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Working with the Revenue code in 1956

James J. Mahon Jr.

Working With the Revenue Code in 1956

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Edited by
James J. Mahon, Jr., CPA
Lybrand, Ross Bros. & Montgomery

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

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INTERNAL REVENUE SERVICE: ORGANIZATION AND PERSONNEL

INTRODUCTION

Almost two years have gone by since the 1954 Internal Revenue Code became the tax law of the land. Accounting practitioners and businessmen have now had a good opportunity to see how the Code works. They have learned how to handle problems that arise in actual practice. They have cleared up many of the controversial and questionable points that have turned up in the Code. And they have developed effective tax planning procedures within its framework.

Working with the Revenue Code in 1956 brings you some of their important and valuable experiences.

Readers of THE JOURNAL OF ACCOUNTANCY will recognize that the book is based on material which originally appeared in the magazine's "Tax Clinic." That column has always been a clearing house of practical ideas rather than a report on current tax developments. In it, seasoned practitioners and accounting executives discuss their experiences with the Code and tell how they have handled specific tax questions. The material therefore has a certain lasting value and interest. Presented as it is in this book, it should be useful as a continuing source of reference.

Working with the Revenue Code in 1956 is a much expanded, up-to-date version of an earlier collection published last year which was excellently received by professional accountants and businessmen alike. The present volume is based on all "Tax Clinic" material published since July 1954.

A review of the original "Tax Clinic" material revealed that some items are now *passé* or of merely routine interest. They have not been included in the book. A number of items were found to need revision because of subsequent developments. They have been brought up to date. In addition, a current (July 1956) commentary has been provided in italics with many of the items.

To increase the book's usefulness as a reference, the material has been arranged in Code 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 such sections in the table of contents.

It should be pointed out that this modest volume is not intended to take the place of the many exhaustive tax services now available. At the same time, it has a definite place in the tax library. It is always important for practitioners and business executives to know how others have been solving tax problems under the new law. For this reason, users of the book will find that they can refer to it time and again for guidance in their tax work. And they will be able to compare their own interpretations and techniques with those of leading practitioners.

None of this —neither the monthly columns of "The Tax Clinic" nor this book which has grown out of them—would be possible without the generous co-operation of hundreds of contributors. Many of them are identified in the book but there are at least as many who, although unnamed, have been equally helpful. Thanks should also go to the New York University Fourteenth Annual Institute on Federal Taxation, the Tax Executives Institute, the American Institute of Accountants and other organizations from whose conferences and seminars certain material was drawn as a basis for discussion.

This unselfish interchange of ideas and knowledge is the life blood not only of "The Tax Clinic" but of THE JOURNAL OF ACCOUNTANCY as a whole. As long as it continues, as long as more and more practitioners and accounting executives can be encouraged to participate, we can look forward to a growing body of practical accounting and tax literature which will benefit all of us.

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

July 1, 1956

COMPUTATION OF TAX

Retirement Income Credit In Community Property States

Sec. 37

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, suggests 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 probably allocable to the other spouse.

Hence, if a couple resided, for example, 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.

Sec. 37

What Is a Widow Within The Meaning of Section 37?

The regulations Sec. 1.37-2 (f), adopted February 3, 1956, have since resolved this by adopting the definition of the second group; viz.: "the status of the individual or the surviving spouse . . . is determined only by reference to his most recent marriage."

Section 37 of the Code grants a retirement income credit to certain individuals who receive retirement income during a taxable year. The benefits of the section are available to a widow or widower, otherwise qualified, whose spouse received at least $600 of earned income in each of any ten calendar years prior to the current taxable year.

Many practitioners in preparing returns have had to consider the difficult question of who is a "widow" within the meaning of this section. In view of the complete lack of legislative history regarding this definition, the argument has now centered upon the dictionary.

Some tax men have decided that they prefer the definition which provides that a widow is "a woman who has lost her husband by death; the female survivor of a marital union."

Others have adopted the definition that a widow is "a woman who has not remarried after the death of her husband." It has not been made clear as to how the second group explain the next sentence in the same definition, stating that, "In the absence of express provisions in the law with respect to the rights of a widow, her rights are not affected by a second marriage."

Determination of Earned Income from Self-Employment

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

Rent *v.* Income from Farming Operations

General law—as distinguished from tax law—must be referred to in making this tax determination.

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 opera-

Sec. 37 tion of a farm does not qualify. However, 30 per cent of such income from operation of a farm is regarded as earned income and can operate to reduce the retirement income credit otherwise allowable.

Finally, rent is not subject to self-employment tax, whereas net income from operation of a farm is so subject.

If a farm is merely rented to an operating lessee, the income to the owner undoubtedly constitutes rent. However, where the contract calls for a profit-sharing arrangement between the owner and the tenant, the determination becomes more difficult. And where an absentee owner retains control over the type of operation and the kind of crops that are to be produced, a further complication is introduced.

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—can best be determined by reference to general law. There, the client's legal counsel can be most helpful.

GROSS INCOME

Sec. 61 The Present Status of Payments to Employee's Widow

A succinct summary—enhanced by the addition of the subsequent Hellstrom *decision.*

The 1954 Code has added a degree of certainty to some heretofore doubtful tax areas. Thus, much of the doubt existing in connection with the taxability of certain reorganization exchanges has been resolved (Subchapter C); and a new rule (Sec. 165) has pinned down the year of deductibility of theft and embezzlement losses to the year of discovery.

However, uncertainty can never be completely eliminated, and when a proposed transaction is doubtful, the current applicable tax law must be regularly examined and appraised.

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

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 BTA 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).

One of the latest decisions *(Est. of Arthur W. Hellstrom,* 24 T.C. 101, August 19, 1955) ruled tax free a gift to an officer's widow, despite the fact that the officer had been president and a substantial stockholder in the corporation and that the corporation had claimed a deduction for the payments in its 1952 return.

Sec. 61 Treasury Checking Controlled Payments by Corporations

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

IR 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 their word) on these affiliated corporations, etc., the returns of the affiliated 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. *Sec. 61*

Qualifications for Sick Pay are Technical

Sec. 105

(From AIA's Annual Meeting)

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.

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.

Sec. 105

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) =	$______	$______	$______

Dividend Credit For Stock Owned Jointly *Sec. 116*

Involves "pennies." However, is "solid." Final regulations (Sec. 1. 116-1[c]) confirm this opinion.

T. T. Shaw, CPA, Arthur Young & Company, New York, submitted this:

If a husband buys stock and has it transferred to both his own name and his wife's as joint tenants for purposes of the $50 exclusion, he and his wife will each be deemed to own one-half of the stock. Accordingly, a total of $100 of dividend income could be excluded on a joint return. This conclusion is based on an informal opinion expressed by personnel of the Treasury Department.

In connection with any transfer to joint names, gift tax implications must, of course, be considered.

DEDUCTIONS

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

(From AIA's 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?

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.)

Sec. 162

Proposed Deduction for Wives' Travel Expenses

Wishful thinking?

Some Congressman, sometime, will endear himself to millions 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, revenue-wise. 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 philosophic groups, who may find moral and social appeal in this encouragement to husband-wife companionship.

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 fully taxable.

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. *Sec. 162*

Vacation Pay Agreements Should be Checked Now

(From AIA's 1955 Tax Conference for Business Executives)

Taxpayers accruing vacation pay where there is not complete vesting at the year end are in danger of losing their accrual at the close of 1956 unless their plans are amended. Consideration should be given to the danger now, while 1956 union negotiations are in progress.

