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Irvin F. Diamond

Mike Walker

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TAX PLANNING TIPS 1982 FROM THE TAX ADVISER

AICPA

AICPA American Institute of Certified Public Accountants

TAX PLANNING TIPS 1982

FROM THE TAX ADVISER

EDITORS: IRVIN F. DIAMOND, CPA / MIKE WALKER, CPA

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EDITORS: IRVIN F. DIAMOND, CPA / MIKE WALKER, CPA
ROGOFF, DIAMOND & WALKER

American Institute of Certified Public Accountants

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Foreword

We are again privileged to have Irvin F. Diamond, CPA, and Mike Walker, CPA, of Rogoff, Diamond & Walker, Albuquerque, New Mexico, as editors of *Tax Planning Tips From The Tax Adviser—1982.*

The book contains items that have appeared in the "Tax Clinic," a monthly column in the *Tax Adviser,* which is published by the AICPA. Approximately two-thirds of the book contains items from previous years, which still are pertinent and of current interest to the practitioner. Each of these items has been reviewed and updated to reflect the most recent developments in the area. The remaining third of the book contains items that are appearing for the first time. These items are also updated to reflect current developments. The book includes a table of court cases and a listing of revenue rulings and procedures cited in the text.

We hope the book will provide a base from which common problems can be identified and the necessary research conducted. The specific items in the book are categorized by code section, providing an orderly approach to the text material. The table of contents (with new items noted by asterisks), case table, and ruling list are additional tools designed to permit easy reference.

The items in the book have been submitted by a number of contributing editors and other practitioners. The contributing editors to the "Tax Clinic" of the *Tax Adviser* for 1981 are

Darwin Broenen, CPA
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We also wish to acknowledge the fine efforts of Jo Proett, CPA, and Diane Bode, CPA, of Rogoff, Diamond & Walker, who assisted the editors in the technical editing of the book, as well as Eugene Linett, editor of the *Tax Adviser*, and Marie Bareille and Michael Esposito of the Institute's production department.

Kenneth F. Thomas, CPA
Director, Federal Tax Division

Editors' note: The Economic Recovery Act of 1981 made significant reductions in the estate, gift, and income tax rate structures, as well as a variety of technical changes, several of which, especially in the depreciation and investment credit area, will alter traditional tax planning approaches. Generally, the changes are reflected in the text; however, in some cases they are not. The reader is cautioned to consider carefully the effect the new act will have on specific situations.

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General tax matters

Tax planning in a recession

Effective tax planning can be just as important, if not more so, during a recession as in periods of prosperity. Some businesses, for example, experience cash flow problems that can be partially alleviated by attention to tax payments, timely refund claims, and other tax matters. For others, decreased profitability may require tax planning in areas that are not normally worrisome (minimum taxes, for example). The following are some procedural techniques and planning suggestions that may be appropriate as a result of the current economic downturn:

- If a net operating loss is expected for the current year, Form 1138 may be filed to extend the time for payment of taxes for the preceding year. However, a 12 percent interest cost will be incurred.
- If estimated taxes have been overpaid, an application for quick refund (Form 4466) may be filed within 2½ months after the close of the taxable year.
- Form 1139 may be filed for expedited tentative refunds (generally within 90 days) resulting from net operating loss, capital loss, investment tax credit, WIN, or unused job credit carrybacks.
- Where the refunds are sizeable and the economic consequences of delay are severe, it may be possible to arrange to hand deliver the Forms 1139 or 4466 to the service and further expedite the refund procedure.
- Form 1127 may be filed to request a sec. 6161 extension of time of not more than six months for payment of tax due to "undue hardship."
- If profits will be down, estimated tax payments for the current year may be reduced by changing the basis of the payments away from last year's tax.
- Where warranted, the minimum funding standards of sec. 412 may be waived and required pension contributions deferred and amortized over 15 years. (See Rev. Proc. 78-14 and Rev. Rul. 78-223.)

- If reduced current taxes result in minimum tax liability, plan to minimize recognition of tax preference items. If preference items have already been realized, consider delaying sec. 38 property acquisitions since additional investment credits further reduce the regular tax offset in the minimum tax calculation.
- If earnings and profits have been reduced by losses, all or a portion of dividends paid may be a return of capital. An earnings and profits study may be in order.
- Where unfavorable capital gain, excess credit, or preference tax consequences may result, consider electing to forgo a net operating loss carryback.
- If an operating loss is expected for the current year, consider delaying the recognition of long-term capital gains until future profitable periods.
- If net operating losses or other tax carryovers will soon expire, plan in general to accelerate income and postpone deductions.
- Consider delaying dividends from foreign subsidiaries where the resulting "deemed paid" foreign tax credits will only result in a carryover that may be difficult to utilize.
- Consider whether changes might be in order for existing intercompany pricing arrangements or for other intercompany allocations, particularly with respect to foreign affiliates so as to minimize worldwide tax burdens.
- Consider whether shareholders have sufficient basis in subchapter S corporations to utilize losses.
- Consider appropriate advance inventory planning for excess stock or abnormal goods, particularly in light of the *Thor Power Tool* decision.
- If lifo inventory levels might be reduced at year end, consider the effects of invading baseyear inventory layers.

Taxpayers held to the terms of written agreements

In *William F. Sullivan* the Internal Revenue Service again succeeded in forcing taxpayers to adhere to the provisions of their written agreements. At issue in the case was whether a taxpayer should be permitted to disregard the form and terms of an agreement and treat two simultaneous sales to the same purchaser as a single sale for tax purposes.

The transfers involved a tract of undeveloped land and several leases for the future use of buildings to be constructed on the land. The leases, signed at various times, were part of an attempt to secure

financing for a proposed shopping center. Not all the leases were held for a period that would have been sufficient to qualify for long-term capital gain treatment. In separate but interdependent transactions occurring on the same day, the taxpayer conveyed the land for $250,000 and the leases for $1,250,000 to the same purchasers. Later, the taxpayer attempted to allocate the entire consideration ($1,500,000) to the purchase of the land, arguing that the right to receive rents was included in the fee simple title to the land and that the assignment of the leases was only a formality.

The Internal Revenue Service contended that the taxpayer should be bound, for tax purposes, by the terms of the contract that he voluntarily entered into following bona fide arm's-length negotiations. In its position, the service relied heavily on *Carl F. Danielson,* which held that, in the absence of unenforceability because of mistake, undue influence, fraud, or duress (if one party would have a cause of action against the other), the parties to a transaction are not permitted to unilaterally set aside the terms of that transaction. The taxpayer argued that the *Danielson* rule should not apply to the case because only capital assets were involved.

The third circuit, in affirming the district court, held that the *Danielson* rule did apply, noting that the leases had an independent value because the land was worth considerably less without the leases.

If the *Sullivan* transaction had been structured simply as a land transfer rather than two separate sales, the entire amount would have been treated as long-term. Tax advisers should construct agreements carefully: In the absence of unenforceability because of mistake, undue influence, fraud, or duress, taxpayers will be bound for tax purposes by the form and terms of their written agreements.

Determination of tax liability

SECTION 46

Investment credit—limitation on noncorporate lessors

IRS Letter Ruling 7928004 denied investment credit to an individual who leased equipment to his controlled corporations on an "as needed" basis. The ruling held that this arrangement failed to satisfy the sec. 46(e)(3)(B) requirement that the lease term be less than 50 percent of the life of the equipment. Many individuals lease equipment to their controlled corporations; and although the holding of the letter ruling may be questionable, tax practitioners should alert clients about possible IRS scrutiny of these arrangements.

The letter ruling involved an individual (*A*) and a corporation (*M*), which was owned 50 percent by *A*, 18 percent by *A*'s two daughters, and the remainder by *M* employees. It also involved the same individual (*A*) and another corporation (*N*), owned 83 percent by *A* and 17 percent by *N* employees. Heavy equipment was leased on an "as needed" basis to the corporations.

The private ruling cited Rev. Rul. 76-266, which includes a situation wherein a lessor arranged to lease "substantially similar" equipment to a subsidiary of the current lessee of new equipment immediately after expiration of the first lease. On its own, the first lease would have passed the 50 percent-of-useful-life test, but the revenue ruling aggregates the two leases and denies the credit for failure to pass the 50 percent test. The private ruling also cited two cases in which courts have disregarded the stated terms of leases involving related parties.

Many individual clients lease equipment to wholly owned corporations for less than 50 percent of the useful life, with no option to renew. The fact that an individual currently has the power to renew the lease through control of the corporation does not mean that the control will be in existence when the lease term expires. For example,

the stock could be sold or passed through the stockholder's estate to beneficiaries who will individually lack such control. Also, in the private ruling, there are substantial minority stockholders whose rights to arm's-length dealing are apparently ignored by the assumption that the majority stockholder will have the corporations continue to lease the equipment.

Editors' note: Regs. sec. 1.46-4(d)(4) has always indicated a restrictive IRS view. See Rev. Rul. 76-266 for examples of when the aggregation principle will not be effective. If practicable, a sec. 351 transfer at the end of the initial lease term might be considered.

SECTION 47

Investment credit recapture: mass assets

The IRS provided a mass asset dispersion table for pretermination investment credit property in Rev. Rul. 67-378. This table could be used either to compute—

1. The qualified investment from mass assets in the year of addition, i.e., concede "up front" recapture, or
2. A presumed recapture for mass asset items in subsequent years.

The ruling table is, of course, based on the four-, six-, and eight-year life brackets.

Unfortunately, the service has never issued a revised ruling or provided new dispersion tables. Taxpayers should be allowed to use a survivor table, such as the Iowa SI Symmetrical Dispersion Table. The table below follows the Rev. Rul. 67-378 format and uses this Iowa Dispersion Table.

Useful life years	Years				Qualified investment
	3 (−)	3–5	5–7	7 (+)	
5	11.50%	38.50%	38.49%	11.51%	50.00%
10	1.79	4.89	11.73	81.59	91.04
15	.82	1.46	3.20	94.52	97.14
20	.54	.68	1.34	97.44	98.56

Thus, if a collection of mass assets is placed in service, such as milk carton trays having an expected average useful life of five years, 50 percent of the cost of the particular year's additions will be eligible for the investment credit, using the "up front" method. If the second method is used, i.e., presumed disposition years, a two-thirds

investment credit should be taken for the year of addition, then 11.5 percent of that amount shown as a recapture disposition in the third year following addition, and 38.5 percent in the fifth year after the addition.

Investment credit recapture: furniture as "mass assets"

Regs. sec. 1.47-1(e)(1) contains specific recordkeeping requirements necessary to claim the investment tax credit on each item of sec. 38 property. Failure to maintain these detailed records can cause partial (determined on a lifo basis) or complete loss of investment credit if the taxpayer can't establish on audit whether some or all of the assets are still on hand. These recapture rules can be avoided, and the recordkeeping requirements substantially relaxed, however, for assets which meet the definition of "mass assets" under the regulations. Investment credit recapture on mass assets is determined in accordance with mortality dispersion tables, which are specifically designed to eliminate the need to maintain certain information for each item of sec. 38 property. (See regs. sec. 1.47-1(e)(2); Rev. Rul. 67-378.)

Regs. sec. 1.47-1(e)(4) defines mass assets as a mass or group of individual items of property not necessarily homogeneous, each of which is of minor value relative to the total value of the group, numerous in quantity, usually accounted for only on a total dollar or quantity basis, and with respect to which separate identification is impracticable. The regulation includes "minor items" of office, plant, and store furniture and fixtures as an example of mass assets.

In IRS Letter Ruling 8008177, the IRS held that a bank was eligible to treat most of its furniture as mass assets for investment credit (and depreciation) purposes. The specific items of furniture that the IRS permitted to be treated as mass assets cost less than a certain (but unrevealed) dollar amount each. The only items excluded—approximately 0.1 percent—were those used principally in executive offices, and could be readily distinguished from the remaining 99.9 percent. One could reasonably infer, therefore, that the furniture held to be mass assets were not limited to low cost items.

According to the IRS, items costing less than the specific dollar amount met all of the provisions of regs. sec. 1.47-1(e)(4) except for the fact that the assets were accounted for in item accounts rather than on a total dollar or quantity basis. This requirement was waived on the grounds that the assets were "the type that normally would be accounted for on a total dollar or quantity basis, because of the large number of the assets." The items costing the specific dollar

amount or more did not qualify as mass assets since they were not numerous, readily identifiable, minor in value, or usually accounted for on a total dollar or quantity basis.

Accounting for furniture as mass assets can provide a significant saving in cost and recordkeeping for many companies. Moreover, since investment credit recapture is based on mortality dispersion tables, rather than on the basis of specific information kept for each particular asset, early recapture under regs. sec. 1.47-1(e)(1)(iii) can be avoided.

Investment credit recapture: reselection of used sec. 38 property

A frequently overlooked tax-saving opportunity is found in the provisions of regs. sec. 1.47-3(d). This regulation provides that where a taxpayer has over $100,000 of used property additions in a given taxable year, upon subsequent disposition of any of the sec. 38 property used to compute the credit for that year (prior to the expiration of its useful life), the taxpayer need compute credit recapture only when the dollar value of property disposed of exceeds the dollar value of the used property acquired but not utilized in the credit computation in the original taxable year. In the terminology of the regulations, in such a situation the taxpayer is entitled to "reselect," as qualifying under regs. sec. 1.48-3(c)(4)(ii) (relating to the selection of specific items of used property as qualified sec. 38 property to be used in the computation of the credit for that year), used property not originally selected and, therefore, not subject to recapture.

