar caption which the company must use for general statement purposes. It soon develops that the company has deferred the uncollected portion of the time-price differential, and the method used was a straight-line basis over the life of the contract. *Sec. 451*

In accordance with the Service's usual distaste, if not downright displeasure, with the practice of deferring income, the agent advises that it is proposed to change the taxpayer's method of accounting to immediately reflect in income, at the time the paper was taken, the full time-price differential. (The question of whether the Service would make a similar proposal in the event of a large deferred balance existing at the beginning of the taxpayer's first open year is not herein discussed.) When the taxpayer's practitioner suggests that such a proposal would violate generally accepted accounting principles, the agent probably agrees, but counters by referring to the decisions in *Weyand Furniture Co.*, 1951 T.C. Memo Decision, and (*Appeal of*) *Anderson & Co.*, 6 B.T.A. 713 (1927). Very likely, the practitioner will be instructed that a time-price differential is not interest and, in any event, the conditional sales contract makes no mention of interest except that which is provided for delinquent installments. Also, it will probably be emphasized by the agent that the retailer has two sales prices, one for a cash payment and another one for time payments.

The practitioner will no doubt point out that the Service accepts such deferral accounting method when used by finance companies who buy conditional sales contracts from retailers. But the agent will probably observe that it is quite obvious that the finance company is lending money and not selling merchandise. With a good deal of feeling, the practitioner states that if the retailer had set up a wholly owned separate entity and operated the financing phase of his business through the entity, there would be no challenge of the entity's deferral method of accounting. At once, the agent reminds the practitioner that the retailer overlooked the small technicality of setting up the separate entity, and as a consequence, the agent has no alternative but to set up the issue for further hearings. As a last resort, the practitioner, who has national professional connections, tells the agent that other District Directors' offices have examined identical issues in cases in their areas and have not questioned or disturbed the accounting methods used. At this juncture, it is probable that the agent (and his supervisor) can do no more than forward the case to informal conference.

The writer believes it is timely for both practitioners and the Internal Revenue Service to face up to the realities of the interest *versus* time sales price area of disagreement. In this connection it seems most illuminating to refer to Internal Revenue Code Section 163(b)(1) which allows those purchasing personal property under installment contract to compute an interest deduction where the interest is not separately stated in the contract. However, the allowance of a six per cent rate does not seem to fairly recognize the generally higher interest rates actually paid.

It seems proper to extend the spirit of Section 163(b)(1) into the field of taxpayers deriving income from installment sales contracts, and the only essential requirement seems to be the development of rule-of-thumb techniques to determine the interest portion of the time-price differential. Although it is understood that many states consider the entire time-price differential in relation to usury statutes, from a layman's standpoint it is believed correct to view the time-price differential as a combination of service charges and interest (assuming no portion of the time-price differential consists of insurance). It is also understood that some states, in the event of a contract pay-off before maturity, allow the owner of the installment sales contract to retain a minimum service charge before canceling, on a straight-line basis, the remaining time-price differential. The foregoing was mentioned only in reference to theory rather than in an attempt to develop a formula.

The accounting methods employed by some major consumer finance organizations might provide an excellent source for reference as to an equitable formula. In outline form, their policies in allocation of the time-price differential are approximately:

20 per cent immediate credit to the dealer's participation reserve

20 per cent immediate credit to taxable income for servicing charges

60 per cent to unearned finance charges to be reported as earned over the passage of the contract life. A declining-balance theory (rule of 78) is used to compute earnings.

---

100 per cent full time price differential.

No great difficulty should be encountered in tailoring the above formula to each individual case, but care should be taken to make the allocation reasonable in the light of local conditions. *Sec. 451*

Some of the merits of the proposal are:

1. By matching income and expense, a true net income will be reported each year.
2. Taxpayers are not required to pay a tax when the funds from which the tax should be paid are uncollected.
3. Retailers retaining their sales finance paper will be accorded the same reporting rights for interest income as financial institutions are now allowed. Thus, an unintended discrimination against certain classes of taxpayers will be ended.
4. The mechanics of bookkeeping and tax auditing are practical and reasonable.
5. The formation of separate financing entities may be avoided.

Avoiding Double Tax on Installment Method Change

Sec. 453

A valuable suggestion for alleviating the double tax.

As acceleration of corporation tax payments continues, a change to the installment method of reporting income may become more attractive to businesses that follow the practice of reporting installment sales of merchandise on the accrual basis for tax purposes.

The switch can be made without obtaining Treasury permission, and the use of the accrual method may be continued for financial reporting. Tax on the portion of installment sales made during the first year after the change that remains uncollected at year-end is deferred until collection is made. No tax is avoided permanently. The amount deferred varies each year. Indeed there is a possibility of sometimes deferring income into a higher-rate year. However, some postponement of tax will be enjoyed as long as installment sales continue.

To be weighed against this advantage is the "double taxation" of amounts collected after the date of change on sales made in *prior years.*

The relief given by Section 453(c) of the 1954 Code falls considerably short of full removal of the duplicate burden because the tax allowance is a fraction of the tax for the year of sale or year of change (whichever yields the smaller adjustment) limited

Sec. 453 to the ratio of doubly taxed profit to total *gross* income—not *taxable income.* If taxable income in the year of the computation is 10 per cent of gross, the "relief" will likewise be no more than 10 per cent of the duplicate tax. For corporations in the surtax bracket and for unincorporated enterprises, the adjustment will be relatively still smaller. If either of the two years shows a loss, the taxpayer will receive no benefit whatever from this provision. The problem of obtaining the deferral without being subject to the double tax therefore largely remains.

This problem does not exist where there are no uncollected installments at the beginning of the year of change.

It has been suggested that one way to *create* such a condition is by sale of installment accounts to a bank or similar institution just before that date. With no old balance remaining to be collected after adoption of the installment method, presumably no amount will be double-taxed.

Such a sale agreement should be very carefully drafted in order to negate possible interpretation of the transaction as a mere loan with the installment accounts assigned as security. An effective arrangement might be an outright sale without any provisions for recourse to the vendor on defaults. This would entail sale of the accounts at a discount; but under Section 1221(4) such a discount would be an ordinary loss. It should not be necessary for customers to be informed of the sale of their accounts; the vendor can continue to receive their payments as agent for the financial institution without impairing the validity of the transfer.

Installment Sale of Receivables May Be Advantageous

Installment sale may be particularly advantageous to the cash-basis taxpayer. However, caution is in order—proposed regulations under Code Section 453 contribute nothing to the subject.

It sometimes happens that a cash-basis taxpayer will sell his accounts receivable at a time when he can ill afford to receive added taxable income. This type of transaction might come about through, say, the sale of a professional practice.

James Pitt, CPA, Touche, Niven, Bailey & Smart, Minneapolis, Minnesota, notes that the installment method of reporting the sale frequently supplies the perfect solution. The seller delays the collection of his installment contract until it is convenient, taxwise. The buyer has no taxable income from the transaction at any time because he is only recovering his cost. By selling to a family buyer, it may be possible to keep the money in the family while still delaying the tax impact. *Sec. 453*

Mr. Pitt knows of no specific authority for the proposition that the installment method is permissible in reporting bulk sales of accounts receivable. On the other hand, he knows of no authority to the contrary. Section 453(b)(1) of the 1954 Code, as well as prior law, permits the use of the installment method of reporting "a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year) for a price exceeding $1,000."

Could it be said that a sale of uncollected accounts would not be "casual," thereby defeating the application of the above-quoted section? Mr. Pitt thinks not. Webster's cites the following definitions of the word, as well as others: "happening without regularity, occasional, incidental." There seems to be little doubt that this is the meaning intended by Congress. Note the specific exclusion of inventory items which would not normally be sold "without regularity." Unless this practice of selling accounts got to be a habit, it seems that a bulk sale would fit within the definition of casual.

Could it be argued, next, that the sales price was not in excess of $1,000 because some or all of the individual accounts were sold for less than that amount? Again, Mr. Pitt thinks not. The Code reference is to a *casual sale*. Presumably there would be only one sales contract which would cover all of the accounts, as a package. In that event, there would be only one sale. (See *Arkay Drug Co., et al.,* 3 T.C.M. 1194.)

Installment Sale of Stock Preferable To Sale of Assets

(From American Institute's 1955 Annual Meeting.)

Stockholders may defer income tax on profit resulting from the sale of corporate stock by electing to use the installment basis.

Sec. 453 However, if the corporation were to sell its *assets* on the installment basis, the stockholders would become taxable immediately on the receipt of the installment obligations in liquidation of the corporation.

Thus, under such circumstances as these, the sale of stock may be preferable.

Installment Sale Requires A Second Look

The election to use a "relief" provision is not always beneficial.

HENRY J. SEBASTIAN, CPA, of San Antonio, Texas, cautions that tax planning on an installment sale is not finished when the original transaction has been consummated. When tax figuring time comes, it may prove advantageous to report all of the gain in the year of the sale. The following is the situation in his recent experience:

The taxpayer made a casual sale of personalty in July 1955 at a gain of about $25,000. Since, at that time, his income from other sources was expected to be about the same amount for 1955, 1956 and 1957, the transaction was set up for 30 per cent of the contract price to be received in 1955 and 35 per cent each in 1956 and 1957. Before the end of the year, however, the taxpayer accepted a position that would more than double his expected income from other sources in 1956 and 1957. Contemporaneously, he made large deductible expenditures that almost offset all taxable income for 1955 if only the 30 per cent collected on the installment sale were included.

Accordingly, the installment election was not made, but rather all of the gain was reported in 1955 for a tax saving of about $5,000 over the three-year period.

Sec. 461 Election to Allocate Real Estate Taxes

A description of Code Section 461.

T. T. SHAW, CPA, Arthur Young & Company, New York City, points out the "one-shot" benefits of electing to allocate real estate taxes ratably over the period to which they relate under 1954 Code Section 461.

This election may be made without consent for the first taxable year which begins after December 31, 1953 and ends after August 16, 1954, or at any other time with the consent of the Commissioner. If the election is not made, real estate taxes are properly deductible by an accrual-basis taxpayer only in the year in which the assessment date falls. *Sec. 461*

Special provisions are included in the Code to prevent taxpayers from getting a deduction twice for the same tax as well as to prevent the loss of a deduction. The operation of these special provisions requires careful study with respect to each state in order to ascertain the effect on a particular taxpayer.

To illustrate how the special rules operate, assume that an accrual-basis corporate taxpayer with a March 31 fiscal year has real property located in Illinois. Real estate taxes there relate to the calendar year, and accrue under the general rule on April 1 of each year. Therefore, in the assumed situation, for the fiscal year ending March 31, 1955, the taxpayer would be entitled to deduct the entire amount of the 1954 Illinois taxes which accrued on April 1, 1954. In addition, if he elects to accrue ratably under Section 461, the taxpayer will be entitled to deduct an additional three-twelfths of a year's taxes for the taxes allocable to January, February, and March, 1955.

Thus, under these conditions, the taxpayer gets a deduction for his 1955 fiscal year of the real estate taxes allocable to a period of 15 months—namely the 12 calendar months in 1954 for which no amount was previously deducted, and the first three months of 1955, deduction for which would be lost if not allowable in the 1955 fiscal year.

Tax Effects of Changes In Accounting

Sec. 481

This describes the problems that have existed under Section 481—and the probable reasons for the nonissuance of regulations. However, passage of the 1958 Technical Amendments Act has clarified the situation by authorizing the taxation of any pre-1954 increment implicit in an accounting change initiated by the taxpayer—and permitting a taxpayer by election to "back off" from a change made in a post-1953 year.

Taxpayers sometimes keep books and file tax returns on the cash basis even though the presence of inventories would dictate that the accrual basis should be used.

Also, despite the long-standing requirements of the Code and regulations, the use of improper inventory pricing methods persists. Generally, the effect is an undervaluation or understatement of the inventory. Over a period of years the understatement or "increment" tends to grow as price levels rise.

In requiring taxpayers to shift over to the correct method of computing taxable income, in these instances, the Treasury formerly attempted to tax all the accumulated increment as income in the year of the changeover. However, its efforts were largely defeated in the courts. Most decisions held, for example, that the increment could not be restored to the closing inventory of the year under review without similarly adjusting the opening inventory (*Caldwell* v. *Comm'r,* 202 F.2d 112; *Comm'r* v. *Dwyer,* 203 F.2d 522; *Hughes,* 32 T.C. No. 1).

Because most of the increment had originated in prior closed years and old Section 3801 (now 1311) was inapplicable to those situations, a great amount of income escaped tax altogether in the switchovers.

Congress sought to correct this situation by the enactment of Section 481 of the 1954 Code, which provides, *inter alia,* that when a taxpayer's method of accounting is changed, adjustments must be made to prevent income from being omitted or duplicated. The adjustment in proper circumstances may be spread over a three-year period.

A primary intent of this provision is to permit the inclusion of the untaxed increment in the closing inventory in the year of "discovery" without making a similar adjustment in the opening inventory.

However, a saving clause states that "there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply." The section applies only to taxable years beginning after 1953, and the Finance Committee's report makes it clear that "the portion of the net transitional adjustment which corrects errors made prior to 1954 will not be made." Therefore, while the Treasury is now authorized to tax increment arising after 1953 at the time an erroneous accounting method is corrected even though the statute of limitations may have closed the intervening years, the taxpayer is nevertheless protected from the taxing of increment that arose in years prior to 1954.

That conclusion is reached easily enough. However, a snag or two develops upon further analysis of Section 481. While taxpayers who have been using an erroneous method of accounting in the past now have an opportunity to correct the method without disastrous tax consequences, by its wording the section does not apply *only* to corrections of erroneous methods. It applies to *all* changes in accounting methods. Therefore, taxpayers regularly and properly reporting on the cash basis prior to 1954 ostensibly may change to the accrual basis thereafter without paying tax on pre-1954 receivables. And it is understood that the Commissioner's permission to make such change has been sought by many such taxpayers. The result, if permission to make these changes were to be granted by the Commissioner, would be a significant loss of revenue. Thus, it is understood that action on such applications has been delayed by the Commissioner because of doubt that Congress intended such general application of the new section.

And that isn't all. There is also a question as to the applicability of Section 481 to changes in accounting that involve regularly recurring items of income or expense which have been consistently reported in the *wrong* taxable year. Such items might include, for example, state and local taxes, vacation pay, or rental income. This type of item involves no "increment" as such. It isn't like an inventory or a receivable, the balance of which may carry over from year to year. It simply is an annually recurring item which is subject to the fixed rules as to the proper year of accrual or deduction. And these fixed rules are not affected by the fact of an omission of income or duplication of deduction in a prior closed year (*Comm'r* v. *Dwyer,* 203 F.2d 522, and others).

It is difficult to apply Section 481 rationally to the correction of this type of item—and yet the committee reports infer that the section was intended to so apply.

These probably are the problems that have confronted the Treasury in its analysis of Section 481; and the reason why it has concluded that Section 481 is simply unworkable. It has sought clarifying legislation from Congress. In the meanwhile, the Treasury has neither issued nor proposed any regulations under the section.

Sec. 481 Inventory Valuation: An Inconsistent Position

This relates to a pre-1954 taxable year. It is conjectural how 1954 Code Section 481, as recently amended by Section 29 of the 1958 Technical Amendments Act, would affect a similar transaction in a later year.

This is related by T. T. SHAW, CPA, Arthur Young & Company, New York City.

Since incorporation in 1946, Corporation A, engaged in distributing propane gas, consistently omitted from inventory all gas in transit to, or on, the customers' premises. In 1953, Corporation A was bought by Corporation X and A was then liquidated. It was estimated that the value of the omitted inventory was $200,000. Corporation X assigned this valuation to its field inventory upon receipt of the assets, the *Kimbell-Diamond* rule being applicable. On examination of the final return of Corporation A, the Revenue Service proposed to include in income for the year of liquidation the entire value of the omitted inventory on the ground that an accounting method which omits a portion of the inventory is not acceptable.

At the Appellate Division level Corporation A agreed to increase its closing inventory provided it was allowed an opening inventory. The conferee allowed the opening inventory adjustment, although initially he contended that under Section 1311-1313 (Mitigation of the Effect of Limitations), the government could tax any remaining increment in the latest statute-barred year (1950). The taxpayer argued that the government was inconsistent in effecting the change in inventories, and accordingly, that Section 1311-1313 did not apply.

The case was settled on the basis of taxing the inventory increment applicable only to open years.

EXEMPT ORGANIZATIONS (Subchapter F)

Charitable Foundations Under Scrutiny by IRS

Sec. 501 et seq.

The inevitable result of the possible over-use of the foundation in personal tax planning.

It has been reported that charitable foundations are under close scrutiny by the Internal Revenue Service to determine whether exemption should be granted them or, once granted, should be revoked. The Commissioner's attack on these foundations seems to be concentrated on those which speculate too actively in the stock market (and therefore might be considered to be in the business of trading in securities for a profit) and upon those which have substantial business income.

Presumably the Service takes the position that under the above circumstances the foundation is not organized and operated exclusively for charitable purposes even though the profits do not inure to the benefit of a private individual. It may be relying on the Ninth Circuit decision in the *Randall Foundation Inc.* case decided in January 1957 wherein a charitable organization exemption was denied an organization which engaged in speculative oil stock transactions.

The status of the sections of the Code taxing unrelated business income is somewhat obscured by the IRS position. It was once thought that these sections were put into the Code to enable the business income of a charity to be taxed. Now, apparently, a business of any substantial nature will threaten *basic* tax-exempt status.

Accumulation of Income by Tax-Exempt Foundations

Sec. 504

Decisions affecting all foundations.

In view of the frequent desire of creators of tax-exempt founda-

Sec. 504 tions to accumulate the income of their foundations, attention is called to *Samuel Friedland Foundation* v. *United States,* decided by the District Court of New Jersey on August 24, 1956. The Court there held that the amounts accumulated out of income by the taxpayer were neither unreasonable in amount nor used to a substantial degree for noncharitable purposes. Further, such amounts were not invested in such a way as to place in jeopardy the charitable purpose or function of the taxpayer.

The decision was among the first reported court cases involving the application of Section 3814 of the 1939 Code, which provides that a tax-exempt foundation will lose its exempt status if it unreasonably accumulates its income. The decision is not only an excellent primer of the history of the provisions of the Code relating to exempt organizations, but it also contains language which is considerably more lenient than have been the Service's published pronouncements upon this question.

However, the Ninth Circuit in *Randall Foundation, Inc.,* 244 F.2d 803, reached the opposite conclusion where the charitable purposes were vague and the investment activity was speculative.

Sec. 511 Exempt Organizations Are Affected by Minor Code Change

JOSEPH E. TANSILL, CPA, Lybrand, Ross Bros. & Montgomery, Chicago, points out one minor change in the 1954 Code affecting exempt organizations with unrelated business income subject to tax.

Under the 1939 Code (Secs. 421 and 422) the deduction for charitable contributions was limited to five per cent of unrelated business net income, computed without the charitable contribution deduction and before the $1,000 specific deduction.