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.

Making the Most of a Bad Business Debt

Sec. 166

Regulations have not yet been issued to resolve the doubt under this provision.

THEODORE PROPP, CPA and a member of the New York Bar, in discussing bad debts said this: Section 166(d)(2) of the 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 legislative 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 himself 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. *Commissioner*, 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

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

Sec. 167 Some Points in Final Depreciation Regulations

The new 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.
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.

More Depreciation Disputes Between Taxpayers and Treasury

There's more at stake now; probably portends busy years for CPAs.

Joseph B. Lanterman, CPA of Chicago, believes that depreciation rate disputes will accelerate because both taxpayers and the Treasury will now have a higher stake in the outcome—because of the new fast depreciation methods.

It also has been suggested by Mr. Lanterman that where the new depreciation methods are adopted for tax purposes, they also might be adopted for general accounting purposes. He pointed out that the use of the new methods was granted by Congress primarily because of industry's plea that straight-line depreciation is insufficient and thus unrealistic. He urged industry to back up the sincerity of its recommendation by computing depreciation consistently for both tax accounting purposes *and* financial accounting purposes.

New Depreciation Methods on Items Capitalized by Revenue Agent

(From AIA's 1955 Tax Conference for Business Executives—confirmed by Sec. 1.167(a)-10(a) of Final 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, or is an improvement to an old asset which did not qualify for a new method, 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.

Application of New Depreciation Methods to Successor Owners

(From 1955 N.Y.U. Tax Institute)

The new 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 in to 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.

Table of Digits Depreciation Rates—By Years*

ALBERT J. JAMES, CPA, of Cargill, Incorporated, compiled the herein reproduced table of decimal equivalents for use in computing sum-of-the-years-digits depreciation for assets of various lives.

TABLE OF DEPRECIATION RATES—BY YEARS
(Sum of the Digits Method)

Effective January 1, 1954 with Respect to New Acquisitions, with Certain Exceptions

ANNUAL RATE OF DEPRECIATION BASED ON ESTIMATED LIFE OF:

Year	*5 yrs*	*7 yrs*	*8 yrs*	*10 yrs*	*12 yrs*	*15 yrs*	*17 yrs*	*20 yrs*	*25 yrs*	*30 yrs*	*33 yrs*	*40 yrs*	*50 yrs*
1st†	16.667	12.500	11.111	9.091	7.693	6.250	5.556	4.762	3.846	3.226	2.941	2.439	1.961
2nd	30.000	23.215	20.833	17.273	14.744	12.084	10.784	9.286	7.539	6.345	5.793	4.817	3.883
3rd	23.333	19.643	18.056	15.455	13.462	11.250	10.131	8.810	7.231	6.129	5.615	4.695	3.804
4th	16.667	16.071	15.278	13.636	12.180	10.416	9.477	8.334	6.923	5.914	5.437	4.573	3.725
5th	10.000	12.500	12.500	11.818	10.897	9.584	8.824	7.857	6.615	5.699	5.259	4.451	3.647
6th	3.333	8.929	9.722	10.000	9.615	8.750	8.170	7.381	6.308	5.483	5.080	4.329	3.569
7th		5.357	6.944	8.182	8.333	7.916	7.516	6.905	6.000	5.269	4.902	4.207	3.490
8th		1.785	4.167	6.364	7.051	7.084	6.862	6.428	5.692	5.053	4.724	4.085	3.412
9th			1.389	4.545	5.769	6.250	6.209	5.952	5.385	4.839	5.545	3.963	3.333
10th				2.727	4.487	5.416	5.556	5.476	5.077	4.623	4.367	3.841	3.255
11th				.909	3.205	4.584	4.902	5.000	4.769	4.409	4.189	3.720	3.177
12th					1.923	3.750	4.248	4.524	4.461	4.193	4.011	3.598	3.098
13th					.641	2.916	3.595	4.048	4.154	3.979	3.833	3.467	3.019
14th						2.084	2.941	3.571	3.846	3.763	3.654	3.354	2.941
15th						1.250	2.288	3.095	3.539	3.549	3.476	3.232	2.863
16th						.416	1.634	2.619	3.231	3.333	3.298	3.110	2.785
17th							.980	2.143	2.923	3.119	3.119	2.988	2.706
18th							.327	1.667	2.615	2.903	2.941	2.866	2.627
19th								1.190	2.308	2.689	2.763	2.744	2.549
20th								.714	2.000	2.473	2.585	2.622	2.471

21st	.238	1.692	2.259	2.407	2.500	2.392
22nd		1.385	2.043	2.228	2.378	2.314
23rd		1.077	1.828	2.050	2.256	2.235
24th		.769	1.613	1.871	2.134	2.157
25th		.461	1.397	1.693	2.012	2.079
26th		.154	1.183	1.515	1.890	2.000
27th			.967	1.337	1.768	1.921
28th			.753	1.159	1.646	1.843
29th			.537	.981	1.524	1.765
30th			.323	.802	1.402	1.686
31st			.107	.624	1.280	1.608
32nd				.445	1.159	1.529
33rd				.267	1.037	1.451
34th				.089	.915	1.373
35th					.793	1.294
36th					.671	1.215
37th					.549	1.137
38th					.427	1.059
39th					.305	.981
40th					.183	.902
41st					.061	.823
42nd						.745
43rd						.667
44th						.588
45th						.510
46th						.431
47th						.353
48th						.275
49th						.196
50th						.117
51st						.039

*The Regulations, Section 1.167(b)-3(a)(2)(ii), also contain a table giving effect to this principle. Such table contains the decimal equivalents of various "remaining lives."

†Rates given for 1st year are one-half of the first year's depreciation.

Sec. 170 The 30 Per Cent Charitable Contribution Deduction

Obtaining extra 10 per cent deduction requires care in drafting the check and making the payment.

Charitable contributions made by individuals under the 1954 Code are allowed as deductions to the extent of 30 per cent of the individual's adjusted gross income, if 10 per cent of the contributions are paid to a church, convention or association of churches, educational organization, or hospital.

Walter W. Woodside, Esq., of Washington, D.C., asks: "What if 30 per cent of the adjusted gross income is contributed to a Community Chest and the individual indicates on the pledge card that the contribution, or at least a third of it, is to go to a hospital? Is the full amount of the contribution deductible by the individual?"

Ordinarily, the Community Chest will have a certain portion of total contributions allocated to hospitals, and the individual's contribution will be paid over to the hospital indicated up to the point that the Chest allocation to that hospital is not exceeded. If this is done, the use of the Community Chest as a conduit by the individual probably ought not to prevent him from claiming the full amount of the deduction.

However, while final regulations have not yet been issued, the "Temporary Rule" issued by the Commissioner requires that to qualify for the additional 10% deduction, a charitable contribution must be paid "to" the qualified organization and not merely "for the use of it."

Thus an individual can best protect his interest, in such a case, by drawing a check in the amount of any excess over 20 per cent and up to 30 per cent of adjusted gross income *to the order of the hospital.* To be absolutely safe, the separate check should be delivered directly to the hospital!

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. *Sec. 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.

Informal Ruling May Affect Loss Carrybacks and Carryovers

Sec. 172

Deductions based on percentage of income lost in prior years can be picked up in net operating loss.