The following example illustrates the application of this regulation:

> On January 1, 1976, *X* Corporation purchased and placed in service as used sec. 38 property machines no. 1 and no. 2. Machine no. 1 had a cost of $100,000 and machine no. 2, $80,000. Each machine had a useful life of eight years. Accordingly, *X* claimed a credit on its 1976 tax return as follows:
>
> Machine no. 1
> 100,000 × .10 = $10,000
>
> On January 2, 1979, *X* sells machine no. 1. The actual useful life was three years; hence, at first glance it would appear that recapture in the amount of $6,667 would result. However, regs. sec. 1.47-3(d) allows *X* to "reselect" machine no. 2 and compute recapture only on the excess of the purchase price of machine no. 1 over the purchase price of machine no. 2, as follows:
>
> 20,000 × .10 × 100% = $2,000 orig. credit
> 20,000 × .10 × 33⅓% = 667 act. credit
> $1,333 recapture

Editors' note: The regulations require filing an information statement with the taxpayer's return for the year involved. The Economic Recovery Act of 1981 changed the used property limit to $125,000 for years beginning in 1981 through 1984 and to $150,000 for the years thereafter.

SECTION 48

Computer software—availability of investment tax credits

Companies that purchase computer software from outsiders are required to capitalize such costs for tax purposes and generally amortize them over a five-year period. Costs attributable to internally developed software may be claimed as an immediate tax deduction, though an election is also available to capitalize and amortize such internal costs. (See Rev. Proc. 69-21.) Recent judicial decisions dealing with qualifying investment credit property have caused many companies to re-examine their tax policies with respect to software costs.

Software is defined in Rev. Proc. 69-21 as including "all programs or routines used to cause a computer to perform a desired task or set of tasks, and the documentation required to describe and maintain those programs." Although viewed in some respects as an intangible asset by the IRS, software is generally physically embodied in reels of magnetic tape, decks of punched computer cards, disks, etc., which constitute tangible personal property.

Rev. Rul. 71-177 makes it clear that where the cost of purchased software is "bundled" together with computer hardware, the total capitalized cost of both software and hardware qualifies for investment tax credit. However, it has been unclear if "unbundled" software costs so qualify, whether developed internally or purchased separately from outsiders. Fortunately, several recent court decisions have thrown some favorable light on this question. The *Walt Disney* series of cases have uniformly held that motion picture film negatives constitute qualifying tangible property for investment credit purposes and that all associated costs are includible in the credit base. More recently, the court of appeals in *Texas Instruments, Inc.*, held that magnetic computer tapes and films were tangible personal property, and again the entire costs associated with producing the tapes were held to be includible in the basis for investment credit.

The Tax Reform Act of 1976 has now codified the decisions in the *Walt Disney* cases, subject to certain limitations (sec. 48(k)). However, this code section applies only to motion picture films and video tapes; computer software does not come within its specific purview. Nevertheless, the rationale of the *Walt Disney* cases—as well as the *Texas Instrument* decision—is strong support for the case for computer software.

Thus, taxpayers expensing software costs ought now to consider capitalizing them and claiming investment tax credits as well as accelerated depreciation. The permanent tax benefits associated with investment credits may be substantially more valuable than the temporary cash-flow savings from immediate software write-offs. Taxpayers already capitalizing software for tax purposes ought to consider also claiming investment tax credits and selecting an appropriate useful life that maximizes these credits. Protective refund claims should be considered for potential investment credits on costs capitalized in prior open years. Of course, taxpayers should be aware that there remains a strong possibility that the service will continue to contest this issue, and, if it's successful, a taxpayer may not only lose claimed investment credits but also the rapid write-offs otherwise available under Rev. Proc. 69-21.

Companies currently expensing computer software costs for tax purposes are required to submit an application to the IRS national office in order to capitalize and depreciate subsequent costs. Form 3115 may be used for this purpose. Unlike the case with most accounting method changes, however, this type of application need not be filed until the end of the year of change. (See Rev. Rul. 71-248 for information required to be included in such an application.) The IRS has permitted use of the "cut-off method" to effect these changes, so the new capitalization method need be employed only for new expenditures with no 10-year spread of a transitional adjustment. The IRS has not required financial statement conformity as a condition for approving these applications.

There does not appear to be an ADR class that would specifically include software costs, although class 00.12 (Information Systems) comes the closest. Software developed specifically for manufacturing, transportation, production, or communication purposes may have to be included in the ADR class for such activities.

Investment tax credit on special-purpose structures . . .

Sec. 48(a)(1) (definition of sec. 38 property) has produced numerous court cases over the years. The issue is when an asset constitutes a

"building and its structural components" (i.e., not eligible for the credit) and when it constitutes "other tangible property . . . (i) . . . used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or (ii) . . . a research facility used in connection with any of the activities referred to in clause (i), or (iii) . . . a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of tangible commodities (including commodities in a liquid or gaseous state). . . ."

The position of the IRS appears to be that the investment credit is allowable only when an asset meets the appearance test, i.e., the structure does not have the appearance of a building. The courts are more lenient, allowing the investment credit where an asset meets the functional test, i.e., the structure does not function as a building.

A key case in this area is *R. E. Catron*. The Catron brothers were partners in an apple-farming business. They purchased a metal structure for use in packaging and storing apples. Two-thirds of the building provided work space. The other one-third was a refrigerated area for the storage of boxed apples. The two areas were separated by a wall with a door in it. The Tax Court ruled that although men using forklifts moved the apples about in the refrigerated one-third, that area did not provide working space. Their work was "incidental, subordinate to, and solely in connection with the qualifying apple storage which was the sole use and purpose of the refrigerated facility. The cold storage facility, including its two-inch-thick insulation, qualifies as Section 38 property. . . . [W]hile the prefabricated Quonset structure may be basically a 'building,' the refrigerated area attached to one end thereof, including the extra thickness of insulation necessary and applied thereto, qualifies separately as a storage facility."

The reasoning behind the Tax Court's decision in *Catron,* to which the service acquiesced, is apparent in section 314 of the '78 act. That provision amended sec. 48(a)(1) and added a new sec. 48(p) to the code. The purpose of section 314 of the act is to insure that the investment credit is provided for "single purpose agricultural or horticultural structures." It specifically mentions greenhouses that contain space to care for plants. Also mentioned are structures employed in the raising of livestock. These must contain feeding and housing equipment. The useful life of one of these structures need not match the useful lives of any equipment contained therein. Note that section 314 of the act is applicable to tax years ending after August 15, 1971.

Had the '78 act been in existence at the time, *Stuppy, Inc.*, would not have come before the U.S. district court. The case involved the

eligibility of greenhouses for the investment credit. The government opposed the investment credit due to the amount of work performed in the greenhouses. The court relied upon the functional test and held that any human activity performed in the greenhouses was merely incidental and was not a primary function of the structures. The taxpayer was permitted to claim the investment credit on the greenhouses.

The changes made by the '78 act also shed new light on *Brown-Forman Distillers Corp.* This case involved the eligibility of "buildings" used for the maturation and storage of whiskey for the investment credit. The court ruled that the appearance of the structure was of no consequence. The court held that the structures afforded space for "no substantial employee activity." The court also relied upon the company's contention that "the enclosure must be retired contemporaneously with the other principal equipment with which they are integrated." The investment credit was allowed. The result in that case would be the same under the new act. The major difference is that there is now some support for the allowance of the investment credit for structures that permit slightly more work activity and for structures that can outlast the equipment contained therein.

Consequently, one should carefully analyze the properties and uses of newly constructed facilities of this type to determine whether they qualify in whole or in part as property subject to the investment credit.

. . . and the appearance test to qualify for the credit

The eighth circuit, in *Yellow Freight System, Inc.*, has ruled that docks and inspection lanes used in the trucking industry do not qualify for investment tax credit because they are "buildings" and not "special-purpose structures." In reversing the U.S. District Court of Western Missouri, the appellate court reinstated the appearance test rather than looking solely to the functional test in the determination of the status of special-purpose structures. While this case will make it even harder to convince the IRS on special-purpose structures, taxpayers should continue to pursue qualification for the credit under this classification aggressively in light of favorable opinions in the other courts. In particular, special-purpose-structure status should be claimed on manufacturing facilities where the structure will be retired when the equipment it houses will be retired.

The reversal of *Yellow Freight System* is significant for several reasons. First, the district court had concluded that all cited authorities

had adopted the functional test to the exclusion of the appearance test in determining special-purpose-structure status. Furthermore, the lower court had adopted the concept stated in *Arne Thirup* that the *amount* of human activity was not as important as the *nature* of the activity. The appellate court did not accept either of these conclusions. Furthermore, the appellate court placed greater reliance on the value of the government's expert witness testimony on the definition of buildings. It was particularly damaging to the taxpayer that an expert witness commented that the docks could be converted to manufacturing or warehouse space with a minimum of structural and building materials changes. Finally, the appellate court found the applicable regulations (regs. sec. 1.48-1(e)(1)) reasonable and as binding on the court as the statute itself.

There are several examples of approved special-purpose structures, including a greenhouse in *Arne Thirup*, a whiskey-maturation facility in *Brown-Forman Distillers*, and electricity-generating stations (Rev. Rul. 69-412). There are also the approved storage facilities used in connection with qualified activities such as manufacturing, production, extraction, or utility functions. Note, however, that all examples could pass an appearance test since they do not look like an ordinary building. Unfortunately, we do not have a good case on the books for a manufacturing facility with limited human activity that has the appearance of a building where, due to the nature of the activity, the structure will become obsolete when the equipment is retired. A recent unreported case of a district court in Idaho held that a paper mill is a special-purpose structure.

Note that the IRS still holds that a craneway structure with no walls is a building because it *functions* as a building by providing shelter (Rev. Rul. 68-209). Thus, the IRS would disallow a special-purpose structure whenever either the functional test or the appearance test is satisfied. In *Yellow Freight System, Inc.*, we have a circuit court agreement with the IRS that an appearance test is relevant and appropriate. It is possible that we have a conflict between the eighth and ninth circuits (*Yellow Freight* and *Thirup*) that will lead to the Supreme Court. In the meantime, aggressive tax return positions are warranted.

Editors' note: Taxpayer victories include Film N' Photos, Inc. *(merchandise huts) and* Fort Howard Paper Company *(housing for steam turbines). The IRS continues its vigorous opposition, however: Rev. Rul. 77-364 announced that* Thirup *would not be followed, and Rev. Rul. 79-406 provides that a self-service car wash structure will not qualify.*

Investment tax credit: functional test applied to trucking terminal dock facilities

The IRS continues to successfully attack dock facilities as ineligible for the investment tax credit. In the Tax Court case, *Consolidated Freightways, Inc.*, the service argued that terminal dock facilities used by a taxpayer engaged in the transportation by truck of general commodities freight was a building within the meaning of regs. sec. 1.48-1(e)(1), and thus not sec. 38 property.

The court focused on the activity in the dock facility, in which the dock workers, using a variety of equipment, moved freight. Because the issue was decided on the functional test, the appearance test was not applied.

However, unlike an earlier Court of Claims case involving the same taxpayer, the Tax Court held that overhead doors and vapor lights were temporary attachments to the dock and not structural components. Therefore, these items qualified for the credit under regs. sec. 1.48-1(e)(2).

The Tax Court also held that fences installed around the dock facility qualified for the investment credit because they were used directly in the company's business of providing transportation services (i.e., protecting the cargo while at the docks) and were essential to that activity.

Certain structural components qualify for investment tax credit

The IRS ruled in Rev. Rul. 79-183 that part of a building foundation and some of the structural steel framing qualified for the investment tax credit. The building was designed to house a number of huge stamping presses with capacities of up to 2,000 tons, and the foundation included such items as a 38-inch-thick mat of reinforced concrete. In its ruling, the IRS said that the concrete mat "serves as a foundation for those presses and in essence it is a part of the machinery and equipment. Although it also serves as a floor . . . this use is strictly incidental to the use that necessitated its special design. It is therefore distinguishable from a floor that would be considered a structural component of a building." In addition, the IRS said that those portions of the steel columns used to support a building and a crane were essentially a part of the crane and that their building function was "incidental."

It is important, therefore, that the tax planner analyze construction projects carefully to make certain that opportunities to take the

investment credit are not overlooked. This ruling makes clear that certain structural items may qualify for the credit if they are specifically designed for qualifying equipment and if they function only incidentally as structural components. Other examples: While flooring and central air-conditioning systems do not normally qualify, the special raised flooring and heavy-duty cooling equipment installed in a computer room do qualify for the investment tax credit. (See Rev. Rul. 74-391.)

Investment credit: joint committee clarification on rehabilitation expenditures

Section 315 of the '78 act amends sec. 48, extending the investment tax credit to qualified rehabilitation expenditures made to 20-year-old commercial buildings. (See secs. 48(a)(1)(E) and (g).) The general explanation prepared by the staff of the joint committee on taxation has clarified several questions that have arisen since enactment of the new provisions.

One question concerns the 20-year requirement where a structure was vacant for a period of time. Although under the statute it seems clear that vacancy creates no problem, the committee reports indicated that the building must be *in use* for a period of at least 20 years. The joint committee report, however, provides that for this purpose the determination of the 20-year period would be unaffected by periods during which a building was vacant or devoted to a personal use.

Sec. 48(g)(1)(B) provides that a 20-year period must have elapsed between the date physical rehabilitation work began and the later of (1) the date the building was placed in service or (2) the date the building was placed in service in connection with a prior rehabilitation for which the credit was allowed. There has been some question whether Congress intended the 20-year period to begin anew where a prior rehabilitation (say 1976) was not subject to the investment credit. The committee reports ignored the statutory language and implied that any rehabilitation within the last 20 years would start a new period. The joint committee report, which follows the House committee report practically word for word, appears to clarify congressional intent by specifically inserting the phrase "for which a credit was allowed." Thus, it appears, for example, that a 20-year-old building that had been rehabilitated in 1976 could still be considered a qualified rehabilitated building.

The joint committee report also explains what constitutes a "major portion" of a building where part of a building is rehabilitated. (See

sec. 48(g)(1)(C).) Such factors as volume, floor space, and functional differences between the rehabilitated and unrehabilitated parts of the building should be taken into consideration. An example is given, providing that where a substantial part of a building is used for commercial activities (such as retail stores) and another part for warehousing, each part will usually constitute a major portion of the building.