Under Sections 511 and 512 of the 1954 Code, the deduction for charitable contributions is limited to five per cent of "unrelated business taxable income" computed without the charitable contribution deduction but *after* the $1,000 specific deduction.

SURTAXES ON RETAINED EARNINGS

(Subchapter G)

Complications in Determining Accumulated Earnings Surtax

Sec. 531-7

Observations concerning possible effects of the Code provision.

THOMAS J. GREEN, CPA, Peat, Marwick, Mitchell & Co., New York City, has made these observations concerning the taxation of accumulated earnings (Code Sections 531-537):

The question of the reasonableness of an accumulation of earnings has always been a complex issue of fact. However, the 1954 Code provisions increase the complexity by applying the tax against only the unreasonable *portion* of the accumulation. Thus, management is now confronted with deciding not only *if* an accumulation may be deemed unreasonable by the Treasury, but also *how much.*

Mr. Green noted that field agents undoubtedly will be called upon to determine the extent to which a particular accumulation is unreasonable. This, he feels, will endow the agent with an instrument of compromise that could easily be misused as a "bargaining weapon."

Over Two Hundred Reasons For Retention of Earnings

A cross-reference to another publication containing an exhaustive tabulation of cases. Happily, the original appearance of this item inspired Dr. Holzman to expand his article into a book (Tax on Accumulated Earnings, *Ronald Press, 1956).*

Corporate taxpayers have advanced 225 reasons to justify retention of earnings in cases litigated under old Section 102 (now

Sec. 531-7 Section 531, et seq.). Of course, they weren't all successful—and in such instances the Treasury's imposition of surtax on the improper accumulation of surplus was sustained by the courts.

The exhaustive research of all Section 102 decisions, including a tabulation of the actual justification that was advanced by *each* taxpayer and the finding of the court thereon, was made by ROBERT S. HOLZMAN, Ph.D., professor of taxation at the New York University Graduate School of Business Administration. The tabulation was published in the September 1955 issue of the *Controller,* the monthly organ of the Controllers Institute of America.

Dr. Holzman's excellent study can save hundreds of hours of research time for any tax man fearful of, threatened with, or confronted by a Section 531 imposition.

Sec. 541 Working Interest in Oil Lease Not Personal Holding Income

Another type of "permissible" investment for near-personal holding companies.

Numerous methods are available to dilute corporate income in order to avoid qualification as a personal holding company. T. T. SHAW, CPA, Arthur Young & Company, New York City, calls attention to a point that should be considered if investments in oil leases are to be relied upon for this purpose.

Assume that the A Investment Company owns $3,000,000 of common stocks. Mr. A owns all of the stock, and therefore annual dividend income of $150,000 (after taxes, etc.) must be distributed to him so as to avoid personal holding company tax.

The A Investment Company purchases the working interest in an oil lease which produces gross income of $40,000. The gross income from oil production income is apparently more than 20 per cent of the A Investment Company's gross income, and the corporation thus will no longer be classified as a personal holding company.

However, "gross income" is deemed to be gross income less cost of goods sold. It will often be important, therefore, to determine what items are properly included in cost of goods sold in determining "gross income" (see *Woodside Acres,* 48 B.T.A. 1124, affirmed 134 F.2d 793 (CA-2) and the item entitled "What Is Precise Definition of Gross Income," page 7.)

In a private ruling on this point in connection with income from oil production, the Revenue Service has held that direct lifting costs must be treated as cost of goods sold to compute gross income—but that overhead, depreciation, depletion and intangible drilling costs need not be so included since deduction of these items is expressly permitted by the Code in computing taxable income. *Sec. 541*

Accordingly, it would be wise for Mr. A to ascertain before investing in the lease that the lifting costs will not be sufficient to reduce the "gross income" therefrom to less than 20 per cent of the A Company's gross income.

Dividends-Received Credit Highlighted Again

Sec. 545

Section 32 of the 1958 Technical Amendments Act closes this "loophole" which has heretofore been available to personal holding companies.

Our thanks to VICTOR COHEN, CPA, James D. Glunts & Co., Boston, for calling our attention to this apparent personal holding company tax "loophole."

Mr. Cohen points out that in computing the undistributed personal holding company income, upon which the tax is imposed, no deduction is permitted for dividends received. However, a deduction is allowed for the "net operating loss" of the preceding year. This loss is computed in the usual manner under Section 172, which permits an unlimited 85 per cent dividends-received deduction in the case of a net operating loss year. The following example will illustrate the interesting results which might develop when certain situations exist:

Assume a small personal holding company in which the sources and amounts of income remain fairly consistent from year to year. Assume that in 1954 the company received $20,000 in dividends and that its net income, which includes such dividends, but before the 85 per cent dividends-received deduction, is $8,000. Its net operating loss for normal and surtax purposes, after the allowance of the 85 per cent dividends-received deduction, would be $9,000. Its undistributed personal holding company income for that year will be $8,000 because 85 per cent of the dividends received will not be allowed to be taken as a deduction.

Now let us assume the same facts for 1955. Again, for normal

Sec. 545 and surtax purposes, we have a net operating loss of $9,000. However, the $9,000 net operating loss of 1954 may be used to reduce taxable income, computed without the benefit of the 1955 dividends-received deduction. Consequently, the company will have no undistributed personal holding company income.

In 1956, again assuming the same facts, there also will be no undistributed personal holding company income because the $9,000 net operating loss of 1955 will offset the taxable income computed without the 85 per cent dividends-received deduction for the 1956 dividends.

In this fashion, because the company will regularly be able to deduct the prior year's loss—which is, in reality, created because of the prior year's dividends-received deduction—the company may escape the high personal holding company tax rates because it will have no undistributed personal holding company income. Consequently, and unless there is corrective legislation, the company may be permitted to accumulate income and after a requisite number of years distribute such accumulation in a liquidation to its stockholders at capital gains rates.

NATURAL RESOURCES (Subchapter I)

Sec. 612 Oil and Gas—Deduction for Dry-Hole Costs

It has been reported that during a discussion at the Denver University Tax Institute held September 12, 13, and 14, 1957, several persons in attendance stated that the Commissioner has abandoned his position that dry-hole costs are not business expenses, hence deductible only from adjusted gross income, if the taxpayer is a casual investor and has no oil or gas income. Apparently dry-hole costs can now be deducted from gross income in arriving at adjusted gross income by *any* taxpayer.

Step-up in Basis of Mineral Properties Often Useless

A self-evident type of thing that might be overlooked easily during purchase negotiations.

Where one corporation proposes to buy 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 to a tax-free exchange. The buying corporation, in such a case, will forsake future depreciation, depletion, etc.

However, if the premium in 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.

Percentage Depletion— The "Cut-Off Point" Dispute

The Treasury has yet to issue regulations to give effect to the almost unanimous findings of the courts.

A great battle has been raging in the percentage depletion area on the question of the cut-off point.

The Code provides that the applicable depletion rates are to be applied to the value of "the commercially marketable mineral product"; but there then follows a description of certain specific technical processes that are either includable or excludable in determining the base to which the applicable rate is to be applied. As applied to some minerals there appears to be a conflict since some of the excludable types of processes would have to be included to produce the "commercially marketable mineral product."

In these cases, the Treasury has taken the stand that it is the nature of the process which controls; that if the process is, say, a heat process, one involving a chemical change or one involving fine pulverization, the depletable value of the mineral must be determined at a stage *short* of these processes, regardless of whether the product is customarily sold at that stage. And to determine the value of the mineral at such intermediate stage for depletion purposes, the Treasury has used a "proportionate cost formula."

A rash of litigation resulted from taxpayers' claiming on the one hand that they are entitled to percentage depletion on the market value of their finished product—and the Treasury insisting on the other that the "cut-off" point is at some stage short of the finished product. And practically *every* important reported case over a fifteen-year period has resolved the issue in the taxpayer's favor.

Not only has the "proportionate cost" formula been impugned but the following processes in effect have been held to be "includable" in arriving at the "commercially marketable mineral product": the furnacing of quicksilver ores (*New Idria Quicksilver Mining Co.* v. *Comm'r,* 144 F.2d 918; C.A. 9, 1944) and the pulverization of talc (*International Talc Co.,* 15 T.C. 981, 1950; and *The Hitchcock Corporation* v. *Townsend,* 232 F.2d 444; C.A. 4, 1956) (both later specifically added to the Code itself); the molding of talc into crayons (*Hitchcock,* supra), the pulverization of gilsonite (*American Gilsonite Company,* 28 T.C. No. 22; 4-29-57), the "burning" of structural brick and tile (*Cherokee Brick and Tile Co.* v. *U.S.,* 218 F.2d 424; 1955, and *Merry Brothers Brick & Tile Co., et al.* v. *U.S.,* 242 F.2d 708, both C.A.-5, and *Sapulpa Brick & Tile Corp.* v. *U.S.,* 239 F.2d 694; C.A.-10, 12-20-56), the "burning" of refractory brick (*U.S.* v. *Acme Brick Company,* and *U.S.* v. *Elgin-Butler Brick Co.,* C.A. 5, 4-25-57); and the kiln process used in converting cement rock into cement (*Dragon Cement Co.* v. *Comm'r,* C.A. 1, 244 F.2d 284). The Supreme Court has denied certiorari (10/14/57) in *Merry Brothers* and *Dragon Cement.*

In T.I.R.-62, October 18, 1957, the I.R.S. announced that in view of the Supreme Court's action, the Service is taking steps to dispose of pending claims involving brick and tile clay and cement, and also that consideration is being given to the applicability of the *Merry Brothers* and *Dragon Cement* decisions in cases involving fire clay and limestone. *Sec. 613*

Mine Development—Should It Be Deducted Currently or Deferred? *Sec. 616*

Factors to be considered in whether to elect or not to elect.

From Crawford C. Halsey, Pogson, Peloubet & Co., New York: When making a decision as to whether mine development expenditures under Section 616 should be written off currently or deferred and deducted on a ratable basis as the units of produced minerals benefited by such expenditures are sold, it is obvious that one must prognosticate the results of operations in five or more future years. If the taxpayer in question is a new company with no other source of income but from the mine which is being developed, writing off the development expenditures currently will produce net operating loss deductions which can be carried forward against income of the next succeeding five years. If it is estimated that profits will not begin to be earned within a five-year period so that all development expenditures so written off could not be applied in full against such profits, it is quite likely that the decision would be to defer the development expenditures of one or more of the earlier years, so that no deduction would be lost.

On the other hand, if the taxpayer in question is an old company with other operating properties which produce earnings in excess of the amounts of development expenditures incurred, it is probable that the decision will be to write off the development expenditures currently, as tax benefits therefrom would be obtained immediately.

However, in reaching any decision to defer development expenditures it should be remembered that, where net operating loss deductions are involved, an adverse effect on the amount of the percentage depletion may result. This adverse effect results because, in a year of profit to which a net operating loss (caused in whole or in part by writing off development expenditures currently) is carried forward, no adjustment need be made in the calculation of the percentage depletion deduction in respect of this net operating loss carryforward. This particular point is covered in a Special Ruling issued on December 20, 1951, as follows:

Sec. 616

"Percentage depletion as computed under Section 114(b)(4) of the Code is an amount equal to a statutory percentage (depending upon the nature of the property) of the gross income from the property during the taxable year, but limited to 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property during the taxable year. It is held that the net operating loss deduction is not one of the items to be considered in the determination of either the gross income from the property or the net income from the property. The percentage depletion, therefore, should not be recomputed because of the reduced income, caused by the net operating loss deduction."

On the other hand, if the development expenditures in the year of loss had been deferred, a ratable portion would have to be deducted in the year of profit. If the amount of percentage depletion for that year is limited to 50 per cent of net income, the percentage depletion deduction would, in effect, have been reduced by one-half of the amount of the deferred development amortized and deductible for that year.

This is a point which can be very easily overlooked as, particularly in the earlier years before the operation reaches its most profitable rate, the percentage depletion calculation may well be limited to 50 per cent of the net income from the property. While the above ruling was made under the 1939 Code, the provisions of the 1954 Code in this respect are substantially unchanged.

Sec. 632 Current Status of Carved-Out Oil Payments

Resolving the loose ends that arose in the wake of the Lake *decision. (Also see item entitled "A-B-C Transaction with Retention of 'Deep Rights,'" page 194.)*

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 taxed as ordinary income, subject to depletion, not as capital gain.

The Treasury attacked only carved-out oil payments; and the Supreme Court quoted language from I.T. 4003, 1950-1 C.B. 10, 11, which limited the government position to such transactions. Responsible Treasury officials with whom the question has been discussed indicate that the government presently has no intention of attempting to extend the *Lake* case. Thus, proceeds from a retained oil payment, a vertically cut oil payment, and the "tail end" portion of a horizontally cut oil payment constitute capital gain; and the A-B-C transaction will continue to be the most advantageous method taxwise to acquire oil properties in most circumstances. 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 C.B. 214.

Presumably, the *Lake, et al.*, cases overrule *Nail*, 27 B.T.A. 33 (NA), and *Nordon*, 22 T.C. 1132 (NA), so that income from a donated carved-out oil payment will be taxed to the donor, subject to depletion, as it arises. Although this point is not absolutely clear, such was the government position; and it is most unlikely either that the donor would escape taxation or that the act of donation would constitute a realization of income.

The Court also held that a carved-out oil payment does not qualify for a tax-free exchange under the like-kind provision (1939 Code Section 112(b)(1); 1954 Code Section 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.

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 Section 613(a) and Section (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 Section 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 Section 213(a) and (b)), but the percentages involved are much smaller.

INCOME TAXES OF ESTATES, TRUSTS, BENEFICIARIES AND DECEDENTS

(Subchapter J)

Sec. 642 Election on Administration Expenses of an Estate

(From 1955 New York University Tax Institute.)

It may be advantageous in some cases for the estate to take administration expenses as a deduction on its income tax return and forsake the deduction of these items for estate tax purposes. The procedure is outlined in Section 642(g).

The choice may be made on an item-by-item basis, or an item may be divided with a portion taken as an income tax deduction and the balance as an estate tax deduction.

The same choice is available for casualty and theft losses incurred during the settlement of an estate.

Tax Planning on Termination of an Estate

A must for the alert executor.

From T. T. SHAW: 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 nearing termination 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, one will offset the other and neither the estate nor the beneficiary will incur any tax liability. 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: *Sec. 642*

The estate would pay a tax on the capital gain on 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 $5,000.

Similar situations may produce tax savings if properly planned.

Corpus Distributions as Distribution of Income

Sec. 662

An appreciated explanation of a complex provision.

Troy G. Thurston, CPA, George S. Olive & Co., Indianapolis, calls attention to a feature of the Internal Revenue Code of 1954 which is important to accountants, trust officers and attorneys in preparing fiduciary returns. It is the provision requiring corpus distributions to be treated as distributions of income. This requirement is contained in Section 662(b). It requires the beneficiary of an estate or trust to include in income "all other amounts properly paid, credited, or required to be distributed for the taxable year." Modifications are provided, including exceptions for certain gifts and specific bequests.

The portion of a corpus distribution which is accountable as a distribution of income is limited to "distributable net income." While the language of Section 662(b) is not as specific and clear as is the provision in Section 316(a)(2) relating to the source of corporate dividends, it appears to have a similar effect—that is, of aggregating the net income for the entire year in determining whether or not a distribution at any time during the year is from distributable income of the year.

Capital gains which are allocable to corpus under local law generally are excluded from distributable net income.

Example:

Ordinary net income of an estate for calendar year 1955, represented by dividends received entirely during December	$30,000
Capital gain allocable to corpus	5,000
Distributable net income	30,000

Sec. 662 Assuming that an advance distribution of corpus was properly made in January 1955 to A, one of three residuary beneficiaries, in the amount of $10,000, A is taxable on the distribution of $10,000 while the estate is taxable on the retained income of $20,000 and the capital gain of $5,000. Everything else being equal, the other two beneficiaries would receive their shares of the undistributed net income subsequent to the year 1955 in the form of corpus which is *not* included in their taxable incomes (assuming the estate has no further distributable net income).

Sec. 673 Don't Overlook the Revocable Trust

(From 1955 New York University Tax Institute.)

In the eagerness of estate planners to save taxes, some old-fashioned advantages of the revocable trust may be overlooked.

Assume that the grantor places property in trust, reserving the full right during his lifetime to change the terms of the trust or revoke it completely. The property will be included in his estate for purposes of the estate tax. However, it will not pass under his will and will not be subject to the various fees and expenses attaching to property in the estate.

There may even be an income tax advantage from the enjoyment of a stepped-up basis derived from the value at the grantor's death, rather than some lower original-cost basis where property is transferred by gift.

Sec. 677 A Short-Term Trust For Junior's Education

(From 1955 New York University Tax Institute.)

The question often arises in connection with short-term reversionary trusts: If a father sets up such a trust in favor of his minor children and they use the income for their college educations, is the income taxable to the father as grantor? If this represents use of the income to meet the father's obligations, then it would be taxable to him.

Two lecturers arrived at the conclusion that the father would be taxable. They considered that a *legal* obligation as such was not required—as one of them put it, if the father's economic position was such that he was thinking of short-term trusts, he could well afford to provide the college education, and the resulting moral obligation was sufficient to render the trust income taxable to him. *Sec. 677*

Income "In Respect of a Decedent" Under Code Section 691

Sec. 691

An excellent primer on a complicated area of the Code.

ALLEN TOMLINSON, CPA, Pentland, Purvis, Keller & Company, Miami, Florida, submitted this fine review of the income tax problems under Section 691 of the 1954 Code (formerly old Code Sec. 126).

The increased scope of Section 691 brings in as *new* areas subjected to specialized income tax treatment partnership payments at death, installment sales obligations, joint and survivor annuities, and restricted stock options. Thus, new questions arise.

Many estates have some sort of income rights or debts which qualify as income and expenses "in respect of a decedent" because usually there exists some accrued interest income, fees and 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 uncompleted sales contracts, compensation agreements, 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 which are not of sufficient substance to be valued in the gross estate.
4. 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 not made applicable 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 (4th 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 Rev. Rul. 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). Ordinarily, this is not too difficult to compute in the average situation falling within the scope of the example given in the Regulations.

Difficulties arise, however, where there is a marital deduction involved in the estate tax return. There appear to be no regulations or rulings setting forth how this computation is to be made. There is one case, *Estate of Thomas Desmond,* 1954 T.C.M. 159, wherein the Court agreed with the Commissioner that the inclusion of the income rights in computing the amount of the marital deduction is tantamount to cancelling out the inclusion of the income rights in the gross estate. Under these circumstances no estate tax can be attributed to the income rights.

This rule seems to be correct, but there is difficulty in applying it to various types of marital deductions. These difficulties concern allocated estate tax where the marital transfers are in excess of the maximum marital deduction allowable and residue marital deductions where algebraic solutions are demanded. The *Desmond* case, cited above, in the Rule 50 computation which followed, seems to hold that in the case of a residuary marital transfer which is less than the maximum marital deduction and requires an algebraic computation, all of the Section 691 items in the gross estate bore estate tax. Could the Court have made its finding for the reason that in this type of residuary marital deduction one cannot prove what items in the gross estate remain in the residuary estate after payment of bequests, claims, debts, administrative expense and estate tax? This is unknown, particularly because the Court gave no discussion of its final determination in the Rule 50 computation, and one can only compare the result of its decision with the stipulated facts in the case. It seems that under the circumstances *none* of the Section 691 items could be said to bear any estate tax. Thus, the apparent result in the *Desmond* case may not be valid.