Laurence J. Wilson, CPA, Lybrand, Ross Bros. & Montgomery, Detroit, notes this informal Treasury ruling:

An unabsorbed net operating loss carryback or carryover can be increased by the amount by which a deduction based on a percentage of net income or adjusted gross income for an intervening year was reduced because of the application of a

Sec. 172

net operating loss carryback or carryover.

For example, assume the following facts relating to a corporation:

1951 net income	$ 95,000
1951 charitable contributions (5 pct.)	5,000
1952 net operating loss	$100,000

Upon applying the 1952 net operating loss to 1951 net income after recomputing the contributions deduction, the net operating loss deduction for 1951 would equal net income and would appear as follows:

Net income for 1951 per return	$ 95,000
Contributions disallowed	5,000
Revised net income before net operating loss deduction	100,000
Less net operating loss deduction	100,000
Net income	—

Under the Treasury's informal ruling, however, the net operating loss carryover to 1953 would be $5,000, computed as follows:

Net operating loss carryback from 1952	$100,000
Less 1951 net income before application of net operating loss deduction as recomputed under Regs. 118, Sec. 39.122-4(c)	95,000
Loss carryover to 1953	$ 5,000

This suggests that claims for refund may be indicated in connection with net operating losses sustained, as, for example, in 1949 and subsequent taxable years, where such losses have been carried through intervening taxable years.

Extra Year's Loss Carryback Not Always Beneficial

An observation.

One of the "relief" provisions incorporated in the Internal Revenue Code of 1954 was to extend the period of carryback of net operating losses from a one-year period to a two-year period (Section 172(b)(1)(A)). At the same time Section 172(e) provides that "in determining the amount of any net operating loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year." Under this provision, the net operating loss of the year 1955, which must first be carried back as a net operating loss deduction of the year 1953, must be adjusted by the exceptions, additions and limitations of Section 122(d) of the Internal Revenue Code of 1939. This section provides, *inter alia,* adjustments in respect of percentage depletion and wholly exempt interest. *Sec. 172*

Due to the necessity of making these adjustments, CRAWFORD C. HALSEY, CPA, Pogson, Peloubet & Co., New York City, finds that companies which use percentage depletion or have large amounts of nontaxable interest may be put into the anomalous position of being worse off under the relief provision giving them a two-year carryback than they would have been if such "relief provision" had not been enacted.

For example, assume that in the year 1953 the taxable net income of a mining company was $900 after deducting an excess of percentage depletion over cost depletion of $600; in the year 1954 the taxable income was $700 after deducting the excess percentage depletion of $500; and in 1955 was a net loss of $500 after deducting an excess of percentage depletion of $100. Under Section 172 of the 1954 Code the carryback loss of 1955 to 1953 is $500 (no adjustment need be made for percentage depletion of the year 1955). However, because 1953 is subject to the Internal Revenue Code of 1939, a further adjustment must be made under Section 122 of that Code with respect to the excess of percentage depletion over cost depletion taken in the year 1953. This means that the $500 net operating loss carried back must be reduced by the $600 of excess percentage depletion in 1953. In other words, there is no carryback to the year 1953 nor to 1954.

If the law had not been changed with respect to the one-year carryback provision, the company would have been entitled to carry the full amount of the 1955 loss, $500, back against the $700 of the taxable income of the year 1954. Thus, the so-called "relief provision" of the 1954 Code, granting an extra year to which to carry back the loss, results in the company getting no benefit whatever from its loss in 1955, whereas full benefit would have been received under a one-year carryback.

Sec. 174 Research and Development Costs: Expense or Capitalize?

Summary of factors that should influence taxpayer's election.

WELDON POWELL, CPA, Haskins & Sells, New York City, cites many complex and interrelated factors that enter into a taxpayer's decision to expense or to capitalize research and experimental expenses under Code Section 174.

Among the considerations are the nature of the taxpayer's research activities, whether recurring or sporadic, his expectations of the level of future income and the probability of sale of research-produced assets, and his estimates of the course of future tax rates and possible changes in the law.

Also, lower working capital requirements resulting from the current reduction in taxes undoubtedly will influence many taxpayers to expense rather than to capitalize.

According to Mr. Powell, if a taxpayer elects to expense his research expenditures currently, it would appear that he need not distinguish between capital and revenue items. All such expenditures, whether identifiable with assets having either definite or indefinite life, or ordinary and necessary trade or business expenses, are to be deducted in the period in which paid or incurred, unless the taxpayer obtains approval for a different treatment. The indication is that he may obtain such approval with respect to a special project's costs which he desires to capitalize, even though he has elected generally to deduct expenditures as they occur.

Deferring Research and Experimental Expense

(From AIA's 1955 Tax Conference for Business Executives)

Where a taxpayer has elected to defer research and experimental expense, there arises the difficult task of determining the month he first realizes or receives benefits from such expenditure —and thus when he can start amortizing. The opinion has been expressed that the most reasonable interpretation would be the selection of the month in which sales began.

It is to be noted that depreciation on research assets must be deferred where such deferment is elected for research and experimental expenses. It loses its identity as depreciation. This would also apply in the case of other expenditures, such as real estate taxes and insurance on buildings devoted to research. This could mean the postponement of such deductions for a considerable period. *Sec. 174*

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.

Quirk in Limitation On Dividend Deduction

Sec. 246

It is now apparent that draftsmen contemplated this result. Companies with 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)).

Sec. 246 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 an infinite 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. 246*

CORPORATE DISTRIBUTIONS AND ADJUSTMENTS (Subchapter C)

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

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

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.

Sec. 302

Using Corporate Funds To Finance Sale of Stock

A practical method of disposing of stock of closely held corporation via the capital gains route.

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. 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 type 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.

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

Installment Reporting for Gain on Combination Sale-Redemption.

(From the AIA's Annual Meeting)

A sole stockholder or group of stockholders may dispose of all their stock in a closely held corporation in a combination type transaction, i.e., sale of part and redemption of the balance —without the hazards of a dividend tax on any part of the proceeds. *Sec. 302*

In such a transaction the selling stockholders are liable only for capital gains on their profit. (See the discussion of the Treasury's acquiescence in *Zenz* v. *Quinlivan*, 213 F. (2d) 914, *supra.*)

Now comes the observation that, if the redeeming stockholder receives bonds or other obligations of his corporation as part of the proceeds of redemption, he may elect to *defer* his gain, reporting it on the installment basis as the bonds are redeemed.

A forewarning: The accumulated earnings tax (Sec. 531) could possibly "rear its head" in these redemption transactions.

Date of Redemption of Stock to Pay Estate Taxes Governs

Sec. 303

(From AIA's Annual Meeting)

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?

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

Section 304 as Estate Planning Aid

Sec. 304

Estate tax funds may be safely raised 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

Sec. 304 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.

Sec. 305 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 sons' and decrease the father's proportionate ownership. *Sec. 305*

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

Stock Dividends v. Recapitalization

(From Tax Executives Institute's 1955 Annual Conference)

Stock dividends are specifically made taxable under the Code if they are made in discharge of preferred dividends in arrears for the current or preceding taxable year (Section 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: 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.

Section 306 Stock May Include Common Stock

Sec. 306

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 is received in exchange for previously outstanding Section 306 preferred stock), the common shares will inherit the "stigma," (Reg. Sec. 1.306-3 (d)).