Finally, the joint committee report makes it clear that a rehabilitation undertaken by a lessee will allow the lessee to claim the credit to the extent such costs are capitalized and not treated as payments in lieu of rent. The useful life of such expenditures will be determined under sec. 167 or sec. 178.

Editors' note: Proposed regs. sec. 1.48-11 generally follows the joint committee report.

Rehabilitation expenditure credits—unanswered questions

Section 315 of the Revenue Act of 1978, added to IRC sec. 48(g), enables investment credits to be claimed for "qualified rehabilitation expenditures." There are a number of unanswered questions regarding this legislation that must be answered via Treasury regulations, rulings, and/or litigation.

Pass through to lessee? If qualified rehabilitation expenditures are incurred by a landlord/lessor, may the credit be passed down to the tenant/lessee under sec. 48(d) of the IRC? Neither the statute nor committee reports address this issue directly. However, the committee reports do indicate that "the costs of acquiring a building or an interest in a building [such as a leasehold interest] will not be considered as qualifying expenditures. . . ." Further, regs. sec. 1.48-4(a)(1)(iii), which does not reflect the Revenue Act of 1978, states as one of the requirements for a pass down of credits to a lessee that the property "constitute 'new Section 38 property' to the lessee *if such lessee had actually purchased the property*" (emphasis added). An interpretation of congressional intent and possible Treasury position would be that since any rehabilitation expenditures, had they been incurred by the lessee, would constitute leasehold improvements (not intended to qualify for the credit), a lessor would not be able to pass a credit to the lessee on such expenditures.

Noncorporate lessors. Sec. 1.46-4(d) of the regulations provides that when a noncorporate lessor enters into a lease of property that

otherwise qualifies for the investment credit, the credit will be disallowed unless the term of the lease (including options to renew) is less than 50 percent of the useful life of the property and unless the sec. 162 deductions during the first year of the lease exceed 15 percent of the rental income. Therefore, when a noncorporate lessor enters into a net lease of a building that otherwise qualifies for the rehabilitation credit, the lease should be structured so that its term (including renewal options) does not exceed 50 percent of the useful life of the building and the lessor's sec. 162 deductions during the first year of the lease do exceed 15 percent of the rental income generated by the lease.

Although at this writing there is a technical corrections bill before Congress that, as one of its measures, would remove the 50 percent and 15 percent tests from the qualification requirements for the rehabilitation credit, the passage of the bill in its present form is uncertain.

Tax year of credit. When is a "qualified rehabilitation expenditure" *placed in service* within the meaning of sec. 46(c)(1)(A)? The answer may be clear where the building will not be used until such time as all rehabilitation expenditures are completed. However, controversies between the taxpayer and the IRS are certain to develop where the building or parts thereof are being used by the taxpayer during the rehabilitation effort. Absent regulations, a reasonable interpretation would permit the taxpayer to claim the credit in the taxable year during which the expenditures are incurred and charged to the capital account if the building is in use by the taxpayer during the period of such expenditures.

Editors' note: Proposed regs. sec. 1.48-11(d)(1) provides a pass through to lessee if the requirements of sec. 48(d) are met. Proposed regs. sec. 1.46-4(d)(5) makes the 50 percent and 15 percent tests inapplicable to rehabilitation expenditure. Proposed regs. sec. 1.48-11(d)(2) provides that regs. sec. 1.46-3(d)(1) will be used to determine when the rehabilitated property is placed in service.

SECTION 51

Targeted jobs credit: problems for new corporations

There is a potential loss of targeted jobs credit for the unsuspecting new corporation. Sec. 51(e) limits targeted jobs credit to 30 percent

of the aggregate unemployment insurance (FUTA) wages paid by the employer during the *calendar* year ending *in* such *taxable* year. Thus, if a new corporation files a short first year return which does not include a December 31, the limitation is zero and the targeted jobs credit is lost. One solution to this problem requires that the new corporation's year end be extended to include a December 31. Although the new corporation's year end should not be chosen solely based upon the availability of the targeted jobs credit, it should be considered.

If the new corporation is a member of a group of trades or businesses under common control under sec. 52(a) (as defined in regs. sec. 1.52-1(b)), the new corporation may be able to claim a targeted jobs credit without having to extend its initial year to include a December 31. This is possible since proposed regs. sec. 1.51-1(d)(2) allows trades or businesses under common control to have a limitation of 30 percent of the aggregate unemployment insurance wages paid to *all* employees of that group of trades or businesses during the calendar year ending *in* such taxable year. Under sec. 52(a) the credit allocable to each member of the group is the member's "proportionate share of the wages giving rise to such credit." The new corporation may, therefore, be able to circumvent the sec. 51(e) limitation by relying on its sister corporation's FUTA wages, and then allocate the entire credit to itself based upon the sec. 52(a) apportionment.

SECTION 53

Jobs credit pass throughs: liberalized rules for carryovers to post-1978 years

On January 6, 1981, the IRS announced that some partners, beneficiaries of estates and trusts, and shareholders in subchapter S corporations may be entitled to a larger jobs tax credit than they claimed on their 1979 tax returns and should amend their 1979 returns to claim the higher credit. (See IR-81-1.)

As part of the Revenue Act of 1978, the limit on the amount of jobs credit that could be passed through from a partnership, estate, trust, or subchapter S corporation to a partner, beneficiary, or shareholder was repealed. This change was effective for tax years beginning after 1978. Although this new treatment was intended for the targeted jobs credit also enacted by that act, it also appeared applicable to carryovers of the old general jobs credit from 1977 and 1978 to 1979 and subsequent years.

On the other hand, proposed regs. sec. 1.53-3(f) stated that carryovers of old jobs credits from 1977 and 1978 to 1979 and later years continued to be subject to the proportionate limitation rule, based on income from the pass through entity.

The IRS now agrees that the repeal of the limitation will apply not only to jobs credits earned in tax years after 1978, but also to jobs credit carryovers to tax years beginning after 1978. Consequently, a jobs credit earned before 1979 and passed through to a partner, beneficiary, or shareholder who carries the credit over to a tax year beginning after 1978 will not be subject to the pass through limitation in the carryover year.

Also note that the 1979 Technical Corrections Act allows taxpayers to retroactively elect not to claim the 1977 and 1978 jobs tax credit. By so doing, the deduction for wages would be increased by the amount of the credit, which would increase the amount of the loss or reduce the income passed through to the partner, etc.

If a jobs credit carryover from 1977 or 1978 exists, determine which alternative is advantageous: (1) file an amended 1979 return to claim the credit carryover and obtain a refund for 1979, or (2) file amended returns for (*a*) the entity to elect not to claim the credit and (*b*) the partner, etc., to increase his loss for that year and obtain a refund.

SECTION 55

AMT may affect conventional shelter strategies

Many high-bracket taxpayers look for investments designed to shelter income or to generate tax credits. In some cases, however, the alternative minimum tax (AMT) may be a reason for rethinking conventional strategies. A taxpayer who is already subject to the AMT because of large long-term capital gains may actually be better off avoiding new tax shelters or even accelerating income. Also, a taxpayer looking for year-end tax credits should be aware that there is a point at which the credits (other than foreign tax credits) will not reduce his overall liability, because of the AMT.

The effect of the AMT is to introduce a point beyond which further sheltering of income, regardless of the taxpayer's regular tax bracket, will produce only 25 cents of tax saving for each dollar sheltered. If a taxpayer is subject to the AMT, his effective tax rate on his last dollar of earnings will be no higher than 25 percent; and if he continues to shelter income, it will be at a rate of 25 percent or less,

regardless of what his regular tax bracket is. Therefore, he may want to avoid additional shelter investments, charitable contributions, etc.

Consequently, a close analysis may be needed to determine whether shelter investments are justified or whether the taxpayer should instead be accelerating income in order to have it subjected to the AMT. A combination of the following items will indicate when an analysis may be in order: (1) large long-term capital gains have already been recognized, or are anticipated, (2) large shelter losses have been recognized or will be by year end, (3) large deductions have already been generated (e.g., charitable gifts), and (4) large tax credits have already been earned.

In addition, if the taxpayer is already subject to the alternative minimum tax, he may want to accelerate income through the sale of additional long-term capital assets. At first this may seem to be unwise because it will result in additional taxes that might otherwise be deferred. However, if the deferral would be temporary and the client's marginal rate is expected to be between approximately 64 percent and 70 percent, a reduction of his effective rate by up to 3 percent may be achieved. The effective rate of capital gains to a taxpayer in a 70 percent marginal bracket is 28 percent, whereas the top effective rate for the AMT cannot exceed 25 percent. (A countervailing consideration is the time value of the extra money paid in taxes for this year that can be postponed and paid as taxes for next year.)

In some cases an acceleration of ordinary income in order to have it subjected to the AMT may be advisable. For example, if the taxpayer is already subject to the alternative minimum tax, and a top marginal rate of more than 25 percent is expected in the next year, accelerating income into the current year to take advantage of a lower alternative minimum tax rate may be advisable. (Again, the time value of money may be a consideration.)

A taxpayer with large tax credits may find that he has an AMT liability even though he has no long-term capital gain or excess itemized deductions (tax preferences). The reason is that in determining tax liability the AMT is not reduced by tax credits (other than the foreign tax credit), but the regular tax is. Consequently, if a taxpayer reduces his regular tax liability with large investment tax credits or energy credits, he may find that these credits reduce his regular tax below his AMT liability, and any additional credits will not reduce his current tax liability.

To the extent that the taxpayer does not take advantage of credits, there is a carryover. To the extent the credits produce a tax benefit in the current year, there is no carryover.

Averaging encumbered by alternative minimum tax?

By now, most practitioners have seen evidence of the eccentric nature of the alternative minimum tax as it interacts with other provisions of the code. It is not too surprising, then, that the AMT can limit the tax benefits of income averaging under sec. 1301, since the tax determined under that section is considered to be the regular tax liability and, therefore, subject to overriding by the AMT calculation.

Given a large capital gain and low-income base years, income averaging can produce an effective tax rate below that of the AMT, causing the higher AMT to apply. The following example uses a couple with two children, filing a joint return, having base period income of $33,400 for each year, and with an unusually high gain in the current tax year:

Capital gain	$1,200,000	
less 1202 deduction	(720,000)	$480,000
Other income		60,000
Adjusted gross income		540,000
Itemized deductions		(10,000)
		530,000
Exemptions		(4,000)
Income subject to tax		526,000
Regular tax		335,000
Regular tax using income averaging		286,000
AMT		298,000
AMT "penalty"		$ 12,000

Note the conflict in policies: Income averaging is intended to give relief to taxpayers with unusually high income in a particular year, but the relief is reduced because of another policy directed toward particular abuses. Here, the AMT produces a reduction of income averaging benefits even in the absence of overt sheltering activities. It should not be assumed, however, that the AMT generally decreases the benefits of income averaging; in the example, a disproportionately high capital gain ($1,200,000) in contrast to ordinary income ($46,000 net) was required to produce a relatively small ($12,000) "penalty."

Also, the interplay of the AMT's tax brackets, the mechanics of income averaging, and the capital gain deduction further exacerbate the unpredictability of the AMT's effects. For instance, it is no real surprise that a substantial decrease in capital gain in the example brings the AMT below the regular tax and eliminates the "penalty" (in this case, an $850,000 decrease would be required), but it is

unsettling to realize that a substantial *increase* in the capital gain ($800,000) or other income ($32,000) does the same!

1978 act makes ITC a "tax preference item"

A taxpayer who is liable for the alternative minimum tax is not permitted to offset that tax by any nonrefundable credit, except for the foreign tax credit. (See sec. 55(c)(1).) Thus, the affected credits are the investment credit, jobs credit, child care credit, retirement income and WIN credit, as well as the newly enacted energy credits. There is a provision for carryovers to the extent that a taxpayer who has these credits derives no tax benefit because of the application of the alternative minimum tax (see sec. 55(c)(3)); however, this is a small consolation to a taxpayer hoping to benefit from the credits in the current year, especially if he is not certain he will be able to utilize them in the future.

Example. A married taxpayer has taxable income of $100,000 and has an investment credit of $35,200 because of substantial investments in equipment. In those circumstances he would pay a regular tax, after the credit, of approximately $6,800. However, due to the new alternative minimum tax, this taxpayer will have to pay a total tax of $12,000, including a minimum tax of approximately $5,200, *even though this taxpayer does not have one dollar of "tax preference items."*

This is an additional factor, involving complex computations, to be considered by the practitioner in advising clients with respect to planned investments. As in the example, one will not be able to assume that a taxpayer with a large amount of taxable income will be able to use significant amounts of credits. Therefore, in addition to a taxpayer's regular and minimum taxes, practitioners will be faced with the burden of forecasting what the taxpayer's alternative minimum tax will be. Such a forecast obviously will require some careful thought, particularly if the taxpayer is also in a position of having tax preference items, such as capital gains, which in and of themselves may trigger the alternative minimum tax.

The alternative minimum tax: unintended effect on oil and gas exploration?

At a time when gas lines are growing longer and energy supplies are shrinking, it seems unlikely that the authors of the Revenue Act of 1978 intended to hamper the search for oil and gas by further limiting the tax incentives available to certain private investors. Apparently unintended, the enactment of the alternative minimum tax could

have just that effect. It can increase the after-tax cost of investments in drilling activities, thereby adversely affecting capital formation in a highly capital-intensive industry.