Thus everyone is more or less "on his own" as to estate tax allocable to Section 691 items where marital deductions are involved. This situation should be a warning to avoid using Section 691 items in making or paying bequests going to the surviving spouse which qualify for the marital deduction—although admittedly there are many estates where there is no surviving spouse and no marital deduction difficulties are to be encountered.

Mr. Tomlinson urges accountants to extend their acquaintanceship with Section 691 in order to become aware of the income rights of a decedent and the estate tax deduction allowable in the income tax return of an estate, beneficiary, or surviving spouse.

An Example of Onerous Double Taxation

An inequity that continues to cry for Congressional attention.

John Hodgkin, CPA, Price Waterhouse, Philadelphia, offers the following comments on a situation which seems to involve confiscatory double taxation.

Income receivable by a decedent is subject to double taxation—as an asset of the estate it is subject to estate tax and as income received by the estate it is also subject to income tax under Section 691(a). In enacting the latter section, Congress apparently realized that double taxation obtained because Section 691(c) at-

Sec. 691 tempts to alleviate it. This it does by providing a deduction in the income tax return for the estate tax payable at top bracket rates in respect of any included items. Thus where the estate tax rate and the income tax rate are both 50 per cent, a net amount of 50 cents per dollar would be included in the income tax return, which is in turn taxable at 50 per cent, leaving a net retention of 25 cents from the $1 of income.

There is a flaw in this arrangement. The state inheritance tax which is allowed as a credit against federal estate tax is *not* allowed as a deduction for income tax purposes. Where the rate brackets are high, this can result in a tax of over 100 per cent.

For example, take an estate of over $10 million with an income in the first period after death of $75,000. In this situation the estate tax on each $100 of includible income would be at the rate of 77 per cent gross with a 16 per cent credit for state tax or a net of 61 per cent. Since only the net federal tax is allowed as a deduction, this would mean that there would be included in income $100 less $61, or a net of $39. The top bracket income tax rate is 81 per cent, or, say, 77 per cent assuming a 4 per cent dividend-received credit so that the $39 included in income would bear income tax of $30. The result is as follows:

Total amount included in estate and in income	$100
Federal estate tax	$ 61
State inheritance tax	16
Federal income tax	30
Total tax	$107
Net disadvantage from this income	$ 7

This result may be constitutional and it may not violate property rights but it certainly seems unduly harsh and can hardly have been contemplated when the law was written.

Even if the state tax were allowed as a deduction in the income tax computation, there would still be a considerable tax, viz.:

Federal estate tax	$61
State inheritance tax	16
Federal income tax (77 per cent of 23)	18
Total tax	$95

It would seem that the frequently used *credit* method of alleviating double taxation might well be applied here. If this were done, the effect would be to subject the income to the higher of the estate tax rate or the income tax rate. In such case, the state inheritance tax also probably should be allowed as a credit. The tabulation below shows the application to the estate described above of the following three treatments: *Sec. 691*

A. Federal estate tax allowed as a credit against income tax; state inheritance tax not allowed either as credit or deduction.

B. Federal estate tax and state inheritance tax allowed as credits against income tax.

C. State inheritance tax allowed as a deduction in computing income tax; federal estate tax allowed as a credit.

	A	*B*	*C*
Total dividend	$100	$100	$100
State tax deducted	—	—	16
Amount subject to income tax	$100	$100	$ 84
Income tax before credit (at 77%)	77	77	65
Amount of credit	61	77	51*
Income tax after credit	16	None	14
Federal estate tax	61	61	61
State inheritance tax	16	16	16
Total tax	$ 93	$ 77	$ 91
Net benefit from $100 of income	$ 7	$ 23	$ 9

*(61% of $84)

The B solution would seem to be a sufficient tax burden. However, even A and C, harsh as they seem, are considerably better than the treatment under the present law, where the recipt of a dividend can actually cost the estate cash.

The situation seems to cry for legislative remedy, preferably retroactive.

Income in Respect of Decedents And the Formula Clause in Wills

An important consideration when the will is drafted.

From RUSSELL S. BOCK, Ernst & Ernst, Los Angeles, Calif.: The present popularity of deferred compensation plans (other than qualified Section 401 plans) results in instances where items classified as income in respect of decedents under Section 691(a) of the 1954 Code constitute a significant proportion of the gross estates of corporate executives. Such income, when received, will usually fall in high brackets for income tax purposes and the fullest use of the Section 691(c) deduction therefore should be made. However, a formula clause designed to effect the maximum marital deduction in the husband's estate by reason of the formula clause, may only constitute a *deferral* of estate tax which ultimately will become payable anyway, upon the widow's subsequent death.

In an assumed estate consisting of $800,000 of deferred income and $450,000 of other assets, the use of a formula maximum marital deduction would result in estate tax of approximately $150,000 on the husband's death. If the formula marital deduction provided for qualification of only half of the adjusted gross estate *exclusive* of any Section 691(a) items, the estate tax on the husband's death would be increased to possibly $275,000. Yet, much of this increase would qualify as a Section 691(c) deduction in the income tax returns of the recipient of the income in respect of the decedent, and thus there would be *some* income tax benefit therefrom. The point is, that where large amounts of income are involved with a short payout period, the income tax bracket of the recipient of the income will be high and a substantial part of any additional estate tax will be recovered through reduced income tax within a period of three or four years. On the other hand, where the additional estate tax payment is deferred until the *widow's* death, no income tax benefit may be realized therefrom.

The eventual savings possible are a matter for computation under the circumstances of each case. This is merely to suggest a careful look at any situation where deferred income may be a significant portion of the decedent's gross estate.

PARTNERSHIPS (Subchapter K)

Part II of Subchapter K relating to partnership contributions, distributions and transfers is complicated. The chart appearing on pages 174-5 may assist in analyzing these provisions.

Be Alert to Partnership Elections Under the 1954 Code

Sec. 701 et seq.

A summary.

From VIRGIL S. TILLY, W. O. Ligon & Company, Tulsa, Okla.: *These are the new ones*: Section 754 provides an election to adjust basis of partnership property. Section 734(b) prescribes the manner of adjustment to basis in case of a distribution of property in kind to a partner, and Section 743(b) prescribes the manner of adjustment on transfer of a partnership interest either by sale or exchange or on the death of a partner.

Section 704(c)(2) relates to property that has been contributed to the partnership by a partner. Depreciation, depletion, and gain or loss with respect to said contributed property will be allocated to a partner in accordance with his distributive share of taxable income or loss of the partnership, as described in Section 702(a)(9) unless the partnership agreement provides that said depreciation, depletion, or gain or loss with respect to such contributed property will be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.

Section 761(a) relates to joint adventurers who wish to elect to exclude their joint undertaking from all or part of the provisions of Subchapter K; that is, the application of partnership provisions. This election may be exercised for any unincorporated organization that is availed of: (1) for investment purposes only and not for the active conduct of a business, or (2) for the joint production, extraction or use of property, but not for the purpose of selling services or property produced or extracted, if the in-

Sec. 701 et seq. come of the members of the organization may be adequately determined without the computation of partnership taxable income.

Finally, Section 1361 permits a partnership to elect to be taxed as a domestic corporation.

The one election that may be made by partners individually: See Section 703(b). "Any election affecting the computation of taxable income derived from a partnership shall be made by the partnership, except that the election under Section 901, relating to taxes of foreign countries and possessions of the United States, shall be made by each partner separately."

A taxpayer may either deduct taxes paid to foreign countries or possessions of the United States or, under Section 901, may claim credit for such taxes. Section 901(b)(4) specifies that an individual who is a member of a partnership is allowed a credit for his proportionate share of the tax paid or accrued by the partnership to a foreign country or a possession of the United States.

Sec. 704 Partners' Shares May Be Set After Firm's Profits Determined

The regulations confirm this. However, no modification of the partnership agreement may be made after the original due date for filing the partnership return (Sec. 1.761-1(c)).

MICHAEL D. BACHRACH, CPA, Bachrach, Sanderbeck and Company, Pittsburgh, points out that one of the most intriguing provisions of the 1954 Code is the one embraced in Section 761(c) dealing with partnership agreements. This section permits a partnership agreement to be modified at any time prior to the original due date of filing the partnership return.

The Conference Committee Report emphasizes this point in the following language: "A partnership agreement with respect to a particular taxable year may be made or modified subsequent to the close of the taxable year, but not later than the date prescribed by law for the filing of such return for such year."

The Committee Report goes on to say that all of this is subject to the provisions of Section 704(b) giving the Commissioner the right to ignore any provisions in a partnership agreement (relating to partners' distributive shares) which are motivated primarily by a desire to avoid or evade tax.

Apparently the framers of the law deliberately intended to give partners a chance to wait until the size of the pie had been determined before deciding on their respective cuts. *Sec. 704*

Apparently they are also free to change the relative slices from year to year, so long as they are not acting primarily for the special tax benefit of a certain partner or partners.

All of which suggests a new look in partnership agreements with the possible evolution of a standard clause along these lines: "The profits or losses shall be divided among the several partners in the manner determined by them after the close of the business year and prior to the due date of filing the partnership tax return."

How prevalent this practice will become remains to be seen.

Limitation on Partner's Share Of a Partnership Loss

A partner's deductible losses are not limited by the amount of his capital account.

Sam Butler, CPA, Butler, Milzer & Co., Denver, Colorado, warns of possible misinterpretation of Section 704(d) of the 1954 Code. This section 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 interest 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 repaid).

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 partner's interest in a partnership results from an increase in a partner's share of the liabilities of a partnership.

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.

The Partner and His Partnership Interest

Basis of Partnership Interest

Amount of cash contributed to partnership by partner, plus his basis of property contributed to partnership (722) and/or

Cost or other basis if interest acquired other than by contribution to partnership, e.g., by purchase, inheritance, etc. (742)

Plus: Distributive share of (705)(a)(1)—
- Taxable income of partnership
- Exempt income of partnership
- Excess of percentage depletion over basis of depletable property

Less: Distributive share of (705)(a)(2)—
- Losses of partnership (to extent such losses do not reduce basis below zero)
- Expenditures not deductible by partnership and not chargeable to capital account

Less: In the case of a distribution other than in liquidation of the partner's interest—
- The amount of money and adjusted basis of property received as determined under 732(a)(1) and (2) (733)

Alternate Basis in Case of Termination of Partnership

Adjusted basis of partner's interest may be determined by reference to his proportionate share of adjusted basis of partnership property under unusual circumstances to be specified by regs. (705(b))

Nature of Gain or Loss on Sale of Partnership Interest

Is capital gain or loss (741) except to the extent gain is attributable to unrealized receivables and appreciated inventories under Section 751(a) which gain is ordinary income.

Property Distributed to Partner by Partnership

Basis of Property Received in Other than Complete Liquidation of Partner's Interest

Adjusted basis to partnership (732(a)(1)) limited however to adjusted basis of partner's interest in partnership less amount of cash received. (732(a)(2))

Basis of Property Received in Complete Liquidation of Partnership Interest

Amount equal to adjusted basis of partner's interest less cash received. (732(b))

Method of allocating basis to classes of assets received in distributions subject to 732(a)(2) and 732(b) above:

First: To unrealized receivables defined in 751(c) and inventory items (defined in 751(d)(2)) to the extent of adjusted basis of each such property to partnership, or if basis to be allocated is less, then in proportion to such basis; and

Second: To other properties in proportion to their adjusted basis to partnership. (732(c))

Special Alternate Basis of Property Received by Partner Within Two Years From Date Partnership Interest Acquired

Even though optional adjustment to basis of partnership assets was not made under Section 743 at time partner acquired his interest, such adjustment may nevertheless be made by partner if he receives assets in distribution within two years from time he acquired his interest. Also Secretary may *require* such adjustment under certain conditions. (732(d))

Nature of Gain or Loss on Sale of Partnership Assets Distributed to Partner and Holding Period

Gain or loss on sale of unrealized receivables (per 751(c)); and inventory items (751(d)(2)) if sold or exchanged in less than 5 years from date of distribution, is ordinary gain or loss. (735(a))

Holding period of property includes period held by partnership. (735(b))

The Partnership and Its Assets

Contribution by Partner to Partnership

(Includes, interalia, assumption of partnership liability by partner, etc., which is treated as a contribution (752(a))

Recognition of Gain or Loss on Contributions of Property

No gain or loss is recognized to partner or partnership on contribution (721)

Distribution of Partnership Property

(Includes interalia, distributions in liquidation of retiring partner's or deceased partner's interest. (736(b)); and includes assumption of partner's liability by partnership, etc., which is treated as a distribution (752(b)), but does not include such portion of a distribution which is attributable to unrealized receivables and inventories which is treated as a sale or exchange under 751(b) (732(e))

Recognition of Gain or Loss on Distributions of Property

To partnership—No gain or loss recognized to partnership (731(b))

To partner—Gain is recognized to extent money received exceeds adjusted basis of partner's interest (731(a)(1))

Loss is recognized to extent of excess of partner's interest over amount of money received plus basis of unrealized receivables (751(c)) and inventory (751(d)(2)) but only where *no other type of property is received.* (731(a)(2))

(Any gain or loss so recognized is capital gain or loss—see last sentence of 731(a) and Section 741 relating to character of gain or loss.)

Basis of Partnership Assets

General rule—Same as basis to partner-transferor (723)

Optional adjustments to basis of partnership assets (when binding election made under 754)—

(1) Upon transfer of partnership interest to new or another partner when partnership interest is acquired by purchase or inheritance, etc., the basis of the partnership assets may, *with respect to the transferee partner only*, be increased to the extent that his basis for his partnership interest (cost, etc.) exceeds his proportionate share of the adjusted basis of the partnership property, or be decreased to the extent of the converse. (743)

(2) Upon any distribution of property to a partner the basis of the partnership assets may be increased by: (a) the amount of gain, if any, recognized to the transferee partner under Section 731(a)(1), and (b) in the case of distributed property to which Section 732(a)(2) and 732(b) applies, the excess of the adjusted basis of the distributed property to the partnership over the basis of the distributed property to the distributee; or it may be decreased by the converse. (734)

Method of allocation of basis of partnership property when optional adjustments are made—Generally, in a manner that has the effect of *reducing the difference* between the fair market value and the adjusted basis of partnership properties. (755)

Sec. 706 Different Tax Years for Partnership and Partners

See also the subsequent item.

A partnership may not adopt a taxable year other than that of all its principal partners unless it establishes to the satisfaction of the Commissioner a business purpose therefor (Code Section 706(b)).

BENJAMIN GRUND, CPA, Seidman & Seidman, New York City, has found the Service to be most reasonable in permitting a new partnership—one organized June 1, 1954—to adopt a May 31 fiscal year, even though all the partners will continue to report on a calendar-year basis.

The request for permission to use different taxable years was prompted by the fact that all of the partners were interested in many other ventures—and the establishment of the fiscal year would facilitate accounting detail by postponing it to a time when it would not conflict with the federal and state returns which had to be filed for their other ventures.

The Service found this to be a proper business purpose for using diverse taxable years and exercised its discretion in favor of the taxpayers.

Partnership Taxable Years

(From the American Institute's 1955 Annual Meeting.)

A partnership has had a June 30 fiscal year. Its principal partners report on a calendar-year basis.

A new partner is admitted as of November 1.

Query: Must the partnership thereafter adopt a calendar-year basis under Section 706(b)(1)?

Consensus: No, it may continue to use the June 30 fiscal year. The admission of a new partner is not a "termination" which requires the partnership to "adopt" a new taxable year corresponding to that of its principal partners. (Code Sec. 706(c)(1).)

A caution: In the past a partner's estate could adopt any fiscal year. However, under the new Code it may have to adopt the same fiscal year as the partnership does if the estate is to continue as a partner. (Code Sec. 706(b)(2).)

A partnership may not adopt a fiscal year different from that of its principal partners. (Sec. 706(b).) Does this apply to a partnership which elects to be taxed as a corporation under Section 1361? Sec. 706

Consensus: No. A partnership electing to be taxed as a corporation shall (with several minor exceptions) "be considered as a corporation." (Sec. 1361(c).) A corporation is not required to adopt a fiscal year corresponding to the taxable year of its principal shareholders—therefore such a partnership similarly would not be so required.

Termination of a Partnership: Status Terms Create Conflict

Sec. 708

The Treasury in the regulations, Section 1.708-1(b)(1)(ii), has since adopted the plain wording of the Code: "Such sale or exchange includes a sale or exchange to another member of the partnership."

The plain wording of some 1954 Code sections is clearly inconsistent with the intent of Congress in enacting those provisions.

Here is an example from ROBERT BUCHANAN, CPA, Lybrand, Ross Bros. & Montgomery, San Francisco:

Code Section 708(b)(1)(B) provides that a partnership shall be considered "terminated" if "within a 12-month period there is a sale or exchange of 50 per cent or more of the total interest in partnership capital and profits."

The Senate Finance Committee Report (p. 91) describes this provision as "the sale of an interest of more than 50 per cent in partnership capital or profits *to persons not members of the partnership*" (emphasis supplied). The staff of the Joint Committee similarly describes the provision in its "Summary of the New Provisions of the Internal Revenue Code of 1954" (p. 90).

Thus, Congress probably intended the statute to say one thing but it clearly says something else.

Deferred Liquidation Of Partnership Interest

Sec. 741

Modification of old partnership agreements may effect tax savings.

Partnership agreements providing for the enforced complete

Sec. 741 withdrawal of partners at a specified age should be reviewed for possible modification in view of the 1954 Code and regulations concerning partners and partnerships.

Let us assume a partnership is on the accrual basis and has no unrealized receivables or substantially appreciated inventories. Partner A, having a partnership interest with a tax basis of $1,000,000 and having attained the "retirement age," is required to withdraw completely. Certain capital assets held by the partnership (e.g., corporate stocks) have enhanced in value to the extent that the fair market value of A's partnership interest is, say, $2,500,000. Any distribution to the partner and/or his estate is to be in cash under the partnership agreement, which also provides that no allowance shall be made for goodwill.

If the partner withdraws his interest in cash he will be subject to a 25 per cent capital gains tax on his $1,500,000 gain.

If, on the other hand, the partner remains a member of the partnership until his death (with possibly a reduced participation in services and income), he would incur no income taxation on the appreciation of his interest in partnership property (except each year's current earnings) until and unless he withdraws sufficient funds to reduce his tax basis to zero.

Upon the partner's death, his partnership basis to his estate will "step up" to its fair market value. At that time, it could be liquidated by the estate without capital gains tax.