Sec. 312 Effect of Distributions in Kind on Earnings and Profits

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 *Com'r* v. *Fannie Hirshon Trust* and *Com'r* v. *Estate of Ida S. Godley*, (CA-2, May 17, 1954, and CA-3, May 28, 1954, respectively). 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 dividend! 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 (Section 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
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, subject to the President's signature, the 1939 Code is being amended to eliminate the *Hirshon-Godley* rule.

Sec. 318 An Interesting Question of "Interest" Posed by a Reader

An illustration of how far-reaching the constructive ownership provisions can be.

LEO W. CROWN, CPA, Alexander Grant & Company, Chicago, submitted this "provoker":

Two brothers, John and Fred, started a business in the late '30's. They got married; their wives worked in the business and a four-way partnership was duly formed.

In 1946 the business was incorporated with 1,000 shares of common stock, of which John and his wife and Fred and his wife each owned 250 shares. All were active in the business. Buy-and-sell agreements, funded with insurance, were entered into which provided redemption of stock at book value to the extent of the insurance proceeds.

In July, 1956, Fred was killed in an accident. In addition to his widow, his two children, Fred, Jr., and Mary, survive him. Fred, Jr., a pre-medical student, is 19 years old; Mary, 16, is in high school. Both Fred, Jr., and Mary work after school and during vacations in the company at 75 cents an hour in order to have pocket money.

Fred's will leaves 50 per cent of his stock to his wife outright and 50 per cent to a trust for the benefit of his children. The insurance carried under the buy-and-sell agreement is sufficient to redeem 125 shares. The death taxes are substantially less than the value of the 125 shares. John, as executor of his brother's estate, has distributed the stock and decides as trustee of the testamentary trust that the stock of the trust shall be redeemed because it is not a suitable trust investment.

John's tax advisers tell him that he will expose the trust to a substantial income tax liability, unless the company fires Fred, Jr., and Mary from their part-time jobs and does not employ them for another ten years!

The statutory authority? Under Section 318(a)(2)(B), Fred, Jr., and Mary are considered to own each 62½ shares of the company because of their beneficial interest in the trust. The redemption would not be a complete termination of their interest under Section 302(b)(3) because, under the facts, they are considered owning constructively their mother's stock under Section 318(a)(1).

Furthermore, the redemption is not disproportionate under Section 302(b)(2). Fred's widow and her children own, before the redemption, directly and constructively 50 per cent. After the redemption they would own more than 40 per cent (80 per cent of 50 per cent) as shown by the following schedule: *Sec. 318*

	Shares	*Pct.*
John	250	28.57
John's wife	250	28.57
Fred's widow	375	42.86
Total	875	100.00

But why lump the interests of Fred's widow and her children together? Because under Section 302(c)(2)(A)(i), Fred, Jr., and Mary, immediately after the distribution, would have an "interest" in the corporation as employees.

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

LIQUIDATIONS

Complete Liquidations Of Subsidiaries

Sec. 332

Summary of 1954 Code provisions.

The tax-free liquidation of "wholly owned" (80 per cent) subsidiary companies (1939 Code Sec. 112(b)(6)) is 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, aff'd 173 F. (2d) 461, and I.T. 4109, 1952, C.B. 138.

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

Description of 1954 "Kimbell-Diamond" 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, aff'd 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). (Section 334(b)(2) gave statutory "dignity" to the principle earlier enunciated in *Kimbell-Diamond Milling Co.,* 14 T.C. 74, aff'd, 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.

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. *Sec. 334*

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

(From 1955 N.Y.U. Tax Institute)

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 Corporation B is liquidated 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 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. If more than 80 per cent of the B stock is acquired, the two-year period for liquidation begins at the end of the *last* period of 12 months *within* which B buys 80 per cent of the stock.

For example, assume that B purchases 20 per cent of the A stock on each of the following dates: March 31, 1954; June 30, Sec. 334 1954; September 30, 1954; December 31, 1954; and March 31, 1955; the two-year period for a qualifying liquidation begins on March 31, 1955. Assume the same facts except that the last purchase is on July 1, 1955; then the two-year period begins on January 1, 1955.

Stepped-Up Basis on Liquidation of Sub-Subsidiary

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 also 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 tax matters, a simple change in mechanics can alter the result. The loss of stepped-up basis can be avoided in such cases by the purchaser simply requiring 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.

Avoiding Corporate Tax by Distributing Receivables

Sec. 336

(From AIA's 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.

Avoiding Double Tax on Liquidating Sale by Corporation

Sec. 337

*Description of 1954 anti-*Court Holding Company *provision.*

A definitive rule has been provided in the 1954 Code to eliminate the uncertainties that formerly arose in the *Com'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.

Com'r v. *Court Holding Company,* 324 U.S. 331, held that a "double tax"—a tax both on the corporation and on the stock-

Sec. 337 holders—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 it is completely liquidated forthwith.

However, the pertinent observation has been made that *Court Holding* may *still* apply in cases of *partial* liquidation.

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 and completing the sale, the double tax still could apply.

Sec. 341 Dangers in New Collapsible Corporation Provisions

A concise history of the practices that led to the 1954 collapsible corporation provision.

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 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 & 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. *Sec. 341*

The *Hirshon-Godley* decisions by the Second and Third Circuits in 1954, although rejected by Congress in the 1954 Code, may prove a potent weapon for the Government in its attack on pre-1954 transactions. Where a corporation distributed appreciated capital assets to its stockholders, the stockholders were taxed on a dividend even though the corporation's earnings and profits were not equal to the appreciated value of the assets distributed. The *Hirshon-Godley* rule probably can be extended to *any* corporation which distributes appreciated assets with the result that the government may not be required to prove intent as under Section 117(m). If so, stockholders will not be able to escape even under Section 117(m) exceptions.

(Note: Subject to the President's signature, the 1939 Code is being amended to counteract Hirshon-Godley.)

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 after realizing substantial profits may be vulnerable as a collapsible corporation, with its stockholders subject to dividends tax.

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

CORPORATE ORGANIZATIONS AND REORGANIZATIONS

Sec. 351 Corporate Organizations

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)) have been modified in the 1954 Code as follows:

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" has been 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

(From Tax Executives Institute's 1955 Annual Meeting)

If debentures (as well as stock) are issued for property by a newly organized corporation, there may be doubt as to whether the exchange is tax free. *Sec. 351*

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 risk of 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. *Com'r,* 331 U.S. 737).

Because of the ostensible conflict, the Internal Revenue Service has had a policy of not ruling 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.

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

(From 1955 N.Y.U. Tax Institute)

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?

Sec. 351 One Way for Young Partners To Buy Out a Business

The retention of preferred stock with terminal voting powers by elders furnishes 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:

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 themsevles.

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 should hold voting rights for the next four years, thus keeping them in control. *Sec. 351*

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

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

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 over 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.

Sec. 351 Stepping Up Property Basis By Taxable Organization

(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 organization.

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 (Section 357(c)).

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 (Section 1231). Otherwise, it's ordinary income (Section 1239(a)(2)).

The basis of the office building to the corporation is $500,000.

Sec. 354 Corporate Reorganizations

Summary of 1954 Code provisions.