Taxpayers realizing large nonrecurring capital gains may seek to shelter the taxable portion of these gains by investing in oil- and gas-drilling programs. By electing to expense the intangible drilling costs (IDC) incurred, a portion of the taxpayer's gain can usually be effectively sheltered. Tax reform, beginning with the 1975 Tax Reduction Act, has sought to narrow the tax benefits available to those investing in oil and gas, primarily by limiting the use and benefits of percentage depletion and by introducing the at-risk limitations; however, the deduction for IDC has remained relatively unscathed. Until now the only real threat to the deduction for IDC lay in the effect of a potential recapture of post-1975 deductions claimed and the inclusion of a portion of IDC claimed in the minimum tax preference base.

While the AMT does not limit the deduction itself, it can have the effect of reducing the tax benefit from a maximum of 70 percent to a maximum of 25 percent—a benefit reduction potentially more damaging than that incurred by the inclusion of excess IDC on productive wells in the add-on minimum tax base. Such a substantial reduction in the tax benefit of incurring a dollar of IDC will present not only a tax trap for the unwary investor but also will cause a reconsideration of the relative risks of oil and gas investments for those with large capital gains.

Congressional intent in enacting the AMT was to have all taxpayers availing themselves of the deductions for long-term capital gains and adjusted itemized deductions pay some tax. Graduated rates (up to 25 percent) are imposed on the sum of regular taxable income plus the excluded portion of capital gains and itemized deductions other than medical, casualty loss, and estate tax attributable to income in respect of a decedent. The tax applies only if it exceeds the regular income tax plus any add-on minimum tax less nonrefundable credits. It is necessary to determine the point where the two taxes are equal to advise clients of the real benefits from IDC or other deductions.

For example, assume a married taxpayer has a $1 million long-term capital gain and other taxable income net of deductions of $50,000. Ignoring the possible effect of income averaging and any nonrefundable credits, the regular income tax would be $281,724. If there are no other tax preference items, a $100,000 deduction for IDC should result in a $70,000 tax reduction for this taxpayer. However, the tax saving is only $57,224 because the AMT has reduced the benefit of a portion of the IDC deduction from an

effective rate of 70 percent to an effective rate of only 25 percent. To illustrate this point, the $100,000 of IDC produced the following tax results.

IDC incurred	Effective tax rate	Tax savings
$ 71,609	70%	$50,126
28,391	25%	7,098
$100,000		$57,224

Keeping in mind that the AMT applies only to the extent that it exceeds the sum of the regular income tax and any add-on minimum tax, the interaction of the AMT and the IDC deduction in our example can be illustrated as follows:

Taxable income	Regular tax*	AMT
$450,000	$281,724	$249,500
400,000	246,724	237,000
378,391	231,598	231,598
375,000	229,224	230,750
350,000	211,724	224,500

* Minimum tax does not apply since one-half of the regular tax exceeds any possible preference for IDC.

The point at which the AMT starts to increase the after-tax cost of each additional dollar deducted (here, $378,391) must be calculated to determine when the after-tax cost becomes 75 cents on the dollar. An actual determination must include the effect of income averaging and the maximum tax on personal service income, the interaction of adjusted itemized deductions and reductions in adjusted gross income, and the impact of any additional deductible expenditures that would cause minimum tax to apply. Such calculations must also include the effect of various limitations inherent in the deductions themselves (e.g., the percentage depletion limitations of sec. 613A).

The above example has focused on the after-tax cost of an oil and gas investment; however, the concept applies to any sheltering of a large capital gain. In high-income years, where IDC deductions traditionally yielded their greatest benefit, there now awaits a trap for the unadvised taxpayer. The effect that this change in the law will have on future shelter investments is uncertain. It is certain, however, that any future investments will need to be carefully scrutinized in light of the AMT if the sought-after tax results are to be achieved.

SECTION 57

Refunds to financial institutions on prior-year preference tax

In September 1978 the IRS issued final preference tax regulations, which, among other things, liberalized the service's stance on computing the sec. 57(a)(7) loan loss tax preference for commercial banks, savings and loan associations, and mutual savings banks. The new regulations effectively permit such taxpayers to recoup deliberately reduced prior-year loan loss deductions without the creation of a tax preference. In addition, thrift institutions that incurred such significant losses that they relied on the experience method in prior years to calculate their loan loss deductions will find that the new regulations significantly ease their tax preference position.

If such a financial institution has paid any preference tax at all in prior years, it may prove beneficial to recompute the tax under the liberalized principles of regs. sec. 1.57-1(g). These new regulations have retroactive effect on all open years, and refunds of preference tax may be available in a number of situations. In fact, very recent IRS private letter rulings confirm the availability of such refunds. (See, for example, IRS Letter Ruling 7927046.)

The key to obtaining relief under the new regs. sec. 1.57-1(g) lies in the calculation of a hypothetical reserve addition by reference to the *lesser* of (1) a hypothetical six-year moving average addition computed under sec. 585(b)(3)(A) or (2) the actual claimed loan loss deduction.

Beware of minimum tax trap for component depreciation

Suppose a client acquires or constructs a building and chooses to use an accelerated method of depreciation (SYD, DDB, 150, or 125 percent). The annual excess depreciation over the straight-line amount, computed as though straight-line had been utilized from inception, represents a tax preference item subject to the minimum tax (sec. 57(a)(2)).

What happens if, either through engineering surveys or actual cost accumulations, the component method of depreciation is utilized to compute annual depreciation? Isn't the resulting tax preference amount determined as above? Not necessarily so! The regulations under sec. 57 specifically state that "[w]here a portion of an item of Section 1250 property has been depreciated or amortized under a

method (or rate) which is different from the method (or rate) under which the other portion or portions of such item have been depreciated or amortized, such portion is considered a separate item of Section 1250 property for purposes of [determining the tax preference]" (regs. sec. 1.57-1(b)(2)).

Accordingly, since each component represents a separate item of property for these purposes, it is necessary to determine the tax preference amount on an individual item basis rather than simply subtracting the "theoretical" straight-line depreciation from the accelerated depreciation for the entire property. And, for tax preference purposes, the negative excess amounts cannot offset the positive amounts!

The following example from the regulations succinctly shows how the annual sec. 1250 tax preference amount may exceed the annual excess depreciation with respect to a building (regs. sec. 1.57-1(b)(7)).

Asset	Useful life	Cost	Salvage value
Building shell	50	$400,000	$50,000
Partitions & walls	10	40,000	0
Ceilings	10	20,000	0
Electrical system	25	40,000	2,500
Heating & A/C system	25	60,000	2,500

(*a*) The taxpayer's item of tax preference for year 1 would be determined as follows.

(1) Item of sec. 1250 property	(2) Declining-balance depr'n	(3) Straight-line depr'n	(4) Excess of (2) over (3)
1. Shell	$12,000	$7,000	$ 5,000
2. Partitions, walls, ceilings	9,000	6,000	3,000
3. Electrical, heating, A/C	6,000	3,800	2,200
Year 1 tax preference			$10,200

(*b*) The taxpayer's item of tax preference for year 4 would be determined as follows.

(1) Item of sec. 1250 property	(2) Declining-balance depr'n	(3) Straight-line depr'n	(4) Excess of (2) over (3)
1. Shell	$10,952	$7,000	$3,952
2. Partitions, walls, ceilings	5,529	6,000	None
3. Electrical, heating, A/C	4,983	3,800	1,183
Year 4 tax preference			$5,135

In year 4, the excess depreciation is only $4,664, which is $471 less than the $5,135 tax preference item. This difference results from the inability to reduce the preference item by the excess of the $6,000 straight-line depreciation over the $5,529 accelerated depreciation for item 2.

SECTION 72

IRS position on deferred variable annuities

If the owner of a deferred annuity contract dies before the contract is converted to an immediate annuity, the beneficiary usually has the option to receive a lump-sum distribution equal to the cash surrender value of the annuity or the premiums paid, whichever is greater.

In Rev. Rul. 55-313, the IRS held that a beneficiary of a deferred *fixed* annuity contract must pay federal income tax on a lump-sum distribution. The taxable income is equal to the proceeds received less the premiums paid by the deceased owner. An opposite conclusion was reached in Rev. Rul. 70-143, relating to deferred *variable* annuity contracts. This ruling held that the beneficiary did *not* have to pay federal income tax on a lump-sum distribution.

In a move that is not too surprising, the IRS has revoked the 1970 ruling by issuing Rev. Rul. 79-335. This ruling holds that the beneficiary of a deferred variable annuity contract, as well as the beneficiary of a deferred fixed annuity contract, must pay federal income tax on a lump-sum distribution in excess of premium payments. This treatment, however, only applies to premium payments after October 20, 1979, for deferred variable annuity contracts purchased after that date.

This ruling highlights a significant difference between life insurance contracts and annuity contracts. The death benefit of a life insurance contract is not subject to federal income tax; federal income tax must be paid, however, on annuity contracts if the death benefit exceeds the premium payments.

SECTION 79

Group-term life insurance planning

Improved investment returns for life insurance carriers have prompted more liberal group-term life insurance premium rates and

dividends as well as better performing ordinary life policies that might be superimposed on group-term plans. In some cases, this has prompted consideration by employers of a change in carriers. These shifts were deterred by Rev. Rul. 79-231, which considered the renewal by a participating employee of his coverage ownership assignment as a new transfer for purposes of sec. 2035 (gifts made within three years of the transferor's death). The gift tax exclusion amount exemption does not apply to life insurance policy transfers in this regard. (See sec. 2035(b)(2).)

Fortunately, Rev. Rul. 80-289 reverses this adverse IRS position and prompts reconsideration of group-term plans which continue coverage beyond normal retirement age of participating employees. These plans involve a "Retired Lives Reserve" which complies with Rev. Rul. 69-382 and Rev. Rul. 73-599. The employer, in addition to paying the premiums for group-term coverage of current employees, makes contributions to a reserve fund exclusively devoted to purchase of term coverage for retired employees on a prefunding basis. The employer has a current deduction for current premiums and the prefunding contributions, whereas the employee reports income only for the value of the coverage in excess of $50,000, while still employed, and reports no income after his retirement. (See sec. 79(b)(1).)

IRS Letter Ruling 7910064 considered a variation, usually called "cost recovery financing," of the prefunding approach which involved purchase of ordinary life insurance policies on current employees and retirees, to be funded and owned by the employer, which used proceeds from the maturing ordinary life insurance policies to make premium payments on the term insurance coverage for the retirees. The ruling approves a current deduction for the premiums paid on these ordinary life insurance policies, even though the employer was the interim beneficiary thereof, and treats the maturity gain on the policies as still tax-exempt under sec. 101(a).

These cost recovery financing policies should be distinguished from ordinary life insurance policies, which are superimposed by an employer for selected participants in a pre-existing conventional group-term life insurance program. Typically, a carrier different from the one involved for the existing master policy is selected in order to avoid disputes as to whether part of the master policy premium should be attributed to the superimposed policies, or vice versa.

The superimposed ordinary life policies are owned by the insured participant, and contain a premium allocation table which divides the premium between the group-term coverage and the paid-up insurance accumulation. The employer then deducts the entire premium on the superimposed policy.

The participant reports only the premium allocated to the paid-up accumulation, then uses table I under the sec. 79 regulations to compute the value of his coverage. Usually this value is substantially smaller than the actual premium allocation. Furthermore, once the participant has reached normal retirement age, no income is reportable for this "term coverage." Technical Advice Memorandum 7852013 considered this type of superimposed permanent policy plan, but declined to apply the sec. 79 rules because a group was not involved. The particular facts indicated that the permanent policies were purchased only for the president and his vice president's son, and not the other 39 full-time employees.

Furthermore, the five coverage classes were said not to preclude individual selection because they did not meet the rules of regs. sec. 1.79-1(c)(2), which require coverage brackets with the lowest coverage at least 10 percent of the highest coverage, and each higher bracket no more than 2½ times the coverage of the immediately lower bracket. Rev. Rul. 80-220 also disapproved an attempted group plan where no participant was covered under a particular bracket. If at least three, or preferably five, brackets can be identified, with participants in each, the superimposed permanent life policies would appear to be an attractive fringe benefit for the selected participants.

Two further notes may be helpful. The participant, either with retired lives reserved coverage or superimposed permanent insurance coverage, can transfer this coverage to an irrevocable trust and take the sec. 2503(b) annual present interest gift tax exclusions, pursuant to Rev. Rul. 76-490, where a trust is required to pay the full death benefits, upon death of the insured, to the trust beneficiary. This transfer should exclude the coverage from the current employee's or retiree's estate, provided the transfer itself occurs more than three years prior to his death.

However, it appears inadvisable to transfer ownership of the coverage to other shareholders of the corporation, or to an insurance trust, for the purpose of funding a cross-purchase agreement. It is understood that the service may disallow premium payments as corporate deductions inasmuch as the group-term life insurance philosophy is not satisfied—i.e., direct benefit of the employees' heirs or designees.

SECTION 83

Restricted stock compensation: possibly disadvantageous despite favorable technical advice

IRS Letter Ruling 8049017 contains technical advice allowing the 85 percent dividends received deduction to an employer corporation for dividends received on stock previously transferred to employees under a substantial risk of forfeiture. While the IRS district director argued that this treatment would give the employer a double deduction (i.e., in addition to its deduction for compensation), the effect of this ruling is merely to provide the employer with a net deduction of only 85 percent of the amount of income recognized by the employees.

This ultimately unfavorable result arose under the following facts. In 1973, Corporation *X* entered into substantially similar employment agreements with two employees pursuant to which *X* transferred to each of them shares of common stock of four companies listed on the New York Stock Exchange. The securities were nontransferable until October 1, 1976, and were subject to forfeiture by the employee if he terminated his employment with *X* prior to that date. In accordance with agreements evidencing the transfers, the employees received dividends on the securities which they reported as compensation under sec. 83. *X* consistently treated the dividend income as having been received by it and paid as compensation to these employees; and it duly withheld income taxes upon that compensation in accordance with sec. 3402. *X*, for its taxable years ended July 31, 1974, and July 31, 1975, reported as income a total of $100,000 in dividends paid on the restricted securities. In each of these taxable years *X* deducted, under sec. 243, 85 percent of the dividend income which was reported from the restricted securities.