TAXES ON FOREIGN INCOME (Subchapter N)

Sec. 901 et seq. Tax Credit on Dividends From English Subsidiaries

Election in United States-United Kingdom Tax Convention to pick up dividend gross versus *net can be advantageous to U.S. taxpayers only when English tax rates are higher than U.S. rates.*

WALLACE M. JENSEN, CPA, Touche, Niven, Bailey & Smart, Detroit, reminds us that domestic corporations having English subsidiaries would do well to bear in mind the election available to them (Article XIII of the Income Tax Convention between the

United States and the United Kingdom) with respect to the foreign tax credit: *Sec. 901 et seq.*

When an English subsidiary pays a dividend, it is authorized by the British Income Tax Act to deduct the tax "appropriate" to the dividend and pay out only the net amount. In effect, this means that the English company is recouping part of the income tax which it has paid on its taxable income.

If the parent company includes in its gross income only the net amount of the dividend from its English subsidiary, it will be entitled to a foreign tax credit for the income tax and the profits tax of its English subsidiary, which the parent is deemed to have paid by virtue of Section 902 (old Sec. 131(f)). However, if the parent company so elects (under Article XIII of the Convention), it may include in its gross income the gross amount of the dividend. In computing its foreign tax credit, the parent will then be deemed to have paid the tax "appropriate" to such dividend and will also be entitled to a credit for the profits tax which it is deemed to have paid by virtue of Section 902.

In many instances, exercise of this election may result in a tax saving.

Foreign Operations: Subsidiary *v.* Branch

A table indicating which type of foreign operation yields greater net return.

The decision to conduct foreign operations by means of a foreign subsidiary rather than through a branch is often based on nontax factors. For example, a foreign government may require that operations in its jurisdiction be conducted through a corporation organized under local law. Branch operation would be precluded under such circumstances.

However, where aggregate taxes are a factor in the decision, a computation of relative tax costs of conducting foreign operations through either a branch or foreign subsidiary may produce unexpected results, according to SAMUEL F. MIRANDY, CPA, Lybrand, Ross Bros. & Montgomery, New York City. Mr. Mirandy notes that under the existing 52 per cent U.S. rate, a branch operation cannot yield after-tax income of more than 48 per cent of foreign earnings.

Sec. 901 et seq.

However, a subsidiary can yield a greater than 48 per cent after-tax income *if* the foreign rate is lower than the U.S. rate. Thus, if the foreign rate is, say, 26 per cent, the after-tax realization on $100,000 would be $54,760 or 54+ per cent. Strangely enough, though, this advantage disappears if there is *no* foreign tax.

Here are the results of Mr. Mirandy's computations of the net realization on $100,000 of income earned by a foreign subsidiary under various foreign tax rates:

Assumed foreign income tax rate	*Foreign tax on $100,000*	*Dividend from foreign subsidiary*	*U.S. tax on foreign dividend**	*Net realization on $100,000*
—	—	$100,000	$52,000	$48,000
13%	$13,000	87,000	33,620	53,380
26%	26,000	74,000	19,240	54,760
39%	39,000	61,000	7,930	53,070
52%	52,000	48,000	—	48,000

*After credit for foreign income tax deemed to have been paid. Sec. 902(a), 1954 Code; Sec. 131(f), 1939 Code.

An Easily Overlooked Tax Credit from Foreign Trusts

The tax credit available for foreign taxes paid or accrued is well known, and a tax practitioner would hardly overlook it.

However, Ralph K. Conrad, CPA, Bachrach, Sanderbeck & Co., Pittsburgh, reminds us that where a United States citizen receives income from a foreign trust which itself holds stocks or bonds of U.S. corporations, it is easy to forget that the U.S. taxpayer may be entitled to an additional U.S. tax credit under Section 1462 of the 1954 Code. This credit occurs because American corporations remitting interest or dividends to the foreign trusts must withhold a 30 per cent United States tax (unless modified by a foreign tax treaty).

For example, consider an American citizen receiving distributive income from a trust set up and operated in Montreal, Canada. Assume the trust has substantial holdings in American Telephone and Telegraph Company and other U.S. corporations. The income received by the American taxpayer will have been reduced, not only by the 15 per cent Canadian tax which must be withheld by the trustee in Montreal, but also by the 15 per cent United States tax which was withheld by the U.S. corporations out of the funds they sent to Montreal.

Canadian trustees furnish a Form T-3 to their beneficiaries on which is listed the Canadian income tax withheld and also "foreign income taxes." If this form has been properly prepared, the distributive income shown on it will be gross before both Canadian and U.S. taxes. *Sec. 901 et seq.*

It is therefore apparent that the Canadian tax should be picked up as a foreign tax credit under Section 901. And the U.S. tax should be picked up as U.S. income tax withheld at source under Section 1462 of the Code and shown on line 8 of page 2 of the American taxpayer's individual Form 1040.

Corporate Operations In Foreign Countries

This summary of U.S. tax implications in foreign operations may be helpful in the light of the increasing prominence that world trade enjoys in the thinking of American business executives.

There follows a brief outline of some of the more important federal income tax considerations in connection with corporate operations in foreign countries.

Foreign Branch *v.* Foreign Subsidiary. The provisions of existing U.S. income tax law appear heavily weighted in favor of conducting profitable foreign operations by a foreign corporation, mainly because of:

1. *Existence of foreign tax credit.* The operation of this credit effects a division between foreign and domestic sources of income. Dividends received from the foreign corporation are taxed at somewhat lower rates than those applicable to domestic income (without considering, of course, the domestic dividend-received deduction). The maximum over-all benefit from the receipt of foreign dividends is realized when the tax rate in the foreign country is exactly one-half the rate applicable to domestic corporation income. (See item entitled Foreign Operations: Subsidiary *v.* Branch, *supra,* p. 179.)
2. *Annual taxation of foreign profits of a U.S. corporation whether or not such profits are transmitted to the U.S.* A foreign corporation is not faced with the annual U.S. tax settlement which confronts a domestic corporation regardless of the fact that profits of a branch operating in foreign countries may have been ploughed back in further investment in foreign oper-

Sec. 901 et seq.

ations. There have been many instances where domestic source dollars have been used to pay the tax on foreign operations only to have the increment in value in the foreign investment disappear as a result of currency devaluation.

There are some tax disadvantages to conducting world trade through foreign subsidiaries. If losses are anticipated during the early years of foreign operations, it may be advantageous to have such losses deductible as branch losses of a domestic corporation. Also, the percentage depletion deduction under the provisions of Code Section 611 is not available to a foreign corporation. In some instances, benefits of U.S. tax treaties in force with a number of foreign countries may be lost.

FOREIGN TAX "SANCTUARIES" OR "HAVENS." One method employed to obtain maximum tax benefits is incorporation in a country which imposes little or no income or capital taxes on income of its domestic companies derived from sources outside the country. The corporation may be responsible for all foreign operations, either through the medium of agents or branches or as a holding company with other foreign subsidiaries. The advantages inherent in centralizing all foreign operations in one company incorporated in a "tax haven" are:

1. Utilization of lowly taxed profits to finance expansion of foreign activity.
2. Capital gain rate available to parent company upon accumulated earnings received in liquidation. However, since the foreign taxes deemed to have been paid are not allowable as a credit in the case of liquidating distributions, it might be more advantageous to declare dividends than to have a capital gain, depending on tax rates involved.
3. In some countries the tax rate exceeds that of the U.S.; thus some benefit of the foreign tax credit might be lost if earnings are received by the U.S. parent directly from a subsidiary in such a country. Centralization of activities in one foreign subsidiary has the effect of averaging the tax rates of all countries in which operations are conducted. This is true even if subsidiaries are established, since, by Treasury Department ruling, all income taxes paid by a foreign holding company's subsidiaries are deemed to have been paid by the holding company.
4. Tax treaties between the country of incorporation and other foreign countries might be more advantageous than those between such other countries and the U.S.

The Treasury has intensified its scrutiny of the methods established for foreign expansion by American industries. Where the foreign corporation is deemed to be a sham, organized solely for the purpose of diverting domestic taxable income to foreign countries, the Treasury, under Code Section 482, has the power to subject such income to U.S. taxes. *Sec. 901 et seq.*

What then determines whether the personality and the income of the foreign subsidiary will be respected from a U.S. standpoint? Here are five tests that may be helpful:

1. Is there a sound business reason for the division of business between the parent and its subsidiary?
2. Is the division a logical and natural one or is it forced and artificial?
3. Is the foreign subsidiary self-sufficient; i.e., does it carry on its own business with its own capital, employees and accounting records?
4. Is there arbitrary shifting of property from parent to subsidiary?
5. Are transactions between parent and subsidiary bona fide?

TAX CONSIDERATIONS UPON ORGANIZATION OF FOREIGN CORPORATIONS. At the time of organization of a foreign subsidiary, certain tax implications must be considered. It is necessary, of course, to transfer cash and perhaps other property to the new company in exchange for its capital stock. If gain should result from a transfer of property, Section 367 renders the tax-free provisions of Section 351 inapplicable unless prior approval of the Treasury Department is obtained. Obtaining such approval is normally quite difficult. Loss, if any, would not be recognized since Section 351 would apply. Of course, the possibility exists of averting recognition of gain by exchanging only cash for the stock of the foreign subsidiary and subsequently transferring any other property to the subsidiary as paid-in capital, accepting no stock in exchange therefor. Under present Code provisions apparently no gain can be imputed to such transactions. Of course, if the transactions closely follow each other, the Treasury may look upon them as steps in an integrated transaction of transferring cash and property for stock. Then gain, if any, would be recognized to the transaction.

The transfer of stock or securities to a foreign corporation as paid-in capital would also not be subject to income tax. However, such a transfer carries with it the possibility of imposition of the

Sec. 901 et seq.

27½ per cent excise tax levied by Code Section 1491. This tax is based upon the excess of the value of the stock or securities transferred over their basis to the transferor. It is imposed unless it can be established that tax avoidance was not a principal purpose of the transfer.

Foreign Tax Sanctuaries And U. S. Tax Rates

An opportunity—and a warning for businesses operating abroad.

Lichtenstein, Liberia and Panama are presently enjoying an exalted status in the eyes of the American businessman. This is due to their being highly publicized as foreign tax "havens" or "sanctuaries."

The income tax rates in these countries are very low. What's more, corporations organized under their laws are not liable for *any* income taxes on dividends or other income from sources outside of the respective countries. Thus, these countries are a sort of tax Shangri-La—offering virtual freedom from taxation of foreign profits of U.S. firms operating abroad.

Like practically every other legitimate tax "shelter," the establishment of foreign corporations based in tax-haven countries probably will be overdone. The otherwise legitimate principle will be stretched too far, and its use extended to some inappropriate cases. And U.S. tax will probably apply to those few foreign arrangements that are lacking in substance and reality. Code Sections 269, 367, 482 and 1491 supply adequate authority for taxing gains or profits on flagrant assignments of property or income to foreign corporations.

Nevertheless, American business management is devoting great attention to the various methods of *legitimately* minimizing taxes on foreign income. Interest in this subject has increased in direct proportion to the increase in U.S. private investments abroad—and such investments have more than doubled since 1948!

The most prevalent method of minimizing U.S. taxes on foreign income is through the use of foreign subsidiaries to conduct manufacturing or selling activities abroad—rather than through the use of branches of the U.S. corporation. Income earned by such foreign subsidiaries is not taxable in the United States until it is collected as dividends by the U.S. parent—and even then the after-tax realization is greater because of the operation of the foreign tax credit. Indeed, in some cases it is not planned to currently remit the foreign subsidiaries' earnings as dividends to the parent, but rather to reinvest them abroad to produce future additional income. And sometimes the ultimate collection of income accumulated by a foreign subsidiary can be effected even cheaper taxwise by liquidating the subsidiary and paying only a U.S. capital gains tax on the profits.

Sec. 901 et seq.

There are some who refer to these foreign tax set-ups as "tax loopholes" in a scurrilous sense—just as percentage depletion, capital gains, dividend credits, and restricted stock options have been similarly criticized. This is, indeed, unfortunate because immorality is implied in their use where none is present.

If there be a major fault in our tax law, it is not the maligned special provisions that are suspect. Rather it is the existence of confiscatory high general tax rates—52 per cent in the case of corporations and up to 91 per cent for individuals. The present tax rates are almost in an "excess profits tax" category, and like an excess profits tax law require many remedial or relief provisions.

In any event, if special provisions be an evil, the way to eliminate them is to remove their cause, i.e., reduce the exorbitant tax rates that spawned them. In just such manner was the evil of bootlegging eliminated—by repealing the prohibition law!

In the meanwhile, it would be interesting to know how much foreign income of U.S. companies unnecessarily reposes in foreign corporations subject to the risks of possible future blockage, seizure or sequestration by foreign governments, and how much tax revenue is currently being lost to the U.S. Treasury simply because U.S. tax rates are not competitive with those of foreign countries.

Equipment Transfer from American Companies to Canadian Branches

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

Sec. 901 et seq.

United States businesses. Their ventures across the border have 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 plans. 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 such a ruling is readily obtainable.

As the Canadian operation unfolds, it may require additional equipment from time to time which also may be available in the United States plant. But there is often no time to wait for a ruling, and the issuance of new stock and the processing of a ruling application appear to be an unnecessary chore. The solution is simple—treat the equipment as a contribution to capital of the Canadian company, for which no stock is issued. It would seem that Sections 351 and 367 should not be applicable to such transfers which are not, in fact, a part of the original transfer for stock. (However, if *stock or securities* were to be transferred, the Section 1491 27½ per cent stamp tax might apply.)

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.

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. *Sec. 901 et seq.*

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.

By comparison, the attitude toward depreciation allowances in Canada will be 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 of depreciation would only increase a loss.

U. S. Capital Gains Tax Offset by Foreign Tax Credit

U.S. citizens residing in Canada, please note!

Jerome C. Bachrach, CPA, Bachrach, Sanderbeck & Co., Pittsburgh, observes that the foreign tax credit computation under Code Section 904 can afford some interesting results.

Assume that a United States citizen is a permanent resident of Canada. He has formed a number of corporations from which he draws 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). He would like to liquidate these corporations.

Under Canadian tax law he will thereby incur no tax. If the Canadian tax on his salaries during the year of liquidation exceeds the United States capital gains tax on the liquidation, no United States tax will be payable, even though the capital gains will, of course, be includible in his United States return.

Such gains are considered to be income derived from Canada 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 in Canada on Canadian income exempt from taxation in this country.

Sec. 901
et seq.

Canadian Investment Companies Offer Tax Savings for Americans

Apparently this is still a valid "loophole."

Per ARTHUR WITTENSTEIN, Lybrand, Ross Bros. & Montgomery, New York City:

Among the most interesting vehicles available to the American investor, from the standpoint of saving taxes, are the shares of investment companies organized under Canadian law and operated in such a way as to be treated under the Internal Revenue Code as "nonresident" foreign corporations deriving no income from United States sources.

Such companies are subject to no U.S. tax on their investment income. Furthermore, there is no tax imposed on the accumulation of earnings under Canadian law. Therefore, income received from Canadian stocks and bonds may be retained and reinvested indefinitely by such companies, subject only to the limited income taxes imposed by Canadian law.

Several well-known United States investment companies have organized Canadian investment companies with the announced policy of reinvesting all earnings and making no current distributions of income or profits to shareholders. U.S. shareholders will be subject to no current tax on company earnings. The amount ultimately realized by the American investor upon the sale of his investment company shares, which presumably will reflect the higher values resulting from continuing reinvestment of income, would be treated as capital gain in the U.S.

An investment company organized in Canada may elect one of two alternative treatments under the Canadian tax law if it meets the requirements of a Nonresident Owned Investment Corporation, as set forth in Section 70 of the Canadian Income Tax Act. Section 70 was enacted to encourage foreign investment in Canada, and, in order to qualify thereunder, 95 per cent of the aggregate value of the stock and all of the bonds of the investment company must be owned by nonresidents of Canada. A qualifying company may elect for the taxable year to be taxed at the flat rate of 15 per cent on its entire investment income.

Alternatively, the company may choose to be taxed at ordinary rates (currently 20 per cent on the first $20,000 and 49 per cent on the balance) in which case the tax is imposed on its income exclusive of dividends from Canadian corporations.

In general, no intercorporate dividend tax is imposed in Canada. Where investment income consists wholly or largely of dividends, it may be advantageous for the company to be taxed as an ordinary Canadian corporation rather than under Section 70. Under either alternative, there is no Canadian tax on capital gain from the sale of investment securities. *Sec. 901 et seq.*

The U.S. tax status of Canadian investment companies of the type described is the subject of Revenue Ruling 55-182.

NONTAXABLE EXCHANGES AND BASIS

(Subchapter O)

The Use of Treasury Stock To Pay Officers and Employees

Sec. 1032

While proposed regulations would have attempted to tax a gain to the corporation in the transactions here described, final Regulations, Section 1.1032-1(a), do not.

Treasury stock which has appreciated in value can now be used to pay salaries or bonuses to employees without gain to the employer corporation. The employee, of course, is taxable on the fair market value of the stock received. The employer corporation's deduction for compensation also is based on the fair market value.

However, 1954 Code Section 1032 precludes the recognition of gain to the corporation on the issuance of the Treasury stock.

Involuntary "Exchange" Taxable— Voluntary Exchange Not

Sec. 1033

Section 46 of the 1958 Technical Amendments Act now removes the inequity here described by treating Section 1033 condemnations of real property—whether for productive use in trade or business or for investment—similar to "like-kind" exchanges.

A turnpike authority has recently acquired several parcels of

Sec. 1033 realty in and around Richmond, Virginia, through condemnation proceedings or the threat thereof. This has focused attention on a long-time inconsistency in the income tax structure which is described by JOHN E. HAMILTON, CPA, A. M. Pullen & Company, Richmond, as follows:

Section 1033 of the 1954 Code provides in part: "(A) General Rule—If property (as a result of its destruction in whole or part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted—(1) Conversion into similar property—into property similar or related in service or use to the property so converted, no gain shall be recognized."

Regulations with respect to the above section read in part as follows: Paragraphs 1.1033(a)-2(c)-(9)(i) and 1.1033(a)-2(g)(1)—"There is no investment in property similar in character and devoted to a similar use if . . . the proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate."

The above provisions are much the same as the corresponding law and regulations under the 1939 Code and as developed by case law.

Section 1031(a) of the 1954 Code reads in part: "(A)Nonrecognition of Gain or Loss from Exchanges Solely in Kind—No gain or loss shall be recognized if property held for productive use in trade or business or for investment . . . is exchanged solely for property of a like kind to be held for productive use in trade or business or for investment."

Regulations with respect to Section 1031 read in part as follows: "Paragraph 1.1031(a)-1(c)—No gain or loss is recognized if . . . (2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate. . . ."

Again these provisions are similar to corresponding provisions under the 1939 Code and court interpretations.

Under these two sections of the Code, one who *voluntarily* exchanges property for similar property may defer any tax resulting from a gain on such exchange whereas one who *involuntarily* exchanges (by way of involuntary conversion) may not defer the tax on any such gain if the two properties are not similar or related in service or use.