The definitions of tax-free reorganizations are generally similar to those in the 1939 Code; the "relative-size" test and "publicly held" requirements prescribed by the House Committee having been abandoned by the Senate Finance Committee. Thus, fleas can still merge with elephants and vice versa! 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)). *Sec. 354*

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 have been 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

Sec. 354 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 Sections 112(b)(3) and (4))—are only slightly modified. Securities, *i.e.*, 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 The Tax-Free Spinning Off Of Real Estate

Real estate incidental to manufacturing apparently cannot be "spun off" tax free. Final regulations confirm (Sec. 1.355-1).

"Spin-offs," "split-ups," and "bail-outs" are as absorbing to tax men as jive is to musicians. Thus, whether realty can be spun off tax free by a manufacturing corporation has been frequently debated at tax "jam sessions."

Opinion of majority: It can't. The manufacturing corporation was not engaged in the "active conduct" of the realty business before the transfer. Rather the ownership and use of real estate were merely incidental to the conduct of manufacturing. Therefore such a spin-off probably could not qualify under Section 355; instead it would be taxable to the stockholders as a dividend. *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 Rev. Rul. 55-103 (IRB 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 the stock 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 Section 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

(From Tax Executives Institute's 1955 Annual Meeting)

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 a separate trade or business!"

Effect of Boot in Tax-Free Acquisitions and Distributions

Sec. 368

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

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

In a C type of reorganization (i.e., the acquisition of substantially all the properties of a corporation in exchange for voting

Sec. 368 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, Sec. 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.

1954 Code Clarifies "B" Type Reorganizations

Description of provision.

The 1954 Code reduced ownership requirements for filing consolidated returns from 95 to 80 per cent (new Sec. 1504(a)). Ownership requirements necessary to qualify for the tax-free liquidation of a subsidiary remain at 80 per cent (new 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? *Sec. 368*

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 *Commissioner* v. *Dana,* 103 F. (2d) 359, and *Pulfer* v. *Commissioner,* 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:

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 new 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 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

Sec. 381 **Carryovers in Certain Corporate Acquisitions**

Description of 1954 Code provision.

The principles of a long line of court decisions *(Helvering* v. *Metropolitan Edison Co.* 306 U.S., 522, *Com'r* v. *Sansome* 60 F. (2d) 931, cert. den. 287 U.S. 667, *Stanton Brewery, Inc.* v. *Com'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, have been 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.

Old Law More Favorable For Loss Carryovers?

(From 1955 N.Y.U. Tax Institute)

New light (or confusion) has been cast on the troublesome problem of carryovers in tax-free reorganizations under the 1939 Code. In *Koppers Co., Inc.* v. *U.S.*, decided October 4, 1955, permission was given to carry back a 1944 unused excess profits credit of the successor corporation in a merger, to the

1943 consolidated return of the predecessor corporations. It was the opinion of the Court of Claims that the allowance of carryovers in Section 381 (1954 Code) "reflects a continuation of the previous realistic approach to corporate reorganization problems and that the provision specifically disallowing a net operating loss carryback is a change in prior policy and law." *Sec. 381*

In November, 1955, the Ninth Circuit overruled the Tax Court to permit a carryover of unused excess profits credit from a merged corporation in the *E. & J. Gallo Winery* case.

If these cases are upheld we may be in the strange position where the old law is more beneficial to taxpayers than the supposedly liberalized carryover provisions of the new Section 381. Under some circumstances the restrictions in Section 382(b) apparently take away much of the benefit of the carryover even where there is no real change in ownership.

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 earnings in the near future should consider a tax-free liquidation or merger of the subsidiaries in order to utilize the subsidiaries' unused operating losses against the 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 carryforward 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, 1951:

Sec. 381

Fiscal year ended June 30	*Income (Loss)*
1952	($100 000)
1953	10 000
1954	5 000
1955	(5 000)

Assume further that it was near the end of the company's 1956 fiscal year and management knew that the result of operations for 1956 would be a loss. The company was not expected to do much better in the 1957 fiscal year.

It was quite evident, then, that a large portion of B company's 1952 loss would never be used to offset taxable income since it could not be carried beyond 1957, 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 1952 loss was June 30, 1956. Consummated on that date, B's unabsorbed 1952 loss could be utilized (to the extent of A's taxable income) for A's fiscal year ended June 30, 1957.

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

(From the AIA's 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?

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).

Special Limitation on Net Operating Loss Carryovers

Sec. 382

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.

LAWRENCE E. COHN, CPA, Washington, D.C., lectured on new 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.

DEFERRED COMPENSATION (Subchapter D)

Benefits of Pension and Profit-Sharing Plans

Sec. 401

(From 1955 N.Y.U. Tax Institute)

Here is a summary of the tax benefits accruing to the employee

Sec. 401 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.
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

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 the proposed regulations, 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 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 apparently 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 its own initiative, or it may be restricted to act only upon the direction of the administrative committee.

The trustee is expected to maintain records showing all cash receipts and disbursements. However, it 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 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. *Sec. 401*

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.

Giving a Profit-Sharing Plan More Flexibility

(From AIA's 1955 Tax Conference for Business Executives)

It is not necessary that profit-sharing plans contain a predetermined formula to determine the extent of the contribution.

In order to provide for more flexibility, it was suggested at a recent tax institute that old plans might be amended so as to give management discretion within certain limits.

Employees of Loss Companies Can Still Obtain Benefits under Profit-Sharing Plan

(From AIA's 1955 Tax Conference for Business Executives)

Where a profit-sharing plan covers a series of corporations, and certain of the companies are loss companies, the profitable companies will be entitled to spread the full deduction among themselves, despite the fact that benefits go to the employees of the loss companies.

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

(From AIA's 1955 Tax Conference for Business Executives)

Where the pension or profit-sharing fund constructs a building

Sec. 401 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 AIA'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."

Unamortized Past Pension Services Forfeited on Liquidation

(From AIA 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

A checklist containing both tax and administrative considerations

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 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) Recogition 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) *Sec. 421*

(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)

IV. *Option Price:*

(a) 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.

Stock Acquired Under Restricted Stock Option

Confirmed by proposed regulations, Sec. 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. *Sec. 421*

Liability for Negligence in Failing to Claim Deduction?

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

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

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, the problem does raise the question as to whether corporate management should keep close tabs on the status of

Sec. 421 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!

ACCOUNTING PERIODS AND METHODS
(Subchapter E)

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

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. *Sec. 441*

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.

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).

Court Overrules Commissioner On Time for Taxing Dividends

Sec. 451

"Constructive receipt" is a practical doctrine.

Dividends constitute taxable income in the year in which received, whether the taxpayer is on the cash or accrual basis. Although the rules of constructive receipt apply, T. T. Shaw, CPA, Arthur Young & Company, New York City, cautions that there must be something more than a *possibility* of demanding payment before a person will be deemed to have received a dividend he actually did not get until a later year.

In *Maurice Fox* (C.A.-3, affirming 20 T.C. 1094), the taxpayer was a depositor in a hundred savings and loan associations located throughout the United States. Twenty-seven of these associations declared a dividend payable December 31, 1949. Fox could have collected these dividends on that day if he had personally called at the offices of the associations (sic). However, pursuant to their established custom all of these associations

Sec. 451 mailed their dividend checks to Fox on December 31, 1949, and he actually received them in January, 1950.

Notwithstanding the physical impracticability of calling at all offices, the Commissioner concluded that Fox had constructively received the dividends in 1949.