The district director argued that *X* received a double deduction: one for employees' compensation (an ordinary expense) and one for the domestic corporation dividends received deduction granted by sec. 243. Based on this position, the district office attempted to deny the sec. 243 deduction through sec. 246(c)(1)(B). *X* contended that sec. 246(c)(1)(B) was not intended to apply to the payment of compensation under a restricted stock arrangement but was intended to be and is applicable only to transactions where a corporation has both a long and short position in substantially identical securities.

The legislative history of sec. 246 indicates that when the section was enacted in 1958 its purpose was to control certain types of tax

avoidance situations. In the committee reports contained in 1958-3 CB 950, the following is stated:

> A similar problem is presented where a corporation maintains both a "long" and a "short" position over the dividend payment date. In this case the corporation receives: (1) Dividend income against which it can take a deduction of 85 percent for the dividend received; and (2) an ordinary business expense deduction, which is fully deductible, for the amount of the dividend which the corporation has to pay the person from whom it borrowed the stock.
>
> * * *
>
> Both the House and your committee's bill also deny the 85 percent dividends received deduction where the corporation is, on the dividend date, in both "long" and "short" position with respect to substantially identical stock or securities (or otherwise under obligation to make corresponding payments and with respect to these securities).

In view of the legislative history of sec. 246(c)(1)(B), the IRS national office did not believe that it could be used in this factual situation. The section was intended to curb certain tax abuse or avoidance situations which were not believed present in these facts. Accordingly, *X*'s dividends received deduction was not disallowed by sec. 246(c)(1)(B).

Even though this ruling was favorable to the taxpayer, it nevertheless demonstrates the asymmetrical treatment of the two parties involved in receiving income from property which was transferred as restricted compensation under sec. 83. This result is caused by regs. sec. 1.83-1(a)(1), which states that until property which is transferred as compensation becomes substantially vested (e.g., no longer subject to a substantial risk of forfeiture), the transferor (employer) shall be regarded as the owner. Thus, any income from such property received by the employee constitutes compensation income to the employee. A corresponding compensation deduction is generally allowable to the employer under sec. 83(h) and regs. sec. 1.83-6. (See example (1), regs. sec. 1.83-1(f).)

The following tabulation illustrates the undesirable treatment afforded compensation income from substantially nonvested property, even under this favorable ruling. Also shown, for comparison, is the treatment without the benefit of this ruling, which is even more dramatically adverse.

	Treatment of compensation income from substantially nonvested property	
	With ruling	Without benefit of ruling
1. Dividends received by employee and treated as compensation income	$100,000	$100,000
2. Employer corporation's dividend income	100,000	100,000

	Treatment of compensation income from substantially nonvested property	
	With ruling	Without benefit of ruling
Employer's deductions:		
3. Compensation expense	100,000	100,000
4. Dividends received (sec. 243)	85,000*	0
5. Total deductions (lines 3 and 4)	185,000	100,000
6. Effect on employer's taxable income (line 2 less line 5)	(85,000)*	0
7. Net effect on combined taxable incomes of employee and employer (line 1 less line 6)	$15,000	$100,000

* Sec. 246(b) limits the dividends received deduction to 85 percent of taxable income (computed without certain deductions) unless there is a net operating loss.

The example below compares the net effect on the combined taxable incomes for the 10-year period, 1981 through 1990, of an employee and his corporate employer, *X*, of the following economically similar compensation alternatives—

- $100,000 bonus paid annually, or
- $1,000,000 worth of *Y* preferred stock yielding 10 percent annually, transferred to the employee in 1981 and not becoming substantially vested until 1990.

X purchased this stock for $1,000,000 in 1981. Its FMV in 1990 is also $1,000,000. Thus, no gain or loss would be recognized to *X* in 1990 under the formula prescribed in regs. sec. 1.83-6(b), as follows:

Amount of deduction allowed under sec. 83(h)	$1,000,000
Less *X*'s basis in the *Y* stock	1,000,000
Gain or loss	$ 0

	Cash		*Y* stock	
	Employer	Employee	Employer	Employee
1. Sales	$1,000,000		$1,000,000	
2. Compensation transferred directly to employee by employer	(1,000,000)	$1,000,000	(1,000,000)	$1,000,000
3. Subtotal of lines 1 and 2	0	1,000,000	0	1,000,000
4. Dividends on *Y* stock			1,000,000	
5. Compensation			(1,000,000)	1,000,000
6. Dividends received deduction			(850,000)	
7. Subtotal of lines 4–6			(850,000)	1,000,000

	Cash		Y stock	
	Employer	Employee	Employer	Employee
8. Total of lines 3 and 7	0	1,000,000	(850,000)	2,000,000
9. Employer's net income or deduction (line 8)		0		(850,000)
10. Combined effect (lines 8 and 9)		$1,000,000		$1,150,000

Thus, the use of *Y* stock provides the employer with additional deductions of $850,000. However, in order to accomplish this result for the employer, the employee must recognize $1,000,000 as compensation income. This $1,000,000 compensation income is in addition to the $1,000,000 of compensation income recognizable upon the vesting of the underlying stock. Consequently, the employee's *total* compensation is $2,000,000.

The impact of this restricted stock compensation on *both* the employee and the employer is summarized as follows:

Employee's income	$2,000,000
Less employer's *net* deduction (net reduction in taxable income)	850,000
Combined effect	$1,150,000

In contrast, payment of the basic $1,000,000 compensation to the employee in cash produces the following results:

Employee's income	$1,000,000
Less employer's *net* deduction (net reduction in taxable income)	0
Combined effect	$1,000,000

The difference between these two ultimate consequences is $150,000, which represents the difference between the $1,000,000 of dividends reported as compensation income by the employee and the employer's net deduction for this "dividend compensation" of only $850,000.

It has been asserted that cash compensation is usually funded through current earnings while this use of restricted stock compensation provides the employer with a deduction (e.g., $850,000) that does not require comparable financing. However, this "paper" deduction does require an outlay of the employer's resources in order to obtain the underlying stock on which the dividends are paid. Comparable to cash compensation, the sources for such stock would be—

1. Operating income:
   - Accumulated (retained earnings), or
   - Present or future (for installment purchase of stock).

2. Sale of operating assets. (This source may not be viable from a business standpoint. It also may precipitate reportable gain.)

Therefore, in order to achieve this "windfall" (e.g., a net reduction of $850,000 in taxable income for the employer), the employee's compensation is increased by an additional $1,000,000. While this latter amount is not directly funded by the employer, the employer's resources are required to fund the underlying stock from which this additional income is derived.

It has been suggested that the risk of forfeiture be so substantial that the stock's reversion to the employer will be assured. Thus, no ultimate outlay of employer resources would be required. However, regs. sec. 1.83-3(a)(3) states that ". . . no transfer may have occurred where property is transferred under conditions that require its return upon the happening of an event that is certain to occur. . . ."

On the other hand, suppose that *X*, the employer, has $1,000,000 in retained earnings and wishes to provide this amount to the employee as compensation over a 10-year period (1981 to 1990). The following alternatives are possible:

- Restricted stock transfer (as above).
- *X* purchases $1,000,000 of *Y* preferred stock yielding 10 percent annually. *X* does not transfer the *Y* stock to the employee. Instead, it uses the $100,000 annual dividend as the source of its annual compensation payments to the employee.

The effects of these alternatives are compared as follows:

	"Self-funding"		Restricted transfer	
	Employer	Employee	Employer	Employee
1. Dividends on *Y* stock	$1,000,000		$1,000,000	
2. *X*'s transfer of *Y* stock to employee			(1,000,000)	$1,000,000
3. Subtotal of lines 1 and 2	1,000,000		0	1,000,000
4. Compensation	(1,000,000)	$1,000,000	(1,000,000)	1,000,000
5. Dividends received deduction	(850,000)		(850,000)	
6. Subtotal of lines 4 and 5	(1,850,000)	1,000,000	(1,850,000)	1,000,000
7. Total of lines 3 and 6	(850,000)	1,000,000	(1,850,000)	2,000,000
8. Employer's net income or deduction (line 7)		(850,000)		(1,850,000)
9. Combined effect (lines 7 and 8)		$150,000		$150,000

Although the combined effect is the same under either alternative, the "self-funding" approach permits the employer to *retain* the basic $1,000,000 funding vehicle.

If X's present and/or future income is assumed to be the source of the funds used to purchase the Y stock, the combined effects are as follows:

	"Self-funding"		Restricted transfer	
	Employer	Employee	Employer	Employee
1. Sales	$1,000,000		$1,000,000	
2. Compensation transferred directly to employee by employer			(1,000,000)	$1,000,000
3. Subtotal of lines 1 and 2	1,000,000		0	1,000,000
4. Dividends on Y stock	1,000,000		1,000,000	
5. Compensation	(1,000,000)	$1,000,000	(1,000,000)	1,000,000
6. Dividends received deduction	(850,000)		(850,000)	
7. Subtotal of lines 4–6	(850,000)	1,000,000	(850,000)	1,000,000
8. Total of lines 3 and 7	150,000	1,000,000	(850,000)	2,000,000
9. Employer's net income or deduction (line 8)		150,000		(850,000)
10. Combined effect (lines 8 and 9)		$1,150,000		$1,150,000

Again, the combined effect is the same—but "self-funding" permits the employer to retain the Y stock. However, the level of the combined effect differs from the prior two illustrations, as follows:

	Source	
	Present and/or future income	Retained earnings
Cash compensation	$1,000,000	$ —
Restricted stock	1,150,000	150,000
Self-funding	1,150,000	150,000

Valuation of stock under secs. 83 and 57: securities law restrictions

It is unclear what effect restrictions imposed by federal and state securities laws have on the amount of income reportable from the exercise of a nonqualified stock option and on the amount of the preference item resulting from the exercise of a qualified stock option. At issue is whether a discount may be taken for the economic effect of these laws in determining fair market value for purposes of secs. 83 and 57.

In *T. R. Pledger* the Tax Court concluded that federal securities

law restrictions (e.g., investment letters) should be disregarded within the meaning of sec. 83(a)(1). The court also concluded that the measure of compensation is determined by the excess of the unrestricted fair market value of the stock on the date of transfer (exercise of option) over the amount paid for the stock. The court concluded that for purposes of sec. 83(a)(1) there is no difference between contractual restrictions and restrictions imposed by law. (See also *T. M. Horwith.*)

The Tax Court also decided in *A. L. Kolom* that, in determining the amount of the preference item under sec. 57(a)(6) from the exercise of a qualified stock option, the fair market value of a relatively small block of stock is its mean selling price on the New York Stock Exchange on the exercise date, with no discount for sec. 16(b) of the Securities Act of 1934 (the insider trading rule).

Despite these cases, an argument can still be made that fair market value of stock subject to securities law restrictions is less than fair market value of unrestricted stock. The Tax Court may be overturned on appeal, or another court may decide otherwise. Nevertheless, these decisions obviously make a contrary position on this point less cogent. If a taxpayer claims a discount because of securities law restrictions, disclosure of this point must be considered.

Sec. 83(a)(1) provides that the amount to be included in gross income is the excess of the transferred property's fair market value (determined without regard to any restriction other than a restriction that by its terms will never lapse) over the amount paid for the property. An argument can be made that it was not the intent of Congress to include restrictions imposed by law (as opposed to contractual restrictions) within the meaning of restrictions for purposes of sec. 83(a)(1). However, the final regulations under secs. 83 and 57 consider state and federal securities laws to be lapsing restrictions. Also, the Tax Court in *Pledger* concluded, "Making restrictions imposed by law an exception to the application of Section 83(a)(1) would clearly thwart congressional intent and result in transactions which Congress intended to eliminate, i.e., tax avoidance." Interestingly, the court did agree that since the taxpayer was subject to a so-called investment letter restriction, a discount of 35 percent would ordinarily have applied in determining true value.

The sec. 57(a)(6) preference item from the exercise of a qualified stock option is the excess of the stock's fair market value on the date of exercise over the option price. Regs. sec. 1.57-1(f)(3) provides that fair market value is to be determined in accordance with the principles of sec. 83(a)(1) and is to be determined without regard to restrictions (other than nonlapse restrictions within the meaning of regs. sec.

1.83-3(h)). A case can be made that the regulations, by adopting the sec. 83 requirement to ignore lapsing restrictions, overextend the language of sec. 57; although sec. 83(a)(1) requires that lapsing restrictions be ignored, sec. 57(a)(6) does not.

Notwithstanding the *Pledger* decision, the question of discounting for preference determination purposes remains unresolved. *Kolom* is significant because the court addressed at great length the question of whether sec. 16(b) does, in fact, have any effect on the fair market value of stock. It concluded that the fair market value of a relatively small block of stock is its selling price on the date of exercise, notwithstanding that the optionee was "an insider."

Sec. 16(b) provides that any profit from the purchase and sale, or sale and purchase, within a six-month period by an insider is recoverable by the issuing corporation. Interestingly, the courts previously have held that repayment of these profits by an insider represents an adjustment to sales price. The Tax Court in *Kolom* did not view the adjustment as affecting the initial determination of fair market value. The court pointed out that it has consistently held that the definition of "fair market value" is not a personalized one that envisions a particular seller and a particular buyer; rather, it contemplates transactions between hypothetical parties. Under this definition, the court noted, the fair market value of the stock itself is not affected by sec. 16(b), because under sec. 16(b) the repayment penalty is personal to the insider and, if incurred, is a separate event.

The courts have not finally resolved whether or not restrictions can be considered in determining fair market value. Note that a concurring opinion might have sustained the taxpayer in his argument that, for purposes of sec. 57, the insider-trading rules affect fair market value; for lack of proof, however, the judges who would have dissented were forced to issue a concurring opinion in *Kolom*. However, the language in this decision is persuasive, although possibly not conclusive, that sec. 16(b) alone does not affect the determination of fair market value for purposes of secs. 57 and 83.