For example, a person who voluntarily exchanges city real estate for a farm may defer the tax. But if his city real estate is condemned and he reinvests the condemnation proceeds in a farm, his tax on the gain is *not* deferred. However, if the turnpike condemnation authorities purchased a farm and gave it to the property owner in exchange for his city real estate it is apparent the transaction would be nontaxable! Mr. Hamilton sees no justification, economic or otherwise, for the qualifications under Section 1033 being more stringent than those under Section 1031. *Sec. 1033*

Nonrecognition of Gain on Sale Of Residences—Fact or Fiction? *Sec. 1034*

The Service undoubtedly is technically correct in taxing these separate sales of land. Thus, Congressional action would be required if the inequity were to be corrected.

From THOMAS J. GREEN, Peat, Marwick, Mitchell & Co., New York, N. Y.: In the Revenue Act of 1951 Congress granted relief from recognition of gain to taxpayers who sell or exchange their residences and reinvest the proceeds in a new residence within prescribed time periods. However, this section, as interpreted by the Internal Revenue Service, does not always accomplish its objective.

Take, for example, the taxpayer who purchases a residence with a considerable amount of land around it. The additional land may be purchased because the taxpayer wishes to prevent any other building being constructed adjacent to his residence. It may be customary for residences in the section in which the house is located to have a considerable amount of land, a zoning ordinance may require vacant land about the residence, or the taxpayer may merely desire to have a recreation area. However, changes can occur in the neighborhood which may be the result of action by a governmental body, i.e., a super highway may be constructed near or even in front of a taxpayer's residence. Another possibility is a change in the character of the neighborhood. For any one of these reasons the taxpayer may desire to sell his residence and buy another residence with a similar amount of land at a price equal to or in excess of the market value of his old place of residence.

In many instances the taxpayer can realize a much higher price

Sec. 1034 if he can sell the land or lot adjacent to his house separately from the house itself. This is particularly true where the district has been rezoned as the result of construction of a highway or a change in the character of the neighborhood. A commercial buyer of land who represents an oil company or other corporation which wishes to put a business on the lot but which does not want the residence may be reluctant to take the entire property and go to the trouble of selling off the residence. In view of the attitude of a commercial buyer that his principal is interested only in the vacant land and in view of the fact that frequently a higher price can be obtained if the vacant land and an older residence can be sold separately, the taxpayer may be forced to sell what was his residence as separate parcels.

However, if the taxpayer does sell his former residence as separate parcels, and reinvests the entire proceeds in another residence with a similar amount of land, the gain on the sale of the vacant land would be subject to tax. The Revenue Service's rule is that where a residence which has been used as such by a taxpayer for a number of years is sold in two parcels, the sale of each parcel is treated as a separate transaction and gain or loss thereon is computed separately (Revenue Ruling 54-95, 1954-1 Cum. Bull. 98). The gain on the vacant lot would be recognized whereas the gain on the sale of the residence would not be recognized according to Section 1034 of the Internal Revenue Code of 1954.

While the result reached by the Revenue Service may be technically sound, it certainly defeats the purpose of Congress to postpone recognition of gain where a taxpayer sells his old residence and reinvests the proceeds in a new residence and viewed in this light form is exalted over substance. On the other hand, if the taxpayer obtains two buyers, one for the land and one for the house, and arranges to sell the property to one party who will immediately sell the portion he does not want to the other buyer, the Service in all probability would contend that in substance the sale of two parcels has occurred and gain on the sale of the lot must be recognized.

The over-all result is that the taxpayer must decide whether the increased price which may be obtained by selling the land and the residence separately is sufficiently high to compensate for the tax which must be paid on the gain on the sale of the vacant land.

CAPITAL GAINS AND LOSSES (Subchapter P)

Offsetting Capital Gains

Sec. 1201

Section 18 of the 1958 Technical Amendments Act closes this loophole by denying the dividends-received deduction in such cases.

Assume that a taxpayer corporation has a capital gain on investments amounting to $50,000. The capital gains tax on such amount would be $12,500. If the taxpayer purchases a stock just before it goes ex-dividend, the taxpayer may, by selling it immediately thereafter, realize a capital loss, probably to the extent of the dividend. If such dividend amounted to $50,000, the capital loss on the sale of the stock would offset the $50,000 capital gain and the taxpayer would pay a tax of only $3,900 ($50,000 less 85 per cent, or $7,500, x 52 per cent), as compared to $12,500.

The only hitch is that the stock's drop in value may not be exactly equivalent to the dividend. The varying factors affecting stock market prices create an additional element of risk in the above transaction.

Converting Capital Loss into Ordinary Loss by Sale and Leaseback

(From 1955 New York University Tax Institute.)

A sale of property used in the business, followed by a leaseback from the new owner, can sometimes convert a capital loss into an ordinary loss. For example, a corporation has sustained a capital loss in the current year, or in a prior year with a carryover to the current year. There is either no tax benefit from the carryover or at best an offset against a 25 per cent tax. Now the corporation sells business property to an investor and realizes a gain to match the capital loss. It leases back the property and pays rent which will reduce ordinary income taxable at 52 per cent. It has obtained the following advantages:

1. In place of a loss which is nondeductible or which reduces a 25 per cent tax, it has a rental deduction which will reduce a 52 per cent tax.

2. It has realized working capital from the sale. While the working capital will be paid back over the years as rent, it may fill an immediate and pressing need.

As usual, there are traps for the unwary, such as:

1. If the lease is unduly favorable to the tenant, it may have a value which should be added to the selling price in computing the capital gain.
2. Section 1239 provides that the gain on certain sales between related parties be taxed as ordinary income.

Using New Subsidiary's Stock To Provide Executive Incentive

A useful method of getting capital gains money to a key man.

Stock options are not the only method of getting a "stake" in the business into a valuable executive's hands. An increasingly prevalent 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 materials "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.

Effect: A substantial incentive to the executive in the form of potential long-term capital gain.

A-B-C Transaction with Retention of "Deep Rights"

Apparently the Lake *decision does not interfere with this. See the item entitled "Current Status of Carved-Out Oil Payments," page 160.*

T. T. Shaw, CPA, Arthur Young & Company, New York City, supplied this item:

Corporation X, a producing oil company, was the owner of several oil and gas leases in Proven Field, production being obtained only from an area above 5,000 feet. Corporation Y was desirous of acquiring Corporation X's leases in the event it could utilize the "A-B-C" method of acquisition, and it made an offer based on such method. However, Corporation X desired to retain all of the "deep rights," i.e., beneath the 5,000-foot horizon, and would not consummate the sale unless it obtained a ruling from the Revenue Service that the transaction would qualify for capital gain treatment. The deal was worked out as follows: *Sec. 1201*

Corporation X sold the working interest (burdened with a substantial retained oil payment) in its Proven Field leases down to the 5,000-foot horizon to Corporation Y in consideration for a fraction of the ultimate total cash consideration desired by Corporation X. Simultaneously, Corporation X sold the retained oil payment to Finance Company for the balance of ultimate total cash consideration desired by Corporation X.

The Revenue Service wanted assurance that production had not been obtained from beneath the 5,000-foot horizon. Upon receipt of this assurance, a favorable letter ruling was received.

Converting Future Income Into Current Capital Gains

This acceptable method of tax minimization is also available to unincorporated business interests. (Section 49 of the 1958 Technical Amendments Act also provides relief by permitting full deduction for casualty losses on certain fully uninsured property.)

The prohibitively high surtax rates are the common foe of most high income earners. Thus, businessmen devote as much thought and effort to converting ordinary income into capital gains as they devote to actually increasing their earnings.

One method of converting *future* ordinary income into current capital gains is to sell off minority chunks of a new business shortly after the business has become sufficiently established to reflect potentially high future earning power.

Indeed, the business need not necessarily be incorporated—it may be an individual proprietorship. Thus, an individual in a service type of business, for example an advertising agency or an accounting practice, might be able to develop it sufficiently within a short time to portend the likelihood of high future earnings. At that point the sale of, say, a 10 per cent interest in the business to

Sec. 1201 an employee will yield capital gains income. Indeed the proprietor's prerogative of management need not be relinquished—he can sell up to 49 per cent of his interest without losing control.

Sec. 1211

Ordinary Loss Deduction Obtainable on Sale of Stock

Litigation is required to realize these benefits in view of the Service's dislike of the principle.

From T. T. SHAW: The possibility of obtaining an ordinary loss deduction rather than a capital loss deduction under certain circumstances involving stock investments should not be overlooked. Recent cases have indicated that an ordinary loss deduction will be allowed where the investment in the stock was made to gain a source of supply of a product necessary to the taxpayer's business and such stock was immediately disposed of where the need to hold the stock disappeared.

Sec. 1231

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.

Stepping Up Property Basis by Transfer to Corporation Less than 80 Per Cent Owned

(From Tax Executives Institute's 1955 Annual Conference.)

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, and minor grandchildren) owns less than 80 per cent of the corporation's stock, he will incur only a capital gains tax on the appreciation. However, the basis of the property to the corporation depreciation, etc., against 52 per cent tax rates will be its appreciated value.

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.

As long as he (or his wife, minor children, or minor grandchildren) does not own more than 80 per cent of the corporation's stock, 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.

Character of Loss Determined By Character of Gain

That the Arrowsmith *doctrine is being applied by the Service in a most orderly fashion is demonstrated by this case study.*

In 1952 an individual and others sold certain oil and gas producing properties for a cash consideration. The individual reported the gain on his 1952 income tax return as a capital gain. As a part of the sale, the purchaser borrowed approximately $600,000 from a bank, but was not personally liable on the indebtedness, the property being the security for the loan. However, it was agreed with the bank that in consideration for the bank advancing $600,000, the note and the mortgage would be purchased from the bank on June 1, 1955 by the sellers if the indebtedness had not been repaid.

Sec. 1231 The indebtedness was not repaid and the properties were returned to the sellers. The individual's share of the payment to the bank on June 1, 1955 was approximately $50,000.

The $50,000 was taken as an ordinary deduction on the taxpayer's 1955 income tax return.

When the transactions were questioned on examination, the agent agreed with the taxpayer that the $50,000 loss was a Section 1231, 1954 I.R.C. (Sec. 117(j), 1939 I.R.C.) transaction. Upon review, the reviewing agent took exception to this treatment and argued that the $50,000 constituted a "capital loss."

Upon return of the case to the revenue agent it was pointed out to him by the taxpayer's representatives that the Revenue Service's published position supported a Section 1231 treatment, i.e., an ordinary loss deduction (Rev. Rul. 55-119, 1955 Cum. Bull. 1, 352). That revenue ruling is based in part upon the *Arrowsmith* case (344 U.S. 6). Where a transaction has been reported for income tax return purposes in one taxable year and payments are made in a subsequent taxable year relating to the earlier reported transaction, the *Arrowsmith* case established the rule that the character of the payment is determined by reference to the character of the first transaction. In Revenue Ruling 55-119, depreciable property was involved and it is there stated that the nature of any gain or loss resulting from events occurring subsequent to the sale of the property will depend upon the purpose for which the property was held.

When Revenue Ruling 55-119 was called to the attention of the reviewer, Section 1231, i.e., ordinary loss treatment, was accorded the aforementioned $50,000 item. Thus, while the original transaction resulted in capital gain treatment, the subsequent payment of $50,000 resulted in ordinary loss treatment, because of the peculiar provisions of Section 1231, 1954 I.R.C. (Sec. 117(j), 1939 I.R.C.).

Sec. 1237 One Advantage of Jointly Owned Property

From J. S. SEIDMAN: Attention has been called to many disadvantages taxwise when a husband and wife own property jointly. Here is one advantage: To get capital gain under Section 1237, dealing with the subdivision of real estate, there must be ownership for at least five years. For this purpose, the regulations say that where a husband and wife own property jointly, the five-year period starts with the commencement of the joint ownership, though the husband dies in the meantime. On separate ownership, the five-year period starts running anew in respect to the deceased's share. *Sec. 1237*

Gain on Sale of Emergency Facilities

Sec. 1238

This is not new or startling—but it could be overlooked.

Emergency facilities currently being acquired and related amortization reserves usually are recorded on the books in a separate group of accounts which often include fully amortized facilities acquired during World War II. However, there is at least one important distinction between World War II facilities and those acquired since 1949.

In the event of the sale of emergency facilities at a profit, Section 1238 requires that a portion of the gain equal to the difference between depreciation computed at the normal rate and the amortization reserve accumulated with respect to the assets sold be reported as ordinary income. Any additional profit is subject to the usual Section 1231 treatment. However, note that this provision is *not* applicable to facilities acquired during World War II and that the *entire* profit on sales of such facilities receives Section 1231 capital gain treatment. Section 1231's predecessor, Section 117(g)(3), 1939 Code, was limited to assets to which Section 124A was applicable, i.e., generally those which were acquired after December 31, 1949.

Because of the groupings of the facilities on the books and the manner in which the Code is worded, the differentiation may easily be overlooked—with detrimental results.

MITIGATION OF EFFECT OF STATUTE OF LIMITATIONS, ETC. (Subchapter Q)

Sec. 1303 Delayed Compensation Not "Back Pay"

Recently finalized Regulations 1.1303-1(b) confirm this observation where there was no prior agreement or legal obligation to pay on the part of the corporation.

Section 1303 accords tax relief from the "lumping" of back pay in one taxable year by permitting such a payment to be spread over the number of taxable years to which it is attributable.

Suppose a new corporation sustains operating losses during its first four years. The president takes no salary until the fifth year when the company is enjoying income.

Query: May the president spread the salary over the five-year period in accordance with Section 1303 in the computation of his personal income tax?

Reply by members of an American Institute tax panel: No. Such delayed compensation would not constitute "back pay" within the definition in Code Section 1303(b).

Sec. 1311-1315 Correction of Errors In Closed Years

Despite the easy mechanics that are here described, Code Sections 1311-15 may not be clearly applicable to all situations. See Heer-Andres, *22 T.C. 385(A). Incidentally, Section 59 of the 1958 Technical Amendments Act has extended the scope of these sections to items of related income, deductions or credits of affiliated corporations.)*

The provisions of the Internal Revenue Code dealing with correction of errors in closed years have often caused considerable difficulty for tax practitioners, as well as representatives of the Internal Revenue Service, because of the uncertainty existing as to the applicability of those provisions (Secs. 1311-1315 of the 1954 Code; Sec. 3801 of the 1939 Code).

These sections provide rules for the correction of the effect of an erroneous treatment of an item, in a taxable year which is closed by the statute of limitations or otherwise, in cases where, in connection with the ascertainment of the tax for another taxable year, it has been determined that there was an erroneous treatment of such item in the closed year. *Sec. 1311-1315*

The Internal Revenue Code of 1954 has broadened the scope of these provisions by including under the definition of a "determination" an "agreement between the taxpayer and IRS" (Regs. 1.1313(a)-4). This innovation is intended to provide an expeditious method for obtaining an adjustment under Section 1311 of the 1954 Code, and for offsetting deficiencies and refunds wherever possible. A determination made by an agreement pursuant to this section becomes final when the tax liability for the open taxable year to which the determination relates becomes final. There was no comparable provision under the 1939 Code; thus, this new provision expedites the method for obtaining an adjustment under Section 1311 and for offsetting deficiencies and refunds.

Let us assume that an accrual-basis taxpayer, after filing his federal income tax return for the year 1955, discovers in the year 1956 that he has failed to claim a deduction for an expense item which had actually accrued in the year 1955. Since this discovery is made while the year 1955 is still open under the statute of limitations, the taxpayer may file a claim for refund for the year 1955 at the time of discovery. Let us assume, however, that, instead of filing a claim for refund, he claims the deduction in his federal income tax return for the year 1956, even though under the accrual method of accounting it properly should have been deducted in the year 1955. Will such action on the part of the taxpayer insure a tax benefit for the item? Is such an item covered by the provisions relating to the mitigation of the effect of the statute of limitations?

Section 1312(4) of the 1954 Code provides that, if a determination disallows a deduction or credit which should have been allowed to, but was not allowed to, the taxpayer for another taxable year, or to a related taxpayer, such a circumstance entitles the taxpayer to an adjustment for the correct year, even though at the time of the determination, the statute of limitations has run for the correct year, if at the time the deduction was claimed for the later year, the correct year was not barred by the statute. In the example outlined above, therefore, it appears that the taxpayer would be protected, since at the time he claimed the deduction

Sec. 1311-1315 for the year 1956, the statute of limitations had not run for the correct year 1955. It would appear that this provision should obviate the necessity of filing claims for refund for relatively small deductions for earlier years, by simply claiming them in the year of discovery.

ELECTION TO BE TAXED AS A CORPORATION

(Subchapter R)

Sec. 1361 **Provision for Election to Be Taxed as Corporation Is Vague**

Election by taxpayers had still better wait until regulations fill in the statute's voids—and such regulations have not been either issued or proposed.

New Section 1361 permits certain proprietorships and partnerships to elect to be taxed as corporations. Such an election is required to be made within sixty days after the end of the first taxable year to which benefits are to be applied.

It is now too late for taxpayers to elect to use the new provision for the calendar years 1955-1957. However, taxpayers who made a "preliminary" or "tentative" election by March 1, 1954, in accordance with the temporary rules issued by the Treasury on February 24, will have until three months after the final regulations are issued to take steps to make the election binding; and those taxpayers who did not make a preliminary election for 1954 through 1957 still may elect the benefits of Section 1361 for *future* years.

JEROME C. BACHRACH, CPA, Bachrach, Sanderbeck & Company, Pittsburgh, Pennsylvania, observes that many unanswered questions are provoked by Section 1361. For example, consider an unmarried proprietor making $50,000 in 1954. He could save nearly $10,000 by taking a $20,000 "salary" and making the election. However, as a minimum, he would want to know whether his net worth at January 1, 1954, would be considered as permanent capital (drawings from which would constitute dividends) or as tax-paid amounts due him which he could take out at any time without tax consequences. If the former, his $10,000 potential tax savings could prove illusory. *Sec. 1361*

Answers to such questions must be given in the regulations before a taxpayer can make an intelligent election to use Section 1361.

CONSOLIDATED RETURNS (Chapter 6)

Importance of the Date of Affiliation of Subsidiary

Sec. 1504

Affiliation begins on the date the subsidiary's stock is purchased and not at the beginning of the following day.

From EVERETT C. JOHNSON, CPA, Arthur Andersen & Co., Chicago:

A Company purchased 100 per cent of the stock of B Company on April 4. On the same day B Company realized a capital gain of $50,000 from the sale of securities. B Company will file a separate return from January 1 until date of affiliation. The income of B after that date will be included in a consolidated return with A Company, which has a large capital loss.

Query: Does the date of affiliation start on April 4, the day A purchased 100 per cent of B's stock, so that B's $50,000 capital gain could be offset by A's capital loss in a consolidated return? Or does it start on April 5, the day *following* the date of purchase, so B's capital gain would be subject to tax and not offset by A's capital loss?

Authoritative opinion seems to indicate that the affiliation commences on April 4, the day of the stock purchase. Thus the consolidated return would include B's income from April 4 to December 31. The result in this case is to offset B Company's capital gain against A Company's capital loss.