The Court of Appeals regarded as controlling these facts: (1) Fox did not intend to delay or control the time for payment, and (2) the checks were mailed in the ordinary course of business, pursuant to an established policy. Accordingly, it held that all of the dividends were properly 1950 income.

How Bookkeeping Entries May Create Taxable Income

"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); aff'd 247 U.S. 179 (1918); and *Standifer Construction Corporation,* 30 B.T.A. 184; *North American Coal Corporation,* 32 B.T.A. 535; and *Adams,* 5 T.C. 351).

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

The decision in *Lime Cola Co.* (22 T.C. 77) graphically illustrates how a bookkeeping entry can give rise to taxable income. There, an unclaimed account payable, inactive for twelve years, was held to be income in the year an entry was made by the debtor, eliminating the liability and crediting the amount thereof to surplus. The amount represented by the liability had been deducted in the earlier year's return. *Sec. 451*

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.

Benefits Under Section 452 Available Despite Repeal

This item has gained stature because the Tax Court has been again overruled, this time by the 5th Circuit, in the Schuessler *case involving a reserve for servicing furnaces. The 10th Circuit's decision in* Beacon Publishing *thus is not alone.*

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 10th Circuit Court of Appeals in the case of *Beacon Publishing Company* v. *Commissioner.*

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

Sec. 451 The Tax Court agreed with the Commissioner. However, on appeal the 10th 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 10th 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. *Sec. 451*

Consistent Accounting Practice And Income Determination

Industry accounting practices appear to be regaining tax stature.

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, reversing the Tax Court in *Pacific Grape Products Co.* v. *Commissioner,* 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 some 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."

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.

Sec. 453

Avoiding Double Tax on Installment Method Change

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 permanently avoided. 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 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 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 negative 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. *Sec. 453*

Installment Sale of Receivables May Be Advantageous

Installment sale may be particularly advantageous to cash basis taxpayer.

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, 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.

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

Sec. 453 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 TCM 1194.)

Installment Sale of Stock Preferable To Sale of Assets

(From AIA's Annual Meeting)

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

However, if the corporation were to sell its *assets* on the installment basis, the stockholders would become immediately taxable 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.

Sec. 461

Election to Allocate Real Estate Taxes

A description of 1954 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 new 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 it 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 its 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.

Correcting Inventory Methods Safer Under the New Code?

Sec. 481

Regulations have not yet been issued and thus this possible boon to taxpayers must be considered conjectural.

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.

Sec. 481 Also, despite the long-standing requirements of the Code and regulations, the use of improper inventory pricing methods still 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 change-over. 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. *Com'r,* 202 F. (2d) 112; *Com'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 switch-overs.

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 to 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, the saving clause, by precluding the taxing of increment that arose in years prior to 1954, prevents immediate disastrous tax consequences to many taxpayers.

While now may seem like a good time for interested taxpayers to consider correcting any clearly erroneous method of reporting, it is understood that the Treasury is diligently searching for some grounds for taxing pre-1954 increment. Therefore until regulations are issued, caution is in order.

Pre-1954 Adjustments on Change in Accounting Method

Sec. 481

The issuance of regulations probably will be long delayed because of such knotty questions as this!

New Section 481 permits the taxing of previously accrued income in the year of a change in accounting. Thus, a taxpayer who accumulates an increment in inventories over a period of many years by using the "base stock," or some other forbidden method, cannot escape paying tax on the increment. In the year in which he shifts over to the correct method, voluntarily or otherwise, he is taxable on the increment. However, increment accrued *prior* to January 1, 1954 is not taxable under the new Code provision.

Suppose that a taxpayer has properly been using the cash basis of reporting, prior to 1954. In 1954, for the first time, he acquires merchandise inventories. He therefore is *required* to shift to the accrual basis for tax reporting. Presumably, the Commissioner must grant him permission to make the change.

Query: Is the increment in accrued receivables at December 31, 1953 taxable in 1954; or does the December 31, 1953 iron curtain absolve such income from tax?

Discussion: Admittedly, if the taxpayer had inventories *before* 1954 and had been *improperly* using the cash basis of reporting in prior years, the new provision would prevent the taxing of income accrued prior to 1954. Therefore, why shouldn't a taxpayer using a proper reporting method in the past obtain similar windfall treatment?

Consensus: Doubtful, but the plain wording of the Code seems to absolve the pre-1954 increment from tax.

EXEMPT ORGANIZATIONS (Subchapter F)

Exempt Organizations Are Affected by Minor Code Change

Sec. 511

JOSEPH E. TANSILL, CPA, Lybrand, Ross Bros. & Montgomery, Chicago, points out one minor change in the 1954 Code affect-

Sec. 511 ing 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)

ec. 531-7 Complications in Determining Accumulated Earnings Surtax

Observations concerning possible effects of the 1954 provision.

THOMAS J. GREEN, CPA, Peat, Marwick, Mitchell & Co., New York City, 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 new 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

Sec. 531-7

A cross-reference to another publication containing an exhaustive tabulation of cases.

Corporate taxpayers have advanced 225 reasons to justify retention of earnings in cases litigated under old Section 102 (now 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.

Tax Dividends-Received Credit Highlighted Again

Sec. 545

Personal holding companies please note.

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 dividend-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

Sec. 545 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 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. 613 Multiple Corporations Desirable To Hold Depletable Property?

An unimportant observation in a giant and unsettled area.

The Treasury reiterated its long-standing position that percentage depletion allowances cannot reduce the adjusted basis of depletable property *below* zero (Rev. Rul. 54-421). *Sec. 613*

However, it still insists that any percentage depletion allowances made after the property's adjusted basis has been reduced to zero should be applied against the cost of any subsequent capital additions to the property (See G.C.M. 22239, C.B. 1940-2, 105).

The latter requirement presumably could require that excess depletion be applied to reduce the cost of an additional oil well before the well is drilled and such cost is incurred.

It seems that the only way the adverse tax effects of this strained concept could be avoided is by separately incorporating each additional oil well, unless, of course, such other factors as the desirability of deducting exploration or development expenses from income of a producing well dictate otherwise.

INCOME TAXES OF ESTATES, TRUSTS, BENEFICIARIES AND DECEDENTS

(Subchapter J)

Election on Administration Expenses of an Estate *Sec. 662*

(From 1955 N.Y.U. 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.

Sec. 662 Corpus Distribution as Distribution of Income

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

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* includible in their taxable incomes.

A Short-Term Trust For Junior's Education?

(From 1955 N.Y.U. 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, upon a recent occasion, 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.

Don't Overlook the Revocable Trust

(From 1955 N.Y.U. 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.

PARTNERSHIPS (Subchapter K)

Part II of Subchapter K relating to partnership contributions, distributions and transfers is complicated. The chart following may assist in analyzing these provisions.

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))

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.)

The Partnership and Its Assets

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. 704 Limitation on Partner's Share Of a Partnership Loss

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.

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 time of 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." Sec. 704

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 has been determined before deciding on their respective cuts.

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.

Different Tax Years for Partnership and Partners

Sec. 706

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

Sec. 706 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 AIA's 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. (Section 706(b).) Does this apply to a partnership which elects to be taxed as a corporation under Section 1361?

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.

Sec. 708 Termination of a Partnership: Statute Terms Create Conflict

The Treasury in the Regulations Sec. 1.808-1(b)(1)(ii) has followed 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 in-consistent with the intent of Congress in enacting those provisions. *Sec. 708*

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.