Editors' note: The fifth circuit has affirmed the Pledger *decision, and the Tax Court continues to reaffirm its position. See* Pasquale N. Cassetta.

Compensation with nonemployer restricted stock

Publication of final regulations under sec. 83 makes clear that there can be advantages to an employer as well as an employee if compensation is paid in the form of restricted nonemployer stock.

Using such stock, the employer can provide an economic incentive to an employee to which he or she will have full rights at the end of a stated employment period or upon some other fixed date. During the intervening period, the dividends on the stock will accrue to the employer and, upon its transfer at the end of the period, the employee will have compensation income and the employer will have a deduction.

To illustrate, Employer *A* could purchase 200 shares of Z stock on a public market for Employee *X* and restrict its transfer until *X* had worked for a five-year period. During the five-year restriction period, 85 percent of the dividends received on this stock would be tax-free to *A* (sec. 243). If the stock appreciates in value during the period, the compensation deduction upon transfer to *A* would include the appreciation (regs. secs. 1.61-2(d), 1.83-6(a)), which would be taxable to *A* (regs. sec. 1.83-6(b)). Since the stock was a capital asset, the gain would be taxable at capital gain rates. Therefore, after tax effecting the appreciation, the net deduction to *A* would equal the full amount of the original purchase price and 38 percent of the appreciation. To demonstrate this 38 percent factor, assume *A* realized a gain of $100 when the *Z* stock was transferred. The capital gain tax on the gain would be $28. The deduction of the $100 gain would generate a tax savings of $46. The difference between $28 and $46, or $18, is the net tax savings or the equivalent of a deduction of $38 at a 46 percent rate. Hence, *A* enjoys a net tax deduction of 38 percent of the appreciation plus the original purchase price.

If the stock declines in value during the restriction period, *A* would not fare so well. The compensation deduction would be the amount of that value on the date of transfer, not the original purchase price. *A* would also realize a capital loss equal to the decline that could only be used to offset capital gains. Note that under the new regulations, to obtain a deduction, *A* is required to withhold income tax at the time the restricted stock is transferred based upon its value at the date of transfer (regs. sec. 1.83-6(a)(2)). This can best be accomplished by requiring the employee to pay cash to the employer equal to the necessary withholding before the stock is released to him.

Sec. 83 property: the withholding requirement

Under sec. 83 an employee recognizes income from property received as compensation for services upon receipt of the property or when restrictions lapse on previously received property. According to regs. sec. 1.83-6(a)(2), however, the employer is entitled to a corresponding sec. 162 deduction in years ending after July 20, 1978, only if income

tax is withheld in accordance with sec. 3402. The service has also ruled that such income is wages subject to the FICA and FUTA provisions (Rev. Rul. 79-305). Therefore, FICA should also be withheld to obtain a deduction.

The withholding requirement suggests that employers must make sure that withholding is possible if the property has appreciated in the employee's hands, if the employee is no longer employed, or if he is employed by an affiliated company. The employer's plan authorizing property transfers should include a provision that permits the employer to withhold amounts, if necessary, from cash payments for salary or bonus otherwise due the employee. If no amounts can be withheld, as in the case of an employee who has resigned, the employer could require the employee to provide a sufficient deposit prior to resignation as a condition of completing the transfer. Even such a deposit could be inadequate if, for example, a nonqualified stock option is granted (without a readily ascertainable fair market value) and the underlying stock has greatly appreciated when the option is exercised. A similar problem could exist if substantially nonvested property is transferred and is significantly appreciated at the time it becomes substantially vested. This problem might be obviated if the employee makes the special sec. 83(b) election to recognize income currently.

The validity of the regulation's requirement for withholding is questionable, since neither the statute nor the legislative history condition deductibility on withholding (compare sec. 274(e)(3)). In cases in which it is too late for withholding, employers should vigorously argue that the regulation is invalid. Until this question is judically resolved, however, it would be prudent to withhold if it is feasible to do so.

SECTION 101

Variable life receives IRS blessing

The typical whole life insurance policy has a fixed death benefit and a guaranteed cash surrender value. At least one life insurance company is currently marketing a variable life insurance policy. The concept underlying variable life insurance is that the death benefit and cash surrender value should vary with the investment experience of the life insurance company: If investment experience is above a minimum level (usually 3 to 3.5 percent), the death benefit and cash surrender value are increased; if investment experience is poor, the

death benefit is reduced (but not below a minimum guaranteed amount) and the cash surrender value is also decreased. Specific assets are segregated to measure investment performance, and both realized and unrealized capital gains directly affect the amount of the death benefit and cash surrender value. Essentially, the amount of favorable investment experience attributable to any particular policyholder is used to purchase additional paid-up insurance, and this provides a higher death benefit. If the policyholder lives, the additional paid-up insurance has a cash surrender value.

A recent private ruling, not released as an IRS letter ruling, discusses the federal income tax treatment of the policyholder. Sec. 101(a) provides that proceeds of life insurance contracts payable by reason of death are excludible from gross income. Apparently, there was some concern that the additional death benefit due to favorable investment experience might not be excludible under sec. 101(a). The private ruling confirms that the entire amount of the death benefit in a variable life insurance policy is excludible from gross income.

Case law and the ruling position of the IRS are quite clear that the increases in cash value of whole life insurance policies are not constructively received prior to actual surrender of the policies. The private ruling holds that the same treatment is applicable to variable life insurance, and there will be no constructive receipt until the policy is actually surrendered.

SECTION 103

Sec. 103(b)(6)(D) limitation affected by taxable corporate acquisition

Regs. sec. 1.103-10(b)(2)(v) provides special acquisition rules for application of the capital expenditure rule of sec. 103(b)(6)(D), relating to the small-issue limit for tax-exempt bond issues (now $10 million). Generally, the regulation provides that after a corporate acquisition covered by sec. 381(a) that occurs within the critical six-year period surrounding the issuance of a small issue of the exempt bonds, the acquired and acquiring corporations are treated as related for the entire six years for purposes of the capital expenditure test. (See regs. sec. 1.103-10(b)(2)(v)(*b*).) As a result, an outstanding tax-exempt small bond issue of either corporation could be rendered taxable because of a tax-free combination of the two corporations. (See regs. sec. 1.103-10(f), example (17).)

The sec. 103 regulations, however, provide no similar guidance regarding application of the capital expenditure test when an acquisition occurs that is not covered by sec. 381(a). The IRS conclusion in IRS Letter Ruling 7916001 suggests that this void is beginning to be filled. In that ruling, Corporation *M* has outstanding industrial development tax-exempt bonds that qualify under the small-issue exemption. Within three years after the bonds are issued, Corporation *S* acquires substantially all the outstanding stock of *M* in a transaction not covered by sec. 381(a). The IRS conclusion in the ruling reads as follows:

> The acquisition of the controlling stock interest in a corporation represents, in substance, the acquisition of the underlying assets of the corporation. Here, under the broad definitional language found in Section 1.103-10(b)(2)(ii) of the regulations, *S*'s purchase of 99.9 percent of *M*'s stock is a Section 103(b)(6)(D) capital expenditure "with respect to facilities" to the extent the purchase price is allocable to *M*'s facilities located in the City. . . . The allocable portion of the purchase price may be determined by multiplying the purchase price by the ratio of the fixed assets in the City to *M*'s total fixed assets.

The effect of this rather harsh conclusion is that at the date of acquisition by Corporation *S*, all the assets of Corporation *M* located in the city, irrespective of when originally acquired, are considered capital expenditures for purposes of the small-issue limitation of sec. 103(b)(6)(D). The amount of the total capital expenditures is based on the purchase price paid by *S*, not the original basis of the assets to *M*. This means that even appreciation of the facilities originally purchased with the bond proceeds by *M* is considered an additional capital expenditure. The ruling graciously provides, however, that the basis of the facilities originally purchased with the bond proceeds are not to be counted as capital expenditures twice.

Although it is impossible to obtain a complete picture of the factual situation from the published version of this ruling, the implied interpretation of the capital expenditure rule therein seems unreasonable. Under that interpretation, a corporation could lose tax-exempt treatment of its outstanding bonds merely because its stock is transferred. A more reasonable approach to this situation would appear to be to apply the look-back rule of regs. sec. 1.103-10(b)(2)(v)(*b*), which covers sec. 381(a) acquisitions. Under that rule, the small-issue limit would only be exceeded by capital expenditures actually made by either corporation in the critical six-year period.

The letter ruling indicates that the acquiring corporation, *S*, had no other operations in the city; therefore no consideration was given to capital expenditures of *S* in the six-year period. However, if *S* had capital expenditures in the city within the six-year period, under the

look-back rule those would be counted for purposes of the small-issue limit. It seems possible that in such a situation the IRS could impose the look-back for *S* additions *and* the sec. 103(b)(6)(D) allocation for *M* additions. Whether the IRS will use a look-back rule in addition to or as an alternative to the allocation is uncertain. In the meantime, acquisitions of corporations that have outstanding tax-exempt bond issues should be considered very carefully.

SECTION 105

"Insured" medical reimbursement plans to avoid sec. 105(h)

Since 1980, highly compensated individuals have been taxed on medical-expense reimbursements paid under a discriminatory "self-insured" plan causing employers to look for alternatives. In an effort to avoid the new rules, a number of "insured" plans are being marketed under which—

- A select group of employees is covered.
- The plan is administered by a life insurance company.
- The employer determines the limits of liability and deposits an advance premium (reserve) with the administrator, or there is an initial installment charge.
- Monthly premiums are subject to periodic or annual adjustment, on a retrospective basis, equal to claims paid plus premium taxes. The premiums also include administrative expenses of handling these claims. In some proposals, there is a ceiling on maximum premiums.
- In the event of the policy's termination, the employer agrees to reimburse the administrator for any benefits paid plus the agreed percentage. Any unused portion of the initial reserve is refundable to the employer.
- Group life insurance may or may not be part of the plan.

What is a "self-insured" plan? The Senate committee report states, "The bill applies only to an insured medical reimbursement plan that is a plan (or a portion of a plan) under which benefits are not provided by a licensed insurance company. . . ." The *General Explanation of the Tax Reform Act of 1978*, prepared by the staff of the Joint Committee on Taxation (March 12, 1979, p. 221), says, "Under the Act, a plan is considered self-insured if reimbursement is not provided under a policy of accident insurance, health insurance, or accident and health insurance. . . ."

Proposed regs. sec. 1.105-7(b)(1) defines a self-insured medical reimbursement plan as follows:

> A self-insured medical reimbursement plan is a separate written plan for the benefit of employees which provides for reimbursement of employee medical expenses referred to in section 105(b). A plan or arrangement is self-insured unless reimbursement is provided under an individual or group policy of accident or health insurance issued by a licensed insurance company or under an arrangement in the nature of a prepaid health care plan. A plan underwritten by a policy of insurance or a prepaid health care plan which does not involve the shifting of risk is considered self-insured for purposes of this section. Accordingly, a plan underwritten by a policy of insurance by a captive insurance company, an experience-rated policy providing no shifting of risk, or a policy which in effect merely provides administrative or bookkeeping services, is considered self-insured for purposes of this section. In addition, this section applies to a self-insured medical reimbursement plan maintained by an employee organization described in section 501(c)(9).

Interestingly, the proposed regulation does not consider a plan that reimburses employees for premiums paid under an insured plan to be a self-insured plan.

Arguments against the "insured" plans described above are—

- The benefits may not in fact be provided by a licensed insurance company. In substance, the employer provides the benefits through the insurer as its agent.
- The IRS may look to the element of risk and decide that benefits are not provided under an "insurance policy." The only risk to the insurer under the proposals is nonpayment of premiums (a risk incurred by any creditor). Without this risk element, there may be no insurance policy.
- Even if there appears to be some risk, the setting of maximum premiums may cause the IRS to contend that no risk exists if the ceiling is unlikely to be exceeded by claims paid.

Therefore, it appears that these attempts to avoid the application of sec. 105(h) will be subject to IRS attack. Pending further clarification in the final regulations, rulings, or possible future legislation, such plans should be approached with great caution.

Self-insured medical reimbursement plans: new regs. quantify outside risks for captives

A continuing problem in the taxation of captive insurance companies is whether and to what extent the insurance of nonaffiliated risks will warrant a deduction for premiums paid on affiliated risks. A significant milestone may be marked by the new regulations on self-insured medical reimbursement plans.

In Rev. Rul. 77-316, the IRS for the first time formally ruled that premium payments to an affiliated captive that insured no other risks did not qualify as insurance. In Rev. Rul. 78-277, that rationale was complemented by a holding that the excise tax imposed by sec. 4371 did not apply to such contracts.

The first semi-official indication by the IRS that a quantitative factor was relevant appears in IRS Letter Ruling 7904047, which held that the receipt of 3 percent of total premiums from nonaffiliated sources did not sufficiently evidence substantial risk-shifting and risk-distribution to qualify the contracts with affiliated companies as insurance. A further development was a Department of Labor class exemption from the prohibited transaction rules. Under the exemption, an employee benefit plan could be insured with a domestic related insurer if more than 50 percent of the premiums received by the captive were paid by unrelated insurers.

Under the Revenue Act of 1978, a self-insured medical reimbursement plan could no longer qualify as a tax-free fringe benefit program unless it was nondiscriminatory. The nondiscrimination rules do not apply to plans that are insured. (See sec. 105(h).) Regs. sec. 1.105-11(b)(1)(iii) provides that a plan under a policy issued by a captive insurer is not considered a self-insured one for purposes of sec. 105(h) if the captive's premiums received from unrelated companies equal or exceed 50 percent of its total premium receipts and the policy of insurance is "similar to policies" sold to such unrelated companies. (See T.D. 7754, 1/31/81.)