ESTATE AND GIFT TAXES (Subtitle B)

Sec. 2001 et seq.

Estate Planning: A Capsule Review

A summary for CPAs of estate planners' techniques.

A CPA may not prepare a will for a client. Nor can he act as a corporate trustee. And he isn't likely to be engaged in selling life insurance.

Nevertheless, the CPA frequently is asked to serve on an "estate planning team." Because he has a specialized knowledge in some areas, his presence can "round out the team." This is particularly true in the field of closely held or family business corporations—which comprise a large part of accounting clientele.

Other members of the team also have something valuable to offer the mutual client. It is not a bad idea to be familiar with the tools and wares of other professions—the lawyer, the insurance counselor, and the trust man. Here are a few classified thoughts on estate planning.

The estate planner is concerned with two main objectives: (1) minimizing death taxes; and (2) assuring the availability of sufficient funds to pay death taxes.

However, the means, plans, or methods by which these objectives are to be accomplished must *always* be subject to two overriding considerations: the testator's wishes as to the disposition of his estate, and his economic welfare during his lifetime.

The most "ideal" estate plan from the viewpoint of tax savings or liquidity is imprudent—in fact, it's downright foolish—if it ignores these basic considerations. Thus, an informed client's desire to bequeath but a third of his estate to his wife must be respected even though greater tax benefits might be derived from leaving her a half. And extra liquidity in an estate is obviously undesirable if its cost is the payment of unduly burdensome life insurance premiums during the testator's lifetime.

The point is that in their zealousness to install a plan which will reduce taxes estate planners sometimes lose sight of the testator's personal desires and economic welfare. In some instances, clients have been urged to make gifts and establish trusts with the result that they were left utterly bereft of funds upon which to live and dependent upon some relative or trust officer for means of support. *Sec. 2001 et seq.*

In addition to federal estate taxes, income taxes are a factor in an estate planning problem. For example, total family income taxes may be sharply increased or reduced by transfers of income-producing property among family members in different surtax brackets.

The estate planner is also, or ought to be, concerned with the economic and efficient administration of the ultimate estate. Administration expenses should certainly be kept to a minimum. And what's also important, the desirability of efficient administration and the safekeeping and conservation of estate assets would seem to merit the selection of experienced and trustworthy executors and trustees, with demonstrated financial responsibility and with an expert knowledge of business and investments.

However, back to the main objectives—minimizing death taxes and assuring the availability of sufficient funds to pay death taxes.

Minimizing the Estate Tax

Steps to minimize the federal estate tax usually include:

1. *Proper will drafting and life insurance arrangements.* A properly drafted will is elementary in estate planning, and the maximum marital deduction must be carefully provided for by the drafting lawyer. Also, life insurance policies are often arranged or transferred so that their value will not be includable in the taxable estate. A widely used plan is to have the testator's beneficiaries pay all the premiums on insurance on his life from their own funds. This saves both estate tax to the estate and gift tax to the testator. However, under the 1954 Code, proceeds of insurance policies are not taxable to the insured's estate if he has no incidents of ownership at his death, even though he paid the premiums.

2. *Lifetime gifts to objects of bounty.* To reduce the taxable estate, estate planners often recommend that the testator make gifts of his property to his children or grandchildren *during his lifetime.* Advantages: Gift tax rates generally are lower than estate tax rates. Also, if the property is income producing, it may be taxable in lower income tax brackets to the recipient. Disadvantages:

Sec. 2001 et seq. Testator needs cash funds to pay gift taxes on the transfer; also, he loses control of his property and the future income therefrom. Gift-making presents problems, particularly if trusts are used. Volumes have been written on the estate and income tax complications of revocable and irrevocable trusts!

3. *Gifts (or bequests) to exempt institutions or foundations.* This method of reducing both estate *and* income taxes is becoming increasingly popular. Advantages: Property so transferred is not subject to estate tax; also, if donated during lifetime, income tax deductions for contributions can be obtained; if testator holds a large block of controlling stock of a close corporation, a conversion to nonvoting stock and (notwithstanding 1954 Section 306) *its* transfer to an exempt institution or foundation will permit retention of voting control in heirs through lesser stockholdings; finally, a foundation may bear the name and be a living monument to its founder. Possible disadvantage: Congress isn't sure it likes the increasing flow of capital into tax-exempt entities. And Congress recently has been investigating the condition.

Funds to Pay Estate Tax

Ordinarily, where sufficient cash isn't available to pay the estate tax, some assets must be sold. They may be readily realizable assets, such as marketable securities. However, it is often desirable to sell assets of a less "liquid" nature—for example, real estate. Not only is cash obtained, but a prompt sale "fixes" the value for estate tax purposes of an asset that otherwise may be difficult to value.

In any event, the problems of raising funds are relatively uncomplicated unless there is involved the ownership of, say, the controlling stock in a close corporation. The reason why that presents a problem is that heirs are usually reluctant to part with voting control in a family corporation. This is understandable. However, raising funds without losing control of family corporations has become a major problem of this generation. Here's what frequently is done.

Sometimes nonvoting stock owned by the estate is sold "outside" to produce the cash. However, this is difficult. There is little market for a close corporation's nonvoting stock.

Therefore, the corporation itself is often looked to for cash. Stock retirement plans are provided for under which the corporation purchases its own stock. Impetus was given these plans several years ago by the enactment of (old) Code Section 115(g)(3) (now Section 303) permitting redemption of corporate stock to provide estate tax funds—without danger of a dividend tax on the proceeds. *Sec. 2001 et seq.*

Life insurance sometimes is carried by the corporation on the life of the controlling stockholder to provide cash funds to redeem his stock at his death. Premiums are not deductible. But neither are proceeds taxable.

"Other stockholders" may supply cash for estate taxes under agreements to buy the decedent's stock. They're advantageous to both the decedent's estate, which has a ready market for its stock, and to the remaining stockholders (or partners) who can retain their "exclusiveness."

The stock-purchase agreement takes various forms. It may be optional or it may be binding. It need not be made with other stockholders. Rather, key employees or a profit-sharing trustee may be the other parties to the agreement. It may provide a fixed price or formula for valuing the stock which usually will "peg" the stock's value for estate tax purposes.

In any event, these plans almost always are funded with "cross" life insurance policies on the lives of the principal stockholders.

Foreign Real Estate Not Subject to Federal Estate Tax

Sec. 2031

An estate tax savings possibility worthy of the estate planner's consideration.

From Jerome C. Bachrach, CPA, Bachrach, Sanderbeck & Co., Pittsburgh, Pa.: Real estate located outside the United States is not subject to federal estate tax. This suggests worthwhile possibilities for American taxpayers interested in estate and gift tax planning.

This exemption probably extends to all property which is defined as real estate under applicable foreign law. Long-term leaseholds may qualify, and even mortgages in certain Latin American countries.

For example, consider a New York resident in his eighties who wants to make a substantial gift to his daughter. He is concerned both about gift tax rates and the three-year contemplation of death rule. Instead of giving New York property to her right now, *Sec. 2031* he buys an expensive residence in Nassau, Bahama Islands, gives his daughter use of the property but not title to it, and provides in his will that she shall own it upon his death.

In this way he avoids gift tax since he makes no lifetime gift, avoids contemplation of death problems for the same reason, and avoids estate tax since the property is located outside the United States.

How does one determine which foreign country is best? The first question, naturally, concerns the death tax rates of the country being considered. For example, the death tax rate in the Bahamas is only 2 per cent. In this respect these islands are much superior to Canada, for example, where Dominion death duties (plus Quebec or Ontario duties if the real estate is in those provinces) are considerably higher. To illustrate, the combined Canadian and Ontario tax bite on the first $50,000 of taxable estate there (over the applicable exemption) exceeds 20 per cent.

The second consideration in choosing where to buy real estate is the convertibility of its currency. In other words, how can the money be gotten back to the United States? Exchange restrictions in the British West Indies make it quite difficult to sell property and convert the proceeds into American dollars. By this test, however, Canada shines. Canadian dollars are the practical equivalent of U.S. dollars.

Property situated in United States possessions (Puerto Rico, Virgin Islands) qualifies for the exemption. But property located in the territories does not. The Canal Zone would probably qualify as well, but all land there is controlled by the United States government and none is available for purchase by an individual.

As between Puerto Rico and the Virgin Islands the preference is all to the latter. The Puerto Rican transfer tax (combined inheritance and gift tax) is markedly higher than the comparable taxes here. For example, the rate is 60 per cent on transfers over $500,000. But the Virgin Islands collects only a flat 2 per cent on inheritances to spouse or children and a flat 8 per cent on inheritances to brothers and sisters.

The Virgin Islands offer United States protection and law, complete transferability of funds (in fact the same currency), and freedom from federal estate and gift taxes. A trust company has recently been organized there. There will be increasing numbers of wealthy U.S. citizens investigating investments in this Caribbean possession.

Optional Valuation Date Sometimes Prohibited

From T. T. SHAW: Where a decedent leaves an estate of less than $60,000 so that an estate tax return is not required to be filled, Proposed Regulations 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.

There is no prohibition against using the optional valuation date to obtain an increase in basis, however, where the value of an estate is $100,000, and where the marital deduction reduces the estate to below $60,000 and no estate tax is due. In the latter situation, an estate tax return is required to be filed.

Estate Tax—Consideration in Selecting Alternate Valuation

These considerations are a "must" for alert executors. However, since this was written Section 43 of the 1958 Technical Amendments Act has provided for an increase in basis to the donee to the extent of gift tax paid on the transfer—with some limitations.

From WILLIAM K. CARSON, CPA, Touche, Niven, Bailey & Smart, New York, N.Y.: Section 2032 of the 1954 Internal Revenue Code provides for an election by the executor to value all the property included in the gross estate of a decedent as of the date one year after the decedent's death. In determining the advisability of exercising his right to this election, the executor has more to consider than the difference in values of the property at date of death and one year thereafter. In the first place Section 2032 provides that when the alternate valuation is used, property distributed, sold, exchanged or otherwise disposed of within one year from the decedent's death shall be valued as of the date of such disposition. Before making a distribution, therefore, an executor should consider the effect of current market values on the alternate valuation computation.

Secondly, the savings in estate tax by using the alternate valuation may not be as great as may first seem apparent. Section 2011 provides for a credit against the estate tax for estate taxes paid to a state. The credit is limited to a percentage of the taxable estate reported for federal estate tax purposes. If the alternate valuation is used and results in a smaller taxable estate, the

Sec. 2032 credit for state taxes paid will be, accordingly, reduced. Many states, of which New York is one, have no provision comparable to the Internal Revenue Code Section 2032. Valuation for state estate tax purposes in such a case is determined at date of death and the tax is based on that amount. Loss of credit therefore is not offset by a reduced state tax.

Sec. 2035 Retention of Appreciated Property Gift Advisable

Making gifts is not always good tax planning.

S. Lester McCormick, Lybrand, Ross Bros. & Montgomery, Cincinnati, Ohio, suggests that the donee of property appreciated in value should not dispose of it too hastily, lest he forsake a possible step-up in basis.

For example, an individual makes a gift of low-basis property. He dies within three years thereafter and the gift is ruled to have been in contemplation of death and includible in the decedent's gross estate.

In such a case, the property in the hands of the donee takes as its basis for determining gain or loss the fair market value at the date of the donor's death (or optional date) under Section 1014 of the 1954 Code, provided the property has not been sold, exchanged, or otherwise disposed of before the donor's death. If the donee sold the property before the donor's death (or if the property was not includible in donor's gross estate) the basis for determining gain to the donee is the basis in the hands of the donor under the long-standing rule.

Therefore, in the case of property having an appreciated value, it will be found advisable for the donee in the absence of other compelling reasons to hold the property for a full three years or until the death of the donor, whichever period is the shorter.

Saving Taxes Through Deathbed Gifts

Though made in contemplation of death, a gift may nevertheless be advantageous.

A gift made within three years before the donor's death is presumed to have been made in contemplation of death, unless the contrary is proved, and is includible in the donor's gross estate for federal estate tax purposes. A limited credit for the gift tax paid or payable is allowable. *Sec. 2035*

Even if a gift is held to have been made in contemplation of death, taxes may be saved because the funds required to pay the gift tax escape estate tax even though the gift tax is credited against the estate tax.

Thus, if a man wills to his wife the entire estate, assumed to be $1,000,000 after debts and expenses, the federal estate tax is $126,500. If he gave the property to her on his deathbed, the gift tax, assuming no prior gifts, would be $101,355. This debt would reduce the taxable estate to $898,645, upon which the estate tax would be $110,283, less credit for the $101,355 previously paid, or $8,928. Thus there would be an over-all net saving in the amount of $16,217.

1954 Code Changes Provision On Life Insurance Proceeds

Sec. 2042

Probably the most important recent estate tax change.

William F. Scheid, Jr., CPA, has observed that one of the most important changes made by the 1954 Code in the federal estate tax provisions relates to the inclusion of the proceeds of decedent's life insurance in his gross estate when such proceeds are payable to persons other than the estate.

Under former law, the proceeds of insurance on a decedent's life were taxable if, and to the extent, the decedent had paid the premiums on such insurance. The amount includible in his taxable estate was a portion of the proceeds based on the proportion of the total premiums that had been paid by him.

Under the 1954 Code, if the decedent has no incidents of ownership at his death, either alone or in conjunction with another person, the proceeds of life insurance are *not* included in his taxable estate, even though he paid the premiums. The incidents of ownership, as under the old law, are not generally defined in the Code, but the new Code *does* expressly provide that a reversionary interest which exceeds 5 per cent of the value of the policy immediately before death is an incident of ownership.

The exclusion, from the taxable estate, of insurance on which

Sec. 2042 the decedent has paid the premiums, offers opportunities for estate planning through the lifetime transfer or relinquishment by a taxpayer to his chosen beneficiary of the incidents of ownership.

There will, of course, be a gift tax on such a transfer. However, the gift tax is at lower rates than the estate tax. The value will approximate the cash surrender value of the policies at the time of the gift. This can result in a considerable tax saving. If the insured person continues to pay the premiums there may be further gift tax, if the amount of premium payment exceeds $3,000 per year, or $6,000 per year in the case of a married person.

Sec. 2053 Estate Tax and Accrued Expenses at Date of Death

This can never "stick"!

Since certain expenses accrued at date of death of a decedent are deductible both for estate tax and estate income tax purposes, it is interesting to note that where the combined tax rates exceed 100 per cent, the higher the accrued expense at date of death (for example, accountant's fees) the greater the net cash saving resulting to the beneficiaries after payment of all taxes and accrued expenses.

Sec. 2512 Gift-Tax Saving Through Treasury Valuation?

And presumably the converse would be true.

From T. T. SHAW: Where a gift is made of property with income for a certain period payable to an individual and the remainder payable to another, the Treasury values the "income" feature of the gift based upon its published valuation tables computed upon a yield of 3½ per cent. Therefore, where a gift is made of property on which the yield is greater than 3½ per cent, for example 6 per cent, and the income is payable for a fairly substantial number of years, the Treasury valuation is considerably less than the actual projected value of the income given, with a resulting saving in gift tax.

PROCEDURE AND ADMINISTRATION (Subtitle F)

Using the Home for Business Purposes

Sec. 6041

From J. S. SEIDMAN: Wherever a home is used primarily for business purposes, so that expenses in connection with it are deducted, it is advisable to fill out a 1099 form covering costs of domestics. The information form is limited to payments made for business purposes. Consistent with the business claim, information returns should be filed. Otherwise, it would be an evidential factor against the claim.

Deficiency Notice in Case of Delinquency Penalty

Sec. 6212

An oversight in Service procedure?

From TROY G. THURSTON: A point of general practice by the Service, the propriety of which seems to be in serious doubt, is the assessment of a penalty under Section 6651(a) of the Revenue Code in cases of delinquent returns, without first sending a notice of such deficiency pursuant to Section 6212(a). If such a notice were sent, the taxpayer would have an opportunity to file a petition with the Tax Court.

The penalty authorized by Section 6651(a) is provided as an addition to the tax shown on the return. It applies only if there is a failure to show reasonable cause and that the delinquency is not due to willful neglect. Such penalty is not included under Section 6213(b) which lists certain exceptions to restrictions on assessments of deficiencies: Section 6659(b) provides as follows:

"(b) Additions to Tax for Failure to File Return or Pay Tax.—Any addition under Section 6651 or Section 6653 to a tax imposed by another subtitle of this title shall be considered a part of such tax for the purpose of applying the provisions of this title relating to the assessment and collection of such tax (includ-

Sec. 6212 ing the provisions of subchapter B of chapter 63, relating to deficiency procedures for income, estate and gift taxes)."

Since the application of the penalty requires a conclusion on the basis of facts about which there can be a dispute, it seems only proper that the taxpayer should be entitled to petition the Tax Court to determine the issue. Otherwise, the taxpayer obtains the benefit of a review by the Tax Court only if the Commissioner determines that there is an increase in the tax liability other than the penalty.

For a recent decision in general agreement with these views, see *Margaret Hackleman* vs. *Granquist*, 147 F. Supp. 826 (Oregon District Court).

Sec. 6405 "Tentative" Refunds Over $100,000 Reviewed After Payment

The Joint Committee refund review requirement is becoming more of an impediment to the speedy administrative disposal of refund cases. Indeed, some practitioners favor court suits in large refund cases to eliminate this stumbling block.

Most practitioners are aware that the 1954 Code includes a section (6405) relating to refunds of over $100,000. If a formal claim for refund is filed on Form 843, such claim cannot be paid until it is reviewed by the Joint Committee. However, this need not delay a *tentative* refund payment resulting from a net operating loss carryback. A claim of this kind, filed on Form 1139, will be processed and paid by the Service just as a smaller claim would be. *After* the refund is made, and after the taxpayer has been examined for the years involved, if the net amount of the refunded tax is still more than $100,000, a report will be made to the Joint Committee.

Sec. 6511 Short Statute of Limitations On Refund Claims

This problem has since been corrected by Section 82 of the 1958 Technical Amendments Act, which brings the refund claim filing period into conformity with the assessment period.

Under the 1939 Code, the statute of limitation on assessments was three years after the return was filed. In the case of refunds, the limitation period was the same except that the allowable refund, where a return was filed, was limited to the amount paid within the three-year period prior to filing the claim. *Sec. 6511*

When the 1954 Code was drafted, the Senate Finance Committee pointed out that this limit on the amount refundable would bar the refund of a tentative tax paid on the original due date of a return which was filed late.

To prevent this, the 1954 Code made the limitation period for refunds start with the required filing date *without regard to any extensions* (Section 6511(a)). The assessment period begins with the actual filing date (but no earlier than the statutory due date). (Sec. 6501(a).)

Thus, commencing with 1954, if a return is filed after the original due date (the reason for such filing is immaterial, although it would usually be because of an extension of time) the three-year refund period and the three-year assessment period do not coincide. The refund period would expire before the assessment period. The three-year period for filing claims commences to run on the original due date whereas the three-year period for assessment of deficiencies commences to run when the return is filed.