TAXES ON FOREIGN INCOME (Subchapter N)

Tax Credit on Dividends From English Subsidiaries

Sec. 901-2

Election in U.S.-U.K. 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:

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.

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.

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.

NONTAXABLE EXCHANGES AND BASIS
(Subchapter O)

Sec. 1032 **The Use of Treasury Stock To Pay Officers and Employees**

Rightfully or wrongfully, Proposed Regulations Section 1.1032-1(b) would attempt to tax a gain to the corporation in the transactions here described. Therefore, caution is in order until final regulations are issued.

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.

CAPITAL GAINS AND LOSSES (Subchapter P)

Sec. 1201 **Offsetting Capital Gains**

(From AIA's 1955 Tax Conference for Business Executives)

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. *Sec. 1201*

Converting Capital Loss into Ordinary Loss by Sale and Leaseback

(From 1955 N.Y.U. 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 suffered 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 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

Sec. 1201 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.

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. *Sec. 1201*

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.

The U.S. tax status of Canadian investment companies of the type described is the subject of Revenue Ruling 55-182.

MITIGATION OF EFFECT OF STATUTE OF LIMITATIONS, ETC. (Subchapter Q)

Delayed Compensation Not "Back Pay" *Sec. 1303*

(From AIA's Annual Meeting)

Section 1303 accords tax relief from the "lumping" of back pay in one taxable year by permitting such a payment to be

Sec. 1303 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: No. Such delayed compensation would not constitute "back pay" within the definition in Code Section 1303(b).

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.

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 the benefits are to be applied.

It is now too late for taxpayers to elect to use the new provision for the calendar year 1954. 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 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 final 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

Sec. 1504 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.

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 elemental 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

Sec. 2001 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: 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. *Sec. 2001*

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.

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.

In any event, these plans almost always are funded with "cross" life insurance policies on the lives of the principal stockholders; they're uncomplicated income-taxwise and they usually will "peg" the stock's value for estate tax purposes.

Retention of Appreciated Property Gift Advisable

Sec. 2035

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

Sec. 2035 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.

Sec. 2042

1954 Code Changes Provision On Life Insurance Proceeds

Probably the most important estate tax change.

William F. Scheid, Jr., CPA, Lybrand, Ross Bros. & Montgomery, Philadelphia, observed in a recent issue of the *L., R. B. & M. Journal* 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 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. *Sec. 2042*

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 still 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.

PROCEDURE AND ADMINISTRATION (Subtitle F)

No Penalty for the Omission of Declaration?

Sec. 6015

JULIAN O. PHELPS, CPA, Lybrand, Ross Bros. & Montgomery, Chicago, made this "discovery":

Section 6015(a) states the circumstances which require the filing of a declaration by an individual. Section 6654 states the circumstances under which a penalty will be imposed because there is an underpayment of estimated tax.

Suppose in a particular case a declaration is required by Section 6015(a) but no penalty would be imposed under Section 6654. (This condition might be present because of losses in the preceding year or because of the tax withheld on salary.) Apparently the 1954 Code imposes no penalty for the mere failure to file a declaration, whether or not the failure is willful. Section 7203, which provides for fines and imprisonment for willful failure to file a return, expressly states that it does not apply to declarations.

The report on the 1954 Code by the Staff of the Joint Committee contains a summary of the new penalty provisions (p. 124). The summary states that the new penalty for underpayments replaces the old penalties for failure to file a declaration or make a payment, or for making a substantial underestimate.

Doesn't this mean that the requirements in Section 6015(a)

Sec. 6015 for filing declarations are meaningless because there is no penalty for failure to observe them?

Sec. 6511

Statute of Limitations for Filing Claims for Refund

Caution: *Extension of time for filing return no longer extends time for filing refund claim.*

The general rule under the 1939 Code for filing a claim for refund for overpayment of income taxes was that the claim was required to be filed within three years from the time that the return was actually filed. Thus, if a taxpayer had obtained a six-month extension for filing his return, the statute of limitations did not run out until three and a half years after the original due date of the return.

Under Section 6511 of the 1954 Code, the period of limitations has been shortened so that a claim must now be filed within three years from the due date of the return, without taking into account any period of extension which was obtained for filing the return.

The following analysis of the applicable Code provisions indicates that the restricted rule will first apply to the first taxable year under which tax liability is determined by reference to the 1954 Code, i.e., generally the year 1954. Section 6511 appears in Chapter 66, which is a portion of Subtitle F relating to procedure and administration. Section 7851(a)(6) provides that Subtitle F, with exceptions not here material, shall apply to any tax imposed by the new Code. Section 7851(a)(1) provides that the tax-imposing chapters of the 1954 Code shall apply to taxable years beginning after December 31, 1953, and ending after August 16, 1954.

Sec. 6654

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. *Sec. 6654*

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 AIA's 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.

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.

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?

Sec. 7122

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. *Sec. 7122*

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.

Exposure of Client In Fraud Cases

Sec. 7201

MURRAY L. RACHLIN, CPA, New York City, 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!

Timely Filing of Refund Claims Under the 1939 Code

Sec. 7503

May still be of interest if question arises on timeliness of pre-1954 refund claim.

Section 7503 of the 1954 Code specifically provides that "when the last day prescribed under authority of the Internal Revenue laws for performing any act falls on Saturday, Sunday, or a legal holiday, the performance of such act shall be considered timely if it is performed on the next succeeding day which is not a Saturday, Sunday, or a legal holiday."

The foregoing rule is made applicable to any act, the last date for the performance of which occurs after August 17, 1954, irre-

Sec. 7503 spective of whether the tax for the taxable year involved was imposed by the 1939 or the 1954 Code. However, questions as to the timeliness of claims filed under the 1939 Code prior to August 18, 1954 will still arise.

HAROLD E. ALBER, CPA, Lester, Herrick and Herrick, San Francisco, notes that where the last day for filing a claim for refund under the 1939 Code fell on a Sunday, the Internal Revenue Service ruled that it is without authority to exclude such day and will disallow a refund if the claim was filed on the succeeding Monday. (G.C.M. 11650, XII-I, CB 325.)

However, in *U. S.* v. *Peters,* et al, 220 Fed. (2d) 544 (cert. not authorized), the Tenth Circuit recently held that such claims *are* timely filed because it was reasonable to assume that in the enactment of Section 322(b)(1) of the 1939 Code, Congress had in mind the common law rule that where the last day falls on Sunday the act may be done on the succeeding Monday.

Research on the subject indicates that this is the first case in which Section 322(b)(1) has been directly involved and the question has been squarely met. Cf. *National Casket Co.,* 16 BTA 1141; *Pleasant Valley Wine Co.,* 14 TC 519; *Jacobs Pharmacy Co., Inc.,* v. *U.S.,* 71 Fed. (2d).

In view of the *Peters* case and the enactment of Section 7503 (which might be considered as clarifying legislation), there appears to be good authority for the Service to accept as timely, claims filed on a succeeding Monday, where such claims are filed under old Code Section 322(b)(1).

MISCELLANY

Alphabetic Guide to Elections Under 1954 Code

A checklist.