The reference to "similar to policies" has been left unexplained. To what extent a captive must duplicate with unrelated companies each type of risk insured for related companies in order to meet the "similar to policies" test is a matter of conjecture at this time. What does appear clear is the fact that if a company is prepared to diversify into the insurance business sufficiently to meet the quantitative test of the new regulations, a captive can qualify as an insurer of related company risks.

Tax-free payments from retirement plans due to disability retirement

In recent years courts have conferred unexpected tax benefits on taxpayers in the form of payments received from retirement plans due to disability.

In the case of *James A. Wood*, the taxpayer terminated employment in 1972 at age 54 due to permanent disability. He was a participant in his employer's profit-sharing plan from which he received a

$101,000 lump-sum distribution. Although he was only 85 percent vested, he received 100 percent of the amount in his account due to a clause in the plan that provided for full vesting in the event of termination of employment by reason of a permanent disability. The taxpayer asserted that the payment should be excluded from gross income under the provisions of sec. 105(a) and (c) as a payment from an accident or health plan. The court agreed.

Sec. 105(a) sets forth the general rule that amounts received by an employee from accident or health insurance for personal injuries or sickness are includible in his gross income to the extent that such amounts are attributable to employer contributions that were not includible in the employee's gross income, or were paid by the employer. Amounts received under a health or accident plan for employees are treated as having been received from accident or health insurance (sec. 105(e)).

In holding for the taxpayer, the court in *Wood* discussed the extent to which the exception of sec. 105(c) can be used by a taxpayer to exclude completely from his gross income certain disability payments received from a retirement plan. In order for payments received from a retirement plan to be excludible under sec. 105(c), two criteria must be met: (1) the provisions of the retirement plan must be said to encompass an accident or health plan and (2) the amounts must "constitute payment for the permanent loss or loss of use of a member or function of the body," or for permanent disfigurement, "computed with reference to the injury without regard to the period the employee is absent from work." Throughout this discussion, this second criterion will be referred to as payment due to a disability.

Retirement plan as health plan. Although one may not necessarily think of a retirement plan as constituting an accident or health plan, *Wood* states that the broad definition of accident or health plan as set forth in regs. sec. 1.105-5(a) suggests that "such a plan can be present in almost any kind of form" as long as it is "in the nature of insurance or indemnification against illness or injury." (See also *Irving N. Sidman.*) Such an intent to indemnify against illness can be evidenced by various factors. In *Wood,* the preamble to the profit-sharing plan provided that one of the purposes of the plan was to provide a measure of security to employees. Thus, the purpose of the plan was not solely to compensate the employee for past services or to share profits, etc. (Cf. *Sidman,* above.) In addition, the disability clause evidenced an intent to create such financial security in that a participant would receive the full amount in his account upon termination of employment due to disability even if he was otherwise less than fully vested.

In *Wood*, both the purpose clause and the disability clause thus evidenced an intent to provide financial security. It is, however, arguable that had only the disability clause evidenced such an intent, this would have been sufficient. Furthermore, it should also not be absolutely necessary that the participant not be otherwise fully vested, as long as his employment terminated because of his disability and as long as the disability clause in some way evidenced the so-called intent to create financial security. However, the fact that the participant, if less than fully vested, will receive 100 percent of his account at the time of disability retirement is certainly relevant. This evidences an intent to create security, i.e., to provide insurance for an employee who incurs a disability that ends his career, and it is such intent that is important.

Early retirement. Under the profit-sharing plan in *Wood*, a participant would receive 100 percent of the amount in his account upon early retirement. Since the taxpayer did not qualify for early retirement at the time the administrator of the plan determined that he was permanently disabled, the issue did not arise in *Wood* whether payments received by a disabled participant after *early* retirement age had been reached would be excludible as payments received due to disability retirement. This situation has been dealt with, however, in *Olga A. Stewart, Dorothy Keefe*, and *William L. Winter*. In discussing the excludability of payments under sec. 105(d) (disability payments), as in effect prior to the '76 act, and under regs. sec. 1.105-4(a)(3), as in effect for the years in issue, the courts held that payments were excludible from gross income in such a situation, implying that it is the reason for termination of employment that is important—i.e., the mere fact that an employee had also reached early retirement age at the time he terminated employment does not conclusively mean that his retirement was not due to disability.

Normal retirement. A case where a taxpayer retires due to disability but such retirement is at or after the *normal* retirement date has not yet been addressed by the courts, since excludability under sec. 105(d) is specifically precluded by regs. sec. 1.105-4(a)(3). It would appear, however, that in a sec. 105(c) situation, it may be difficult for a taxpayer to prove that the proximate and compelling reason for his cessation of employment was his disability rather than his retirement.

Permanent disability. As stated, in addition to the payments being made from a health or accident plan, such payments must be made under the conditions set forth in sec. 105(c). The fact that the taxpayer in *Wood* met the standards of sec. 105(c) was not disputed by the

commissioner, and the facts set forth inform us only that the taxpayer was "permanently disabled." Examples of payments that meet the standards of sec. 105(c) are set forth in regs. sec. 1.105-3. Although those examples deal mainly with the loss, or loss of use, of an appendage or of one of the senses, such as sight or hearing, the examples are nonexclusive. The extent to which the exclusionary provisions of sec. 105(c) can be applied is shown by a revenue ruling in which it was held that a payment received by a taxpayer who was permanently and totally disabled, with a life expectancy of a few months due to an acute cancerous condition, was excludible from gross income under sec. 105(c), since "whether payments received by an employee qualify for the exclusion under sec. 105(c) depends upon all of the facts and circumstances in each case" (Rev. Rul. 63-181).

Planning. Thus, in instituting or amending a retirement plan it might be advisable to have counsel include in the preamble, as one of the purposes, that of providing financial security to an employee in the event of disability, or of providing insurance to an employee who incurs a disability that ends his career before he would normally stop employment, etc. The best evidence of such a purpose would be to provide for full vesting, or for otherwise increased benefits, upon disability retirement. And for those employees who have already retired because of a permanent disability, check the provisions of the retirement plan, especially the disability clause, to determine whether a purpose of the plan is to provide for the employee's financial security in the event of disability.

SECTION 107

Parsonage allowance for administrative clergymen, etc.

Sec. 107 excludes from gross income the rental value of a home or a housing allowance (including utilities) received by a minister of the gospel. Regs. sec. 1.107-1(a) provides that to qualify for this exclusion, the clergyman must be performing services which are ordinarily the duties of a "minister of the gospel," a term nowhere defined in the code or regulations.

Normally, one thinks of this exclusion as applying to the home or housing allowance provided by a church or synagogue to house the parish priest, minister, or rabbi serving that house of worship.

However, regs. sec. 1.107-1(a) is much broader than that, giving the minister the opportunity to qualify for the sec. 107 exclusion when he is performing services other than traditional pastoral duties. Examples of such services, according to the regulations, are the administration and maintenance of a religious organization, and teaching and administrative duties at theological seminaries. Thus, a minister of the gospel who performs no sacerdotal duties may still exclude from gross income the rental value of a home or a housing allowance provided to him or her.

SECTION 108

Debt discharge income: savings certificates' interest and principal forfeitures

The issuance of savings certificates by a financial institution imposes an obligation on the institution to pay an interest rate that is usually substantially higher than passbook savings rates. The depositor is required to hold the certificate until maturity in order to collect the stated rate of interest. In the event of early withdrawal of the funds evidenced by the certificate, the provisions of the certificate require—

1. Forfeiture of interest in whole or in part, and/or
2. Forfeiture of a portion of the principal.

If the financial institution has recorded interest expense at the stated rate and the certificate holder withdraws before the maturity date, the financial institution's interest expense would be reduced or its income would be increased. To the extent the obligation to repay the certificate holder's full principal is reduced, the financial institution may realize economic gain.

Sec. 108, as amended by the Bankruptcy Act of 1980 (1980 BTA), permits nonrecognition of income from the discharge of indebtedness for which the taxpayer is liable provided an election is made, and there is an agreement, on Form 982, to reduce the basis of assets under sec. 1017 (as amended by the 1980 BTA). The result is the same as a deferral of income until the period in which the property, with the reduced basis, is depreciated or sold.

The following discussion pertains to the application of sec. 108 to these forfeitures for taxpayers who are solvent and outside of bankruptcy. No distinction has been made as to the effect on cash or accrual basis taxpayers, and the reader should adapt these conclusions to the method of accounting employed.

There is little doubt that the obligation to repay principal to a

depositor of a financial institution constitutes a debt, and there appears to be adequate support to conclude that sec. 108 can be properly applied to this discharge of indebtedness. On the other hand, it is doubtful that amounts accrued and forfeited within the same taxable year qualify for nonrecognition treatment under sec. 108. The Senate Finance Committee Report on the 1980 BTA states: "Further, cancellation of a previously accrued and deducted expense does not give rise to income if the deduction did not result in a reduction of tax (code sec. 111)" (page 8).

Although sec. 111 does not appear to specifically cover accrued but unpaid items, the regulations broaden its application by stating:

> The term "section 111 items" as used in this section means . . . all other items subject to the rule of exclusion, for which a deduction . . . was allowed for a prior taxable year. Regs. Sec. 1.111-1(a).
>
> The term "recovery exclusion" . . . means an amount equal to the portion . . . of all other items subject to the rule of exclusion which, when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer under Subtitle A (except for certain conditions not here applicable). . . . Regs. Sec. 1.111-1(a).

Merten's Code Commentary on sec. 111 explains the judicial extension of sec. 111 to include the recovery of items not previously deducted as not constituting income—i.e., if there was no tax benefit from an accrued expense, cancellation of that expense does not give rise to income. Therefore, if the accrual and forfeiture of interest occur in the same taxable year and sec. 111 requires no realization of income, sec. 108 cannot apply.

A literal reading of sec. 108, both before and after amendment by the 1980 BTA and existing regulations, leads to the conclusion that an indebtedness must exist before there can be forgiveness. There is a valid and strong argument that no indebtedness existed for the current year's accrual (except for the passbook rate, if applicable) because of early withdrawals by the certificate holder. The original accrual of the current year's interest represents an estimated expense. Subsequent adjustment of that estimated expense to a more accurate number merely reduces the accrual for the expense and does not logically represent income.

Accordingly, there should be no deduction for the current year's accrued interest which is forfeited, and correspondingly, no income from discharge of indebtedness should exist.

Rev. Rul. 67-200 (clarified by Rev. Rul. 70-406) holds that the forgiveness of interest accrued in a prior year and forgiven in a subsequent year is eligible for exclusion under sec. 108 to the extent that sec. 111 (tax benefit theory) is not applicable. Therefore, income

arising because of forfeiture of prior year's accrued interest is eligible for exclusion under sec. 108, provided the election and consent to reduce basis are made on Form 982.

SECTION 111

Unusual, if limited, opportunity from excess state income tax payments

Rev. Rul. 79-15 explains the determination of the portion of a state income tax refund that may be excluded from current income, based on the tax benefit rules of sec. 111. The IRS approach in Rev. Rul. 79-15 bases the sec. 111 "recovery exclusion" on the difference between the deduction-year zero bracket amount and all itemized deductions *except* state taxes for that year. In effect, the refunded tax is allowed in full against the excess zero bracket amount before any of it is applied to produce income.

The approach taken by the service could, in limited circumstances, allow an increased deduction from excess taxes paid in a current year without countervailing income recognition in the later year when the excess is refunded. As the following example illustrates, when the total itemized deductions other than state income taxes are less than the zero bracket amount in year one, the refund of taxes is excluded from income in year two, even though it reduced taxable income in year one.

Example. A married taxpayer filing jointly has remitted state income taxes, through withholding and estimated payments, of $2,100 through December 30, and the taxpayer has other itemized deductions of $2,500. The result will be $1,400 of itemized deductions after subtracting the $3,200 zero bracket amount. (Note that the zero bracket amount here is $3,400 for years after 1978.) On December 31 the taxpayer makes a $700 estimated state tax payment. This increases itemized deductions from $1,400 to $2,100 and the state income tax deduction from $2,100 to $2,800 (thus decreasing tax table income by $700). Further, the $700 payment turns out to be unnecessary, since state tax liability would have been satisfied wthout it.

In the following year, the taxpayer receives a $700 state income tax refund due to the overpayment. The taxpayer then computes the income effect of the refund following Rev. Rul. 79-15, comparing the return as filed with a return incorporating the same information but excluding the entire deduction for state income tax. The following schedule is presented in the format of the revenue ruling, but using the figures appropriate to this example.

By using the recovery exclusion rules, the taxpayer has obtained an additional $700 deduction in 1978, and no offsetting income upon refund in 1979.

If the IRS were to perceive the payment as nothing more than a tax avoidance scheme, it could, of course, challenge the payment as

a distortion of income. However, since the proper facts for this technique do not usually arise, it seems worthwhile to keep this device in mind for use in appropriate cases.

	Tax table income for 1978		Tax table income for 1978 without deduction for state income tax	
Adjusted gross income		$30,000		$30,000
Itemized deductions	$ 5,300		$ 2,500	
Zero bracket amount	(3,200)		(3,200)	
Excess itemized deductions		(2,100)		—
Tax table income		$27,900		30,000
State income tax deductions for 1978				2,800
Tax table income for 1978 without deduction for state income tax			30,000	
Tax table income for 1978			(27,900)	
Tax benefit (amount of state income tax deduction that resulted in a reduction of 1978 tax)				(2,100)
Recovery exclusion, 1979				$ 700

SECTION 117

Sec. 117: private educational foundation

The private educational foundation is a little-known fringe benefit that can provide tax-free scholarships to children of a corporation's employees. The private educational foundation should not be confused with the so-called educational benefit trust. It has been held that contributions by an employer to the latter, established to pay college expenses of children of certain employees, were taxable as income to the parent-employees. (See *Richard T. Armantrout.*)

Under the private foundation approach, the corporation sets up a tax-exempt charitable foundation that pays the educational expenses of certain children of officers and employees. Contributions by the

corporation to the foundation are deductible as charitable contributions, and the parents of the recipient children will not be taxed on any payments that their children receive.