The inequity may be even greater where the government requests a taxpayer to voluntarily extend the three-year statute. If the taxpayer agrees to an extension after the three-year period for filing claims has expired, the government has the additional time in which to make assessments of deficiencies, but the taxpayer does not get a similar extension of time to file claims.

To some extent, the above inequities are alleviated by the fact that under Section 6511(a) a taxpayer may file a claim for refund within two years after the payment of a tax. However, under this two-year rule the refund may not exceed the amount of tax paid within the two preceding years. Therefore, a deficiency regardless of when assessed may, in any event, be recovered by the filing of a claim within two years after the time the deficiency is paid. But if the issue upon which the claim is based would produce a refund greater than the deficiency, the refund by law is nonetheless limited to the amount of the deficiency (unless the claim is filed within the three-year period—plus valid extensions thereof—following the original due date of the return).

In view of the two-year period for refunds to a taxpayer, the Code also provides a two-year period during which the government may recover erroneous refunds (see Sections 7405 and 6532).

Sec. 6511 Legislation to correct these problems was introduced in the first session of the Eighty-fifth Congress as part of the Technical Amendments Bill of 1957.

At manuscript date the bill (H.R. 8381) has been passed by the House and reported to the Senate Finance Committee. It was hoped that at least this part of the bill would become law prior to March 15, 1958. Now, however, many practitioners and their clients, whose 1954 returns were filed late, are placed in a difficult position when an extension has been requested after March 15, 1958.

Sec. 6611 Overpayment of Tax Affected by Repeal of Sections 452 and 462

Although Section 83 of the 1958 Technical Amendments Act now generally adopts the "mutual indebtedness" theory for computing interest on coexisting overpayments and deficiencies, it doesn't appear to alleviate this particular inequity.

In a recent case, a calendar year corporation paid its 1954 tax on June 15, 1955, but because of the repeal of Sections 452 and 462, a subsequent deficiency was paid on December 15, 1955. Although it was determined on an examination of the corporation's return that there was actually an overpayment of tax for that year (unrelated to Sections 452 or 462 items) the revenue agent would allow interest on the overpayment only from December 15, 1955 rather than from the date of the overpayment of the tax, June 15, 1955.

Correspondence with the Service in Washington supported this action on the following grounds.

Any increase in the tax liability arising from the repeal of Sections 452 and 462 of the 1954 Code was due on the due date of the return. Form 2175 was an information statement showing the effect of the repeal and the increase in tax liability attributable thereto. The increase was not a deficiency and no interest was collectible if the increase was paid on or before December 15, 1955. The overpayment, therefore, did not exist prior to payment of the increased liability resulting from repeal of Sections 452 and 462. There can be no overpayment until all of the liability is satisfied. Accordingly, interest is allowable from the date of payment of the first amount which is in excess of the liability.

It would seem that the Service's view may be contrary to the intent of Congress that the repeal of Sections 452 and 462 should not result in interest penalties.

Basing Estimated Tax on Prior Year Not Foolproof

GORDON S. MOORE, CPA, Arthur Young & Company, Houston, Texas, cautions that a declaration of estimated tax that is based upon the tax or income shown by the return for the preceding year is not completely free of penalty hazards if the amount to be paid includes an estimate of income tax to be withheld from wages during the ensuing year.

In connection with penalties, Code Section 6654(e) specifies that (1) the estimated tax shall be computed without any reduction for the amount which the individual estimates will be withheld from his wages and (2) the amount which is actually withheld shall be deemed a payment of estimated tax.

The exceptions provided by Code Section 6654(d)(1)(A) or (B) depend upon installment payments actually having been made which equal or exceed (1) the tax shown on the return for the preceding year or (2) an amount equal to the tax computed at current rates and on the basis of the taxpayer's current exemption status but otherwise on the basis of the facts shown in the return for the preceding year.

Thus, if the actual withholding falls below the estimate, a declaration thought to be "safe" because of the exception contained in Section 6654(d)(1)(A) or (B) may not protect the taxpayer from the underpayment penalty.

Loophole in Estimated Tax Provision

(From the American Institute's 1955 Annual Meeting.)

An employed taxpayer files his 1955 declaration in April, showing an estimated tax of substantially less than 70 per cent of his anticipated tax. He pays installments on that basis.

Later in the year he makes an arrangement with his employer whereby the latter deducts from the taxpayer's salary for the balance of the year and remits to the Service substantially greater amounts of withholding tax. Thus, by year's end the aggregate tax paid, directly and through withholding, is *greater* than 70 per cent.

Sec. 6654 Query: Any penalty for underestimating or failure to pay installments of estimated tax?

Consensus: No. There is a loophole here for the taxpayer—a presumption that the withholding payments are spread evenly over the taxable year.

Proper Planning of Individual's Estimated Tax to Avoid Penalties

Note: The agreement providing for additional withholding should be in writing (Reg. Sec. 31.3402(i)-1).

From T. T. SHAW: 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, approximates 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 substantially 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 an agreement. Therefore, proper planning of estimated withholding tax *before* the end of the year can serve to eliminate penalties for underpayment of estimated tax for each installment period.

Sec. 6655 Is Form 2220 Defective for Computation of Tax Penalty?

While the Service has made no official pronouncement, it is understood that the second exception is considered valid despite the omission on Form 2220.

THEODORE K. WARNER, JR., Director of Taxation, the Pennsylvania

Railroad Company, remarks that it is strange and possibly misleading that only two exceptions have been set forth on Form 2220, which is used for the purpose of computing exceptions to the penalties for the underestimation of corporation income tax. *Sec. 6655*

Section 6655 provides *three* exceptions, of which the Form covers only: (1) the tax for the prior year if the return showed a liability for tax, and (3) placing the income on an annualized basis. There has been omitted the second exception by which the taxpayer can avoid liability if the computation is based upon the facts shown on the prior year's return.

If there was a loss for the preceding year and, therefore, no tax was paid, the taxpayer cannot use exception Number (1) (since there was no tax liability), but it certainly seems that exception Number (2) (based on the previous year's facts) is available. Despite the seemingly plain wording of Section 6655(d)(2), this problem has caused concern to many taxpayers because of the failure to make any reference to this "escape hatch" on last year's corporate estimated tax return.

Such taxpayers may set their minds at ease. It is the position of the Service that taxpayers may rely upon this provision and escape penalties for underpayment of estimated tax, even though the return for the preceding year showed no tax liability. It was noted, however, that this result would not obtain in the case of a net operating loss *carryback* which was used to wipe out the preceding year's tax liability, since in such case the *return* for the preceding year would have disclosed a tax liability.

Compromise of Tax Liabilities By the Commissioner

Sec. 7122

What to expect when a client simply cannot pay a tax liability.

What happens when a taxpayer can't pay? Is it possible to effect a compromise settlement of the liability?

Our thanks to Ernest D. Loewenwarter, CPA, of New York City, for casting light on a subject which has been so scurrilously discussed by some newspaper columnists.

Code Section 7122 contains the statutory authority for the compromise of tax cases. Practically speaking, however, the Commissioner's present position appears to make this provision virtually inoperative except in extreme circumstances. His position is based on a long-standing opinion of the Attorney General to the effect that "where liability has been established by a valid judgment or is certain, and there is no doubt as to the ability of the government to collect, there is no room for 'mutual concessions' and therefore no basis for a compromise."

With this dictum before him there is small wonder that the compromise of an unpaid tax for a lesser amount is virtually impossible unless the taxpayer is over 65 years of age and there is no possibility of collection. If the taxpayer is young and healthy, the government will enforce payment out of any presently available assets, and will insist upon an agreement to turn over all future earnings in excess of essential living requirements until the liability is discharged.

The Attorney General has gone further, in stating that "there appears to be no statutory authority to compromise solely upon the ground that a hard case is presented which excites sympathy or is merely appealing from the standpoint of equity."

But despite all these very clear statements of the official position, Mr. Loewenwarter observes that there seems to be an underlying desire to recognize and deal practically with an impossible situation. To the extent that there is any amelioration of the "tough attitude," it comes into play where the ability of the government to collect is not clear.

For example, agreements have been accepted in which the taking of all earnings in excess of living requirements has been expanded to allow the taxpayer to retain, in addition to the minimum earnings, a sum sufficient to pay the current income taxes thereon. Also it is not infrequent that an estimate may be made of the time required to liquidate the tax liability, and if, for example, a ten-year estimate was determined, the government has accepted an agreement limiting the payment of excess earnings to that period. The advantage to the taxpayer lies in the cancellation of any portion of the tax liability unpaid at the end of the ten-year period. Naturally, the agreement terminates if the tax liability is paid in full before expiration of the ten years. It is quite common to obtain consent to a discontinuance of further interest accumulations during the agreement periods.

It is quite clear that interest and penalties may not be considered separately in a compromise offer because they are held to be as "certain as the taxes on which they are based." Nevertheless, the accumulation of an inordinately large amount of penalties and interest, where some extenuating circumstances prevail, has been taken into account in reaching an agreement with the taxpayer. *Sec. 7122*

Exposure of Client In Fraud Cases

Sec. 7201

When fraud is inferred, have the client engage a lawyer.

Murray L. Rachlin, CPA, New York, N.Y., cautions accountants against inadvertently "sending their clients up the river" in cases where fraud is about to be asserted by the Treasury.

Because a net worth statement may constitute a "confession," Mr. Rachlin believes that accountants should be wary of submitting such financial data and background to Service representatives when a fraud charge is threatened.

As a matter of fact, the accountant's knowledge of his client's financial matters is not "privileged." Therefore, where the accountant has valid reason to suspect his client of fraud or where fraud is asserted by the Treasury, the most valuable service which he can render his client is to recommend to him the immediate retention of legal counsel!

Right to Subpoena Accountant's Work Papers in Fraud Cases

Sec. 7602

Of particular interest to CPAs.

David G. Housman, CPA, Albuquerque, New Mexico, furnishes the following analysis which is of particular interest to accountants.

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 to 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 Commissioner unfettered power to examine the work papers of the accountant concerning a taxpayer being investigated for fraud is *Falsone* v. *Comm'r,* 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 recent holding in the case of *Application of J. M. House,* 144 F. Supp. 95, in which the judge 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. Whether this holding will stand on appeal is extremely questionable in the light of the holding in the case of *Gariepy* v. *United States* (189 F.2d 459 (4th Cir. 1951)) to the effect that even if the accountant were in the employ of an attorney, the privileged status would be denied.

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.

MISCELLANY

The Need for Uniformity in State Income Tax Acts

Perhaps a special American Institute committee could help to achieve state tax "Utopia."

JOHN E. HAMILTON, CPA, A. M. Pullen & Company, Richmond, Virginia, decries the growing nuisance resulting from the imposition of multi-type income taxes by the various states.

Mr. Hamilton notes that our changing economy has resulted in many businesses which formerly were small now finding themselves extended over two or more state lines. Practically every state levies some form of income tax on business which is transacted within the limits of its territory.

Although the taxes are called by many different names, they are mostly taxes upon income. The definition of "business done" within a state varies from state to state. Most states provide formulas for apportioning income between the different states. The methods of computing net income and apportioning net income taxable within each state exhibit an utter lack of uniformity. Finally, the problems caused by some state income tax laws where the accrued federal income tax is deductible in the state return is very vexing. This is particularly true where there are bonus arrangements or profit-sharing plans which are based upon the net profits which remain after income taxes.

Mr. Hamilton suggests that a campaign through the various state societies to educate legislatures towards simplification and uniformity in the various state income tax acts should be a worthwhile project. Indeed, perhaps an American Institute committee might be organized and assigned the project of campaigning for the eventual realization of uniform state income taxes!

Tax Court Not Bound By Court of Appeals

This is not the last word on this problem.

The Tax Court recently considered in *Lawrence,* 27 T.C. 713, January 25, 1957, the very important question of whether it is bound by a decision of the Court of Appeals. It has always seemed clear that while the Tax Court must give great weight to a decision of the Court of Appeals, it is not bound by that decision where the particular case would go on appeal to another circuit. The more difficult question in the *Lawrence* case, however, was whether the Tax Court is bound by a prior decision of the same Court of Appeals to which the case under consideration would be appealed.

The Tax Court, in a very well-reasoned opinion in the *Lawrence* case, unanimously held that it is not bound by a prior decision of the Court of Appeals even where the case on appeal would go to the same circuit. The Court pointed out that it has national jurisdiction rather than a jurisdiction limited only to a particular part of the country. It stressed the confusion that could follow, for example, where it was considering cases involving several partners or several stockholders each of whom lived in a different circuit. If the Tax Court were bound by prior decisions of the Court of Appeals, it might have to render different decisions on the same point respecting the several partners or stockholders. The Tax Court accordingly held in the *Lawrence* case that while, of course, it must carefully reconsider its own prior opinion in light of a subsequent reversal by the Court of Appeals, it nevertheless must decide itself in the subsequent case whether to adhere to its original views or to accept those of the Court of Appeals.

It will be important to watch whether the Court of Appeals, and perhaps the Supreme Court, sustains the Tax Court in its views. The answer to this problem may well have a bearing in many cases on deciding whether a tax controversy should be litigated in the Tax Court or in the District Court of Claims.

Tax Principles We Don't Live By

A philosophy of taxation to which the Editor heartily subscribes.

Aside from their preoccupation with the technical provisions of the tax law, tax men have been known to have rather definite views on fundamental features of the tax structure—such as the precipitous graduation in individual tax rates.

For example: Should income in excess of $16,000 of a single person or in excess of $32,000 of a married couple be subject to a 50 per cent tax rate? Can a 91 per cent rate ever be justified rationally?

Here are one tax man's views on a sharply graduated income tax in substantially his own words:

"Unless it is desirable to inhibit the initiative and drive which have attended the course of American individualism, it is a mistake to discourage these things by confiscatory income taxes. Foreign opinion to the contrary, few Americans work solely for profits. Business is their game, and they play it mostly for the game's sake. The dollars are the score with which the count is kept and, unless in the case of the congenital hog, it is as such that they are prized. If, while the game is on, the government sweeps the table of a share of the counters that the player deems unfair, his interest in the play abates and he is likely to yield it in anger and disgust. Hence a sharply graduated income tax is a social mistake."

The tax man was Wm. Bingham Kay of Philadelphia, who died in 1948. He cited the above principles in 1935 when the highest bracket rate was only 63 per cent and when the 50 per cent rate did not obtain until about the $90,000 income bracket.

It is probably too late to heed Mr. Kay's philosophy—or is it?

New Powers of Attorney by Revoking Existing Powers

A change in Treasury procedure.

From Leslie Mills, CPA, Price Waterhouse & Co., New York, N.Y.: Where the taxpayer wishes to designate an attorney or agent to represent him before the Treasury Department, and where previous powers of attorney had been granted which were either general powers or limited powers covering the same matters, taxpayers were often granted "additional" powers of attorney. These were the usual powers of attorney containing the statement that the power was in addition to any other powers already on file.

Apparently the Internal Revenue Service now objects to this procedure and will require that any powers of attorney now submitted contain the statement that all other powers previously filed are revoked. Henceforth it will be necessary to submit an entirely new power of attorney naming not only those persons desired to be brought into the power but also any persons named on existing powers where those persons are desired to be continued on the power. In addition, it will be necessary to notify those persons on previous powers of the revocation of the existing powers.

Postponing Elections May Be Hazardous

(From Tax Executives Institute's 1957 Annual Conference.)

In a number of instances proposed regulations under the 1954 Code provide for the making of an election to do or not to do an act on the part of the taxpayer. Rather than make the elections under the proposed regulations, many taxpayers are postponing action in this respect until the final regulations are promulgated. Such taxpayers are warned that there is no power in the Commissioner or in the regulations to suspend the statute of limitations by reason of failure to issue final regulations, and that, where necessary, taxpayers should take the necessary steps to prevent the statute from running on the year or years involved.

Concerning Rulings

(From Tax Executives Institute's 1957 Annual Conference.)

Questions have been raised concerning the impossibility of a taxpayer obtaining a ruling after an audit has been commenced.

It was stated by Service representatives at a recent Tax Institute conference that in general when the audit has been commenced the case is in the hands of the field agents and it is not the policy of the National Office to intervene. However, in cases where proposed action by the agent may be at variance with the policy in other field offices or with national policy, it was stated that there is now under study a formal certiorari proceeding to the National Office where a conflict exists in the field or where the action of a District Director is contrary to the national division's policy. At present it is possible to obtain certiorari only under Section 401 ruling to exempt trusts.

Many taxpayers have complained of their inability to find out what advice has been given to an agent when the agent asks for technical advice. It was pointed out that the taxpayer is entitled to file a brief and may come to Washington for a hearing but is not entitled to be told at that hearing what the decision will be. A Service representative stated that after the decision has been given to the District Director there is no reason why the taxpayer should not be informed of the reasons underlying the decision of the National Office, but that in some cases the National Office fails to give its reasons to the District Director.

A question was raised as to whether or not a taxpayer is entitled to rely upon a ruling given him in the face of a subsequent adverse court decision. The Service man stated that in general a taxpayer could rely upon a ruling pretty much as though it were a closing agreement. He further explained, however, that a published ruling or Revenue Procedure, which is contrary to a private ruling, would *ipso facto* revoke any contrary private ruling.

Another Service representative stated that where a ruling is changed or revoked it is not the practice of the Service to apply the revocation retroactively if: (1) the taxpayer has acted in good faith and (2) retroactive applicability would be detrimental to the taxpayer. In this regard, he pointed out that the *Michigan Auto Club* case was not applied retroactively prior to the date of the ruling revoking its exempt status.

CPAs Should Consider Possible Litigation Aspects of Their Work

Some CPAs learn these things by sad experience. Others take heed!

From JEROME C. BACHRACH: When dealing with books and tax returns CPAs should not forget that the exact wording of the entries they place on these records might become highly significant if the client's tax liability for the year concerned is ever litigated. Despite the well-known doctrine that book entries are not conclusive of the facts they purport to represent, it is sometimes dismaying how persuasive they tend to be when opposed to a taxpayer's later position.

For example, consider a partnership which is being incorporated. The tax results may be quite different depending upon whether it is the partnership entity which first transfers its assets to the new corporation and thereafter dissolves, or whether the partnership dissolves first and the partners as individuals thereafter transfer its assets to the new company. If the first situation is the one giving the better tax answer, opening entries on the corporation's books should certainly not show issues of its stock directly to the individuals. True, this is the substance of what has happened, as well as perhaps the most convenient way to record the transaction. But after a challenge is issued by the government form may also become important.

For a second example, assume a corporation is retiring a substantial amount of its outstanding stock. On its balance sheet you may quite properly wish to reduce capital and surplus by the cost of the treasury shares. However, similar treatment on Schedule L of the corporation's federal income tax return, Form 1120, may become an annoying handicap if the government should allege that the price paid was in effect a dividend to the remaining shareholders. Such treatment is inconsistent with the argument that the treasury stock constituted a valuable asset to the corporation, one available for resale if needed to raise additional capital. Furthermore, the reduction in net worth must be shown in Schedule M where it cries for further attention by a revenue agent.