LEONARD B. JOHNSON, CPA, of T. M. Byxbee Company, New Haven, Conn., combed the 1954 Code to come up with the following list of elections:

Topic	Code Section
Accounting Methods. Selection of method (cash, accrual, etc.)	446(c); 481(c)
Accounting Period. Change of taxable year.	441
Bad Debts. Method of computing.	166(c)
Bad Debts. Mutual savings banks, etc.	593
Bond Premium. Amortization.	171(c)
Charitable, Religious, etc., Organizations. Option to waive exemption from social security tax.	3121
Charitable Trust. Option to file for restoration of unlimited charitable deduction.	681
Circulation Expenditures of Publication. Option to capitalize.	173
Commodity Credit Loans as Income in Year of Receipt.	77
Computation of Tax. Option of individual to have Treasury Department compute tax.	6014
Computation of Tax under Alternative Method for Short Year Resulting from Change of Accounting Period.	443(b)(2)
Consent Dividends of Personal Holding Companies.	565
Consent of Husband and Wife on Allocation of Basis of Residence.	1034(g)
Consolidated Corporation turns. Election to file, etc.	1501-1505; 1552
Contributions on Accrual Basis. Corporations.	170(a)(2)
Dependents. Multiple support agreements.	152(c)
Depletion. Aggregation of separate mineral interests.	614(b)
Depletion. Option to compute on basis of cost or percentage of gross income.	611; 613
Depreciation. Methods available.	167(b), (e)
Depreciation, etc. Allowed before 1952 in adjusting basis of property.	1020
Development Expenditures. Election to treat as deferred expense.	616
Effective Date of Corporate Liquidation.	392(b)
Effective Date of Corporate Reorganization.	393(b)
Emergency Facilities. Amortization.	168
Estate Tax. Extension of time for payment available to executor with respect to tax on reversionary or remainder interest in property.	6163

Unintended Tax Disclosures May Harm the Client's Case

ROBERT S. HOLZMAN, Ph.D., professor of taxation, NYU Graduate School of Business Administration, has observed that tax cases are frequently lost because of inadvertent public statements made by the taxpayer who is involved that contradict arguments advanced in his behalf by tax counsel.

For example, tax counsel, in defending the right to a loss from demolition, argued that his client at the time of purchasing a parcel of real estate had no intention of tearing down an old building that was situated on the land. The purchaser's intention at the time of purchase was important.

The taxpayer lost his case, however, because of a news release appearing in a local newspaper at the time of purchase to the effect that the taxpayer "purchased the property . . . to erect an office building for his own use," and further that "the buildings now standing on it will be removed."

Another individual was denied a deduction for the expenses of writing a book, which project was purportedly entered into for profit. The author lost the tax deduction because he previously had admitted in a letter that he had been actuated in his work solely by the altruistic motive of being useful to society rather than that he had been moved by any "sordid" profit motive.

According to Dr. Holzman, the case books are sprinkled with such instances. He warns that "if one would not let the tax cat out of the bag, the most important factors to be watched are his own words."

"Side Agreements" Not Cricket

(From 1955 N.Y.U. Tax Institute)

The matter of "side agreements" has come in for recent attention. For present purposes a "side agreement" covers a phase of a larger agreement, possibly some protection that one of the parties insists upon. There is concern that the notice attracted by including this phase in the principal document will lead to undesirable tax consequences. Therefore, the "side agreement" is executed with the expectation that it will not become part of the income tax file.

That such agreements should be condemned goes without saying. If present law does not have the teeth to deal with them properly, it is to be hoped that the teeth will be provided. Moreover, as one eminent practitioner has commented, very often the exercise of industry and ingenuity will lead to an alternative procedure, the disclosure of which will produce relatively satisfactory results.

Uniformity in State Income Tax Acts

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 are utterly *un*-uniform. 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 worth-while 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!

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.

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, are technicians of the highest ability. They are Dan J. Ferris and Ralph S. Gayton.

There are seven branches in the Tax Rulings Division. They are: Corporation Tax Branch, Employment Tax Branch, Estate and Gift Tax Branch, Pension and Exempt Organizations Branch, Excise Tax Branch, Individual Income Tax Branch, and the Reorganization and Dividend Branch.

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 who we're apt to run into during consideration of the problem. Such a question could concern the interpretation of an abstruse provision of Regulations 130, relating to Consolidated Income Tax returns.

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 fully capable of answering the letter himself. However, since he must review all rulings which are issued to corporations, he assigns the case to David T. Deutsch, who specializes in consolidated return problems.

The problem is thoroughly considered by Mr. Deutsch. 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

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 field experience, having been formerly the Assistant District Director 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, partnerships, the statute of limitations, and penalty provisions, is headed by Mr. J. Donald Latimer. Problems involving nonresident citizens, resident and nonresident aliens, foreign tax treaties and credits, filing requirements, personal exemptions, 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

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.

Rulings on such transactions are issued by the Reorganization and Dividend Branch. Ralph Gayton, Assistant Director of the Tax Rulings Division, was for many years Chief of the Branch. He probably has considered and ruled on more cases involving reorganizations than any other living person. It is natural, therefore, that Mr. Gayton keeps in touch with the activities of the Reorganization and Dividend Branch even though he now has much broader duties.

The present Chief 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.

Mr. Glen Paschall, the Assistant Chief of the Reorganization and Dividend Branch, is another extremely able technician. In over twelve years of experience within the Branch he, too, has gained an excellent insight into problems involved in Subchapter C and related sections of the Code.

Wilma Van Deman, Lloyd G. Haag, George Terry, and Elmer Tamkin are able assistants who aid Mrs. Rapp and Mr. Paschall in holding conferences with taxpayers and their representatives and in reviewing the work performed by other members of the staff.

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 ruling 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 only required to determine if the facts on which the ruling was based were properly presented to the Internal Revenue Service in the application. Secondly, 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

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 two 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.

The Division also carries out the Commissioner's responsibility as regards recommended legislation, technical content of tax return forms, and certain other Service forms used by the public. The Division's recommendations concerning legislation are, of course, transmitted through the Chief Counsel's Office to the Secretary of the Treasury. Furthermore, 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 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.

Under Mr. Littleton's and Mr. Lewis' supervision are the Chief of the Analysis Branch, Mr. E. H. Hatfield, and the Chief of the Programming Branch, Mr. Paul T. Maginnis.

Prior to joining the Technical Planning Division, Mr. Hatfield was an accountant and auditor in the Audit Review Division. Mr. Maginnis was formerly a member of the Legislation and Regulations Division of the Chief Counsel's Office.

Other key personnel of the Analysis Branch are Assistant Chief Linder Hamblen and these Section Chiefs: Henry B. Jordan, Substantive Law; Ruhl H. Cooper, Administrative Provisions; John F. McGuire, Forms and Instructions; and Robert S. Cooper, Liaison. In the Programming Branch, key positions are held by Charles E. Mercogliano, Assistant Chief, and the following Section Chiefs: Howard W. Lehman, Forms; Bernard L. Payne, Regulations and Hearings; and George L. Dickerman, Legislation.

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.

IRS Engineering and Valuation Branch

There are four separate sections in this Branch, all supervised and co-ordinated by Ralph C. Staebner. The sections and their chiefs are: Appraisal Section, Darrell S. Parker; Court Defense Section, Harold L. Parrish; Natural Resources Section, Delbert W. Williams; Public Utilities Section, John H. Fahrenbach.

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, under Mr. Parker, 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.

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.

John H. Fahrenbach and the capable individuals in his 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.