Even a small point like entering "Part" or "All" in the column on the schedule of officers' salaries which calls for the amount of time spent by an officer in the company's business can be the source of embarrassment. Frequently "full time" is unthinkingly inserted for practically any officer in the thought that this helps support his salary. Government lawyers have a field day with this type of entry when it develops in cross-examination that the officer testifying in justification of his salary has other business interests to which he also devotes some time. The officer may then be asked whether it is his signature on the return, whether he usually reads what he signs, why the "sworn" statement that he put in his full time is incorrect, etc., etc.

Of course, corporate officers should not be expected to be personally familiar with all the intricacies of the tax returns they sign. Proper explanations to your client before going on the witness stand will enable him to handle this type of cross-examination with equanimity. He should clearly understand that he is not expected to be an expert accountant and that he may properly testify that while he generally reviews tax returns before signing, he fully relies upon his certified public accountants as to the technical matters in them.

Nevertheless, to the extent feasible, entries on returns and in books should be considered from the point of view of possible litigation. When doubtful treatment of an important amount is involved the client's lawyers might well be consulted in advance.

INTERNAL REVENUE SERVICE: ORGANIZATION AND PERSONNEL

IRS Tax Rulings Division

Should be extremely helpful to CPAs in obtaining rulings pinning down tax effects of transactions. Personnel named are as of June 1, 1958.

It's difficult to give clients tax advice concerning proposed transactions where the applicable tax law is not clearly established. Such advice usually requires a recommendation as to the course of action the client should take. Though it may be hedged with warnings and disavowals, the responsibility for such a recommendation can never be taken lightly. Every possible insurance against disastrous tax effects must be sought by the tax adviser.

The CPA generally has a dual concern, a double responsibility, in advising his client concerning the tax effects of a proposed transaction. He is, of course, concerned that the transaction create a minimum tax liability, or at least that his client will have a fair or reasonable "tax break" without incurring the risk or expense of litigation. That's a responsibility of all tax advisers.

However, the CPA is additionally concerned because of his responsibility for the accuracy of the provision for taxes in the client's financial statements. A mistake in judgment, and the client not only is in tax trouble, but his financial statements are wrong!

Sometimes the risk of litigation can be minimized or eliminated, and the amount of tax liability pinned down by obtaining an advance ruling from the Internal Revenue Service before the proposed transaction is consummated. In fact, a "vulnerable" feature or a "bug" in an otherwise acceptable transaction can often be modified while the application is under consideration. Service personnel will frequently suggest these modifications or changes themselves, so that a favorable ruling may be issued.

Because the practice of obtaining rulings from the Service is of inestimable value to business clients of CPAs, it is here heartily encouraged. To help familiarize practitioners with the Service people they will encounter in the course of obtaining rulings on proposed transactions, we will discuss them on the following pages.

Rulings on proposed transactions, or on certain consummated transactions prior to filing of the pertinent return, are handled by the National Office of the Internal Revenue Service in Washington, D.C. These rulings should not be confused with "determination letters" issued by District Directors with respect to tax effects clearly established by the tax law.

Chain of Responsibility

The chain of responsibility in the issuance of a ruling by the National Office is as follows: Commissioner, Russell C. Harrington; Assistant Commissioner, Technical, Justin F. Winkle; Director of Tax Rulings Division, Harold T. Swartz.

There are two Assistant Directors who, like Mr. Swartz, must be technicians of the highest ability. At the present time, Dan J. Ferris is one of the Assistant Directors, and the other is Eugene G. Parker. In addition to the two Assistant Directors, Mr. Swartz has in his own office three very able technical advisors who review the thousands of assignments which are carried out by the Rulings Division. These extremely capable technical advisors are Clarence N. Thurston, David T. Deutsch, and Arthur Singer.

There are eight Branches in the Tax Rulings Division. They are: Corporation Tax; Employment Tax; Estate and Gift Tax; Excise Tax; Individual Income Tax; Exempt Organizations; Pension Trust; and Reorganization and Dividend.

Proper Subjects for Ruling

Two general types of transactions are proper subjects for ruling: (1) a proposed transaction, one that is not yet consummated; and (2) a completed transaction which is to be reported in a tax return not yet filed, and where no identical issue is involved in a prior return of the same taxpayer.

Let's consider a type of question that might be within the jurisdiction of the Corporation Tax Branch, what will happen to it, and whom we're apt to run into during consideration of the problem. Such a question could concern the interpretation of an abstruse provision of the "collapsible corporation" tax regulations.

Our request for ruling, which is required to be accompanied by a power of attorney authorizing us to represent the taxpayer, sets forth the basic problem in the first paragraph. Thus, it can easily be routed to the person specializing in the subject.

Our letter will be routed quickly to Theodore Edelschein, Chief of the Corporation Tax Branch, who is a member of the bar of the District of Columbia and has had long and varied experience in the Service. He is fully capable of answering the letter himself. However, since he must review many rulings, and arbitrate those cases in which particularly close issues are involved, he assigns the case to Arnold J. Levine, who specializes in "collapsible corporation" problems.

The problem is thoroughly considered by Mr. Levine. If he requires further information before resolving the question, he will request it from us. He will also afford us an opportunity to discuss the question personally, if we so desire. In any event, the forthcoming ruling will represent a carefully considered and impartial interpretation of the tax law by some of the best tax minds in the country in that particular tax area.

The ruling procedure is a most satisfactory procedure. If a ruling on a proposed transaction is unfavorable, the transaction need not be consummated; or a request for ruling may be withdrawn, which will prevent an unfavorable ruling from being issued.

If it's favorable, it's generally as good as money in the bank. It will be scrupulously honored by the examining revenue agent a year afterwards—or ten years afterwards—if the ruling was based on an accurate statement of facts, and the transaction was carried out substantially as proposed. Although technically it may do so, the Internal Revenue Service almost *never* reneges on a ruling!

Individual Income Tax Branch of IRS Tax Rulings Division

Personnel named are as of June 1, 1958.

The many advantages a corporation enjoys by obtaining an advance ruling pinning down the tax effects of a proposed transaction have been discussed above.

While lesser amounts are usually at stake in the case of *non*corporate taxpayers, these advantages are equally important to them. Rulings on noncorporate tax questions, such as individual, estate, trust, and partnership problems, are issued by the Individual Income Tax Branch of the Tax Rulings Division. Mr. Harold T. Swartz is Director of this Division.

Like other branches in the Rulings Division, the Individual Income Tax Branch also renders technical advice to Service representatives in the field who require assistance involving the review of an item concerning an individual, estate, trust, or partnership. And it is responsible for conducting technical reviews of material contained in the many educational programs which are conducted by the Internal Revenue Service on a nationwide scale. Among these are the high school training course and the booklet entitled *Your Federal Income Tax.*

The Chief of the Individual Income Tax Branch is Mr. Lester W. Utter. Mr. Utter is a certified public accountant and has had long and varied experience within the Internal Revenue Service, including a period of service as a revenue agent.

Mr. Utter has two very capable principal technical assistants. They make technical reviews of the rulings which are prepared by the technicians within the five sections which constitute the Branch. One of the assistants is Miss Kate Barkdull, who is recognized throughout the nation as an authority upon the taxation of estates, trusts, and partnerships. The other assistant is Mr. Jules F. Addor, who also has had extensive experience both in Washington and in the field, having been formerly the Assistant District Commissioner (Audit) in Baltimore, Maryland. Both Miss Barkdull and Mr. Addor are attorneys admitted to practice before the Supreme Court.

The Branch is divided into five sections, each of which is responsible for certain sections of the Code. In spite of this division of responsibility among the sections, each section chief maintains a high level of familiarity with the problems involved in the other sections. Thus, in the event of emergency, a section chief can function in any of the sections within the Branch.

Mr. Robert Pratesi is Chief of Section 1, which handles generally questions relating to income, such as room and board allowances and long-term compensation. Mrs. Esther A. Critchfield is Chief of Section 2, which is responsible *inter alia* for exclusions, capital gains, and accounting methods. Miss Ruth F. Wilson is Chief of Section 3, which handles deductions, casualty losses, contributions, business expenses, and operating and capital loss carryovers and carrybacks. Section 4, which deals with questions involving estates, trusts, and partnerships, is headed by Mr. J. Donald Latimer. Problems involving nonresident citizens, resident and nonresident aliens, foreign tax treaties and credits, filing requirements, personal exemptions, the statute of limitations, penal-

ty provisions, and *information returns* are dealt with in Section 5, whose Chief is Mr. A. C. Gasperow.

The effect which the enactment of the 1954 Code has had upon the entire Internal Revenue Service has been most keenly felt in this Branch. Because of the existence in the new Code of many provisions relating to individuals for which there was no counterpart in the past, thousands of individual taxpayers have addressed inquiries to the Service concerning a particular section. The personnel of the Branch accordingly have been required to work long hours in order to consider as quickly as possible the many applications for ruling, requests for technical advice, and thousands of informal inquiries which have been received.

Taxpayers or practitioners who consult the Individual Income Tax Branch of course do not always obtain the answer which they prefer. However, anyone who has had occasion to deal with its personnel knows that he has been dealing with capable, experienced technicians and that his particular question has received adequate and fair consideration.

Reorganization and Dividend Branch of IRS Tax Rulings Division

Personnel named are as of June 1, 1958.

When a purportedly tax-free reorganization later backfires, the tax consequences can be disastrous. However, there is little excuse for such a calamity in view of the avenues that exist for obtaining advance Service approval of practically every type of corporate transfer, exchange, or distribution.

The Chief of the Reorganization Branch is Mrs. Frances B. Rapp, who is widely known and respected by the many taxpayers and their representatives who have presented cases before her. Anyone who has ever dealt with Mrs. Rapp on a reorganization or dividend matter is greatly impressed by her ability to analyze transactions and to apply the thousands of precedents with which she has dealt for many years. She probably has as complete a command of the reorganization provisions of the 1954 Code as any individual in the country—and this knowledge, combined with the experience which she has gained in over twenty years in the Reorganization and Dividend Branch, makes her fully capable of fulfilling the tremendous responsibilities which rest in this Branch.

On the staff of this Branch are a number of technical assistants who are well trained, able and cooperative. One of the most outstanding is Mr. Glen Paschall who, as one of the principal assistants, acts as Chief of Branch in Mrs. Rapp's absence. He is a lawyer and an accountant and his demonstrated knowledge of Subchapter C and related sections of the Code, together with his sensitiveness to taxpayers' problems, has won him the respect of taxpayers and tax practitioners throughout the country.

The Reorganization and Dividend Branch performs an important internal function in giving technical advice to personnel in the District Directors' offices. However, its most important function from the taxpayers' point of view is that of issuing important letters relative to the tax consequences of proposed transactions.

Even in transactions which appear with some degree of certainty to be nontaxable, it is often advisable to obtain a ruling. First, it saves the Internal Revenue agent time in his examination, since he is required to determine only if the facts on which the ruling was based were properly presented to the Internal Revenue Service in the application. Second, even if a transaction is in fact nontaxable, it may still be questioned and it often requires a great expenditure of time to satisfy a doubting official, which is understandable in view of the complexity of this portion of the Code. Finally, both the tax adviser and the taxpayer will gain a certain sense of security from having a favorable ruling safely in hand. It's a nice feeling!

As the name of the Branch implies, questions concerning the taxability of dividends and the make-up of earnings and profits for dividend purposes are also within its purview.

IRS Technical Planning Division

Personnel named are as of June 1, 1958.

There could be no more fitting place for the next stop in our quick tour through the National Office of the Internal Revenue Service than the Technical Planning Division. Technical Planning, under Assistant Commissioner, Technical, Mr. Justin F. Winkle, has the primary responsibility for the preparation of regulations under the Code. To appreciate the extreme pressure under which the Division has been operating for almost four years, one has only to call to mind the tremendous number of changes effected by the Internal Revenue Code of 1954, together with those Code sections which, though not changed materially, are being studied with a view to simplifying and clarifying their regulations. In addition, Congress has made a substantial number of amendments to the 1954 Code since its enactment. Each of these amendments has caused additional work for this Division in preparing reports, taxpayers' information releases, and regulations.

The Division also carries out the Commissioner's responsibility as regards recommending legislation, technical content of tax return forms, and certain other Service forms used by the public. The Division's recommendations concerning legislation are transmitted through the Chief Counsel's Office to the Secretary of the Treasury. All questions of a legal nature whether involving forms, regulations, or other technical matters, are co-ordinated by Technical Planning with the Chief Counsel's Office. This Division does not handle questions involving alcohol or tobacco tax.

Another important function of the Division is that of consultation with professional groups which are vitally interested in the revenue laws. Thus, co-ordination and discussions of appropriate items with the American Institute of Certified Public Accountants, the American Bar Association, the American Bankers Association, Tax Executives Institute, and similar organizations are handled by Technical Planning.

One other responsibility of the Division may be of particular interest to our readers. It has always been difficult for the national office to place itself in a position close enough to the "grass roots" of tax problems. Naturally, it is desirable for Washington personnel to be promptly advised of the ideas of, and problems faced by, its field service. Of great importance, for example, are revenue agents' opinions on the technical content and adequacy of tax return forms as well as the regulations prescribed for the administration of the revenue laws. The Technical Planning Division has a link with each of the regional and district offices through a technical co-ordinator who has the training and experience required to "take a reading" of the field services' ideas upon any tax problem on very short notice.

Mr. John W. S. Littleton, an accountant, is the Director of the Division. He is extremely capable and has the background of many years of experience, which are particularly desirable in this position. After an early career in both accounting and the technical aspects of business, he joined the Service in 1942 as a Deputy Collector. His fine Service background includes experience as an instructor in income tax law in the Training Division, as a conferee in the old Income Tax Unit, as a member of the Forms Committee, and as Chief Analyst of the Analysis and Planning Staff, which was created in the reorganization of the Service in 1951. He was later Chief of the Technical Analysis Branch of the Technical Planning Division, and immediately before his present assignment he was Assistant Director of the Division.

His Assistant is Mr. Maurice Lewis, who, like Mr. Littleton, has had varied experience which serves him in good stead in his present position. He joined the Treasury Department's Tax Research Division (predecessor of the present Tax Division, Analysis Staff) in 1943 and later became an accountant and auditor in the Audit Division of the Internal Revenue Service. He gained further experience in the Practice and Procedures Division of the Service, after which he transferred to the Analysis and Planning Staff, which became the Technical Planning Division.

Any taxpayer or practitioner who has had occasion to discuss his problems with the Technical Planning Division knows that these individuals are very competent and are working constantly to fulfill promptly and fairly the many difficult responsibilities of the Division. We regret that limitations of space prevent our setting forth each one's detailed biography.

The division is organized into four Branches: Programming, under Mr. Paul T. Maginnis; Income Tax, under Mr. Erskine H. Hatfield; Wage and Excise Tax, under Mr. P. Henry Needham; and Mr. John F. McGuire, Forms and Instructions.

These skilled and capable leaders are assisted by the following supervisory personnel whose outstanding ability and long and varied experience in the Service makes them highly qualified to handle the exacting work of the Division: Programming Branch, Charles E. Mercogliano, Assistant Chief; Robert S. Cooper, Liaison; George L. Dickerman, Legislation; Bernard L. Payne, Regulations; and James N. Kinsel, Forms. Income Tax Branch: Mr. Linder Hamblen, Assistant Chief; Ruhl L. Cooper, Administrative Provisions; Henry B. Jordan and Eugene A. Ross, Substantive Income Tax Law. Wage and Excise Branch: Howard W. Lehman, Assistant Chief. Forms and Instructions Branch: Robert W. Connelly, Assistant Chief.

IRS Engineering and Valuation Branch

Friends of Ralph Staebner will view with mixed emotions his recent retirement. They will undoubtedly be pleased that he has reached the point where he can take life easier, but they will miss his wealth of knowledge and his careful consideration of their cases. We are pleased to report that Mr. Darrell Parker has been appointed chief of Engineering and Valuation Branch to succeed Mr. Staebner. Mr. J. R. Thomas will succeed Mr. Parker.

We regret to report that Mike Cairns who was formerly chief of the Public Utilities Section passed away in July. His successor had not been appointed at publication date. Other personnel named are as of June 1, 1958.

There are four separate sections in this Branch, all supervised and co-ordinated by Darrell S. Parker, who recently succeeded Ralph S. Staebner. The sections and their chiefs are: Appraisal Section, J. R. Thomas, succeeding Darrell S. Parker; Court Defense Section, Amos T. Pagter; Natural Resources Section, Delbert W. Williams; Public Utilities Section, the successor to Michael J. Cairns was not yet appointed at publication date.

Because the work performed is highly specialized, the efforts of a versatile type of individual—a sort of engineer-lawyer-accountant —is needed to produce the desired results.

But, although the job demands an engineering background, the most proficient engineer could not perform the required duties without a general understanding of most of the tax law, and an exhaustive knowledge of the portions of the law most frequently dealt with.

The Branch issues rulings directly to taxpayers on engineering questions. If such rulings also involve questions of law, set a precedent, or establish a new or different IRS policy, they are also reviewed by the Tax Rulings Division. This is not necessarily the case with rulings that simply reiterate an established policy or apply such a policy to new facts.

Engineering and valuation services are also furnished to field personnel. A particular question may be considered in the National Office and "technical advice" furnished, or an engineer may be dispatched from Washington to assist the District Director in his consideration of the matter.

Specialized types of problems are handled by each of the four sections.

The Appraisal Section, now under Mr. Thomas, answers all engineering and valuation questions falling in categories *other* than public utilities or natural resources. For example, this Section has jurisdiction over questions involving the value of property included in an estate tax or gift tax return. Problems frequently before this Section concern the value of unlisted stock (that of a closely held corporation) and basis for depreciation, which usually involves the useful life of an asset and its resultant depreciation rate.

The Court Defense Section assembles valuation and engineering data for presentation as evidence before the courts in particular federal tax cases. Its members, in close co-operation with the government attorney in charge of trying the case before the particular court, may also act as expert witnesses or, where necessary, engage outside experts to testify. They also assist in the preparation of stipulations and make recommendations to the Chief Counsel's office concerning settlement offers.

The Natural Resources Section is principally concerned with depletion problems, particularly percentage depletion. For example, what is "gross income from mining" and, consequently, what are "ordinary treatment processes," in the case of many minerals and ores? Natural deposits must also be classified to determine what depletion rate is applicable to the particular mineral or ore extracted therefrom. To make such determinations it is necessary to have not only a background of mining engineering but also a knowledge of chemistry and metallurgy.

The capable individuals in the Public Utilities Section are called upon to rule for a taxpayer, or to give advice to an Internal Revenue Service official, on all valuation, depreciation and other engineering questions concerning public utilities, including railroads. The year of deductibility of loss from abandonment or obsolescence of electric lines, generators or similar property would be typical of the problems considered here, and timber questions and pulp and paper matters are also handled.

In dealing with the Engineering and Valuation Branch, one gains the pleasant impression of ease and informality, which may be attributable to the nature of the problems. They are tangible, not abstract, and require a practical, down-to-earth, pipe-smoking type of approach.

More likely, however, it's due to the broad backgrounds of the versatile personnel.