To qualify for this treatment, there are seven conditions as well as a percentage test that must be met. The conditions, which are set out in Rev. Proc. 76-47, are as follows:

1. The program must not be used to recruit employees or to induce them to stay with the employer.
2. Selection of grant recipients must be made by an independent committee.
3. The program must impose acceptable and identifiable minimum requirements for grant eligibility.
4. Selection of grant recipients must be based solely on substantial objective standards, such as prior academic performance and test performance, completely unrelated to employment of the recipients' parents.
5. A grant may not be terminated because the recipient or parent terminates employment.
6. The courses of study for which grants are available must not be limited to those that would be of particular benefit to the employer or to the foundation.
7. The terms of the grant and the courses of study for which grants are available must meet all other requirements of sec. 117.

Under the percentage test, the number of awards made to children of employees is limited. The program will meet the percentage test if the number of grants awarded under that program in any year to such children does not exceed 25 percent of the number of employees' children who—

- Were eligible,
- Were applicants for such grants, and
- Were considered by the selection committee in selecting the recipients of grants in that year.

Alternatively, the program will meet the percentage test if the number of grants awarded in any year does not exceed 10 percent of the number of employees' children who can be shown to be eligible for grants (whether or not they submitted an application) in that year.

If a private foundation's program satisfies the seven conditions and the percentage test, the service will assume that grants awarded under the program to the children of employees will be scholarships or fellowship grants subject to the provisions of sec. 117(a). If a private foundation's program does not satisfy the seven conditions, the service will not rule that the grants qualify under sec. 117. If the program satisfies the seven conditions but does not meet the per-

centage test, other facts and circumstances can be used to determine whether the grants are qualified under sec. 117(a).

In any event, under the percentage test, it is clear that not all children of employees can benefit from the program. In addition, as can be seen from the conditions, it is not possible to award grants exclusively to children of officers. However, this program *can* provide a tax-free fringe benefit that is available to the children of all employees.

It is important to remember that the foundation must seek, in advance, Treasury approval as a tax-exempt charitable organization; the larger the employee group, the better are the chances of obtaining such approval. In addition, it is essential to obtain advance approval from the commissioner on the program itself under the rules of Rev. Proc. 76-47.

SECTION 162

Salesman's residence outside territory was tax home (it says here)

The service's long-standing position is that a taxpayer's "tax home" is his principal place of business, and not his personal residence for purposes of deducting traveling expenses under sec. 162(a)(2). (See, e.g., Rev. Rul. 75-432.)

A recent fourth circuit decision, *Lee E. Daly,* changes this rule for salesmen whose only office is their personal residence and who do not have an office in their sales area. In *Daly,* the taxpayer lived in the suburban Washington, D.C., area, but worked in Delaware, New Jersey, and eastern Pennsylvania selling office furniture. The service disallowed Daly's traveling expenses incurred between his Virginia home and Philadelphia, the principal focus of his work, on the grounds that such expenses were nondeductible personal expenses. The Tax Court upheld the IRS.

On appeal to the fourth circuit, a majority of the panel held, over a strong dissent, that the concentration of income-producing activity by itself is insufficient to create a "tax home." A taxpayer who does not have an office in his area of principal business activity or who is not required by his employer to either live there or keep an office there will not be found to have a "tax home" there. The court distinguished prior cases—e.g., *J. N. Flowers,* in which the taxpayer had a residence in one location and an office in another. The court permitted Daly to deduct the costs of traveling from Virginia to

Philadelphia (about 130 miles) and the costs of lodging and meals while staying in Philadelphia, because the taxpayer maintained no office in Philadelphia.

The taxpayer had retained his Virginia residence, after switching jobs in order to begin selling office furniture, so that his wife could keep her job in Washington and so that they could avoid the inconvenience of moving. Obviously influenced by the taxpayer's plight, the court quoted from another opinion the statement that it was not the intent of Congress to impose on the taxpayer the burden of establishing two homes in order to satisfy tax law requirements. (See *W. P. Schreiner.*)

It appears unlikely that other courts will follow the rationale of *Daly,* even though they might be sympathetic to the plight of salesmen with working spouses whose jobs are not conveniently located near the taxpayer's sales area. As was pointed out by the dissenting judge in *Daly,* the logic of the majority opinion would permit the taxpayer to deduct his travel costs to Philadelphia from a residence as far away as the Bahamas. The dissent concluded that since the taxpayer's decision to remain in Virginia was not due to business considerations, all the travel costs to Philadelphia were personal nondeductible expenses.

Partner's deduction for expenses paid by him

Expenses paid by a partnership in connection with its trade or business are generally deductible on the partnership return, but when an individual partner pays expenses relating to the partnership's business, deductibility is less clearcut.

If otherwise allowable expenses are reimbursed to the partner by the partnership, they are of course deductible by it. If, however, the expenses are not reimbursed by the partnership, the deductibility by the partner will depend upon the surrounding facts and circumstances. Generally, if the expenditures are made in connection with partnership business, and it is understood that expenses of a specified type are the responsibility of the individual partners, the courts have held that the payments are deductible. Thus, travel and entertainment costs paid by individual partners, and not reimbursed by the firm, have been held to be deductible by the partners themselves in a number of cases, e.g., *F. S. Klein* and *M. L. Dotson.* In those cases in which the expenses have not been allowed, there was typically no agreement or understanding among the partners that the expenses were to be borne by the partners individually and not reimbursed.

(See, e.g., *Cliff C. Wilson* and *Robert J. Wallendal.*) Furthermore, if the expenses in question are reimbursable under policies of the partnership, a partner who does not seek reimbursement will not be allowed a deduction. (See *Frank Occhipinti.*)

Where the partner has been permitted the deduction, the rationale appears to be that, in fact, the partner is himself engaged in a trade or business by virtue of being a member of the firm. (See *George A. Butler* and *Charles B. Harding.*)

Consistently, where a partner borrows money to provide capital to the partnership, it can be argued the interest expense paid on the borrowed funds should be deductible as a business expense and an "above the line" deduction (deduction for adjusted gross income under sec. 62(1)). There is some question whether such interest constitutes investment interest subject to the limitations of sec. 163(d). It appears, from a review of regs. sec. 1.57-2(b)(1)(iii)(a) and the general explanation of sec. 163(d) prepared by the staff of the Joint Committee on Taxation in connection with the Revenue Act of 1971, that interest on indebtedness incurred in the ordinary course of business (as opposed to a passive activity) does not constitute investment interest. Sec. 163(d)(7)(A) does provide that the limitation on investment interest, in the case of "*any* 50 percent owned corporation or *partnership*" (emphasis added), may be increased from the usual $10,000 level to $15,000. Thus, there may be a potential limitation on partnership-related interest expense, but this is far from clear. (But see sec. 163(d)(3)(D).)

In IRS Letter Ruling 8037024, the service concluded that an outlay by a partner treated as a capital expenditure under the code may be capitalized and amortized by the partnership, but not by the partner. This holding, along with the Tax Court's holding in *Russell A. Bufalino,* suggests that an expense that would be currently deductible by the partnership if paid by it will, if paid by the partner (without reimbursement by the firm), be allowed to the partnership. Although neither the letter ruling nor the case addresses the question of the partner's treatment, it would appear that in these circumstances the partner's basis for his partnership interest should be increased by the payment made.

To sum up, unreimbursed expenses paid by a partner in connection with partnership business or with the business of being a partner would appear to be deductible as ordinary and necessary business expenses under sec. 162, as "above the line" expenses offset against the share of partnership income. However, the area is not totally clear, and the facts in a particular case might affect the deductibility of payments by the partner.

Reasonable compensation and dividend policy

In *McCandless Tile Service* the Court of Claims held that payments for services rendered by stockholder-officers of a closely held corporation could be taxed in whole or in part as dividends, even though the amounts of such payments constituted *reasonable* compensation. The court felt that even if the payments were deemed reasonable, they would not be deductible to the extent that they were in reality a "distribution of corporate earnings and not compensation for services rendered." Later, in *Good Chevrolet* the Tax Court held, under similar facts, that if such payments are in fact compensation for services and are reasonable in amount it will not disturb the compensation deduction, regardless of the dividend-paying policy of the corporation. The service supported this position in Rev. Rul. 79-8, which holds that the determination of whether a payment constitutes compensation, and is reasonable, will be made without regard to the corporation's dividend policy.

More recently, and subsequent to the issuance of Rev. Rul. 79-8, the Court of Claims in *Petro-Chem Marketing Co., Inc.*, reaffirmed its position by using the *McCandless* rationale in holding compensation excessive in a case in which a closely held family-owned corporation paid out most of its earnings as compensation. The court based its findings in part on the fact that the corporation never declared or paid any dividends to its shareholders or had any pre-existing plan to pay year-end bonuses that far exceeded salaries. Even though the taxpayer was able to provide unchallenged expert testimony from witnesses in the petro-chemical industry that the compensation was in fact reasonable, the court concluded in favor of the government on the basis that the taxpayer failed to discharge its burden of proof by showing that the payments to its officer-shareholders were "purely for services."

Taxpayers should be aware that in cases in which compensation is likely to be questioned the lack of more than nominal dividends magnifies the problem significantly. It is important to adopt a reasonable dividend policy.

Editors' note: The Tax Court has specifically rejected the automatic dividend rule of McCandless. *See* Paramount Clothing Co., Inc.

Tax Court says $1 million-plus compensation is OK

The Tax Court in *Home Interiors and Gifts, Inc.* held that compensation was reasonable within the meaning of sec. 162(a)(1) even

though 1975 compensation for three officer-shareholders was $1,137,000, $1,135,749, and $277,954 respectively.

Four main facts supported the decision:

1. The corporate officers' efforts produced extraordinary results in sales growth and after-tax profits.
2. Compensation of other employees had increased proportionately during the years and was also substantially above the norm.
3. The officer compensation consisted mainly of commissions based on sales, and this was a long-standing practice.
4. Although actual commissions increased, commission percentage represented a "sharply declining percentage of the earnings" of the corporation.

The corporation began business in 1957, rapidly increasing sales from a modest $518,203 to a startling $168,944,103 by 1977. Between the years 1968 and 1975, sales increased by nearly 2,300 percent. Pretax and after-tax earnings rose 108 times and 114 times respectively. Such extraordinary growth was due largely to the efforts of the president and founder of the company, her son, and a third officer who joined the firm in 1968. Their combined talents in recruiting and motivating personnel, in managing efficiently, and in developing good relations with suppliers were remarkably effective.

While the Tax Court found that the commissioner did illustrate that the compensation paid the three officers was above the norm for positions of similar "skill, responsibility and creativity," the circumstances precluded the application of the norm as dispositive. The court held that sec. 162(a)(1) was "not designed to regulate businesses by denying them a deduction for the payment of compensation in excess of the norm," and it found that, given the impressive performance of the corporation vis-a-vis the growth of the GNP and of retail establishments in general, the compensation was not unreasonable.

Loan commitment fees—must they be amortized?

Loan commitment fees were the subject of one of the issues decided in *H. K. Francis*. Two such fees were involved—a construction loan commitment fee and a permanent loan commitment fee. The court held that these loan commitment fees for an apartment complex should be amortized over the periods of their respective mortgages. However, it held further that since the construction loan commitment fee would be amortized within the construction period, the amount amortized must be capitalized as part of the cost of construction (and, presumably, depreciated as a part of the cost of the asset).

The court stated that it is well established that fees paid to obtain financing are to be amortized over the definite period of the loan or mortgage, citing a number of authorities. However, none of the authorities cited deal with commitment fees.

Lovejoy pertains to amounts paid for a number of items, including services rendered in selling notes, a guaranty policy covering title to property, payment of fees for certifying the notes, and printing the mortgages and notes. *Enoch* involves amounts paid as loan fees and escrow charges for services rendered in obtaining a loan. (In fact, the court said that where premiums or bonuses are an increment in the cost of borrowed money, they shall be treated as interest.) *Anover Realty Corp.* deals with mortgage discounts, legal fees, mortgage-recording taxes, title insurance, and brokerage commissions—all involved in the underlying loan. *Longview Hilton Co.* involves amounts paid as broker's fees and commissions for services in processing a loan. *Chicago, Rock Island & Pacific Railway Co.* concerns discounts and expenses incurred in connection with the sale of bonds. Rev. Rul. 75-172 pertains to fees paid for specific services, for legal services, and for other expenses incurred by the lender in obtaining the loan proceeds.

Commitment fees should be distinguished from the expenses discussed in the authorities cited by the court in *Francis*, since commitment fees are not required as a condition to obtain a loan but are paid to secure an option by the borrower to ensure the availability of a loan at a specific time with specific terms. Each of the expenses discussed by the above authorities is either for services rendered in connection with obtaining a loan (and not an option) or is an expense of the loan and not separable from the loan itself.

Rev. Rul. 56-136, on the other hand, provides that commitment fees in connection with a bond sale agreement are not considered bond discounts or expenses amortizable over the life of the bonds, but are business expenses deductible under sec. 162 when paid or accrued, depending on the taxpayer's method of accounting. Thus, the IRS's own published position would support the conclusion that the commitment fees in *Francis* should have been deductible when paid or accrued and not required to be amortized over the life of the loans. We note that Rev. Rul. 75-172 did not purport to modify or distinguish Rev. Rul. 56-136.

Further, what about the court's requirement that the construction loan commitment fee must be capitalized as part of the cost of construction? Regs. sec. 1.266-1(b) allows the taxpayer to elect to capitalize carrying charges. Rev. Rul. 56-136 states that commitment fees are considered carrying charges, which may, at the election of

the taxpayer, be capitalized as part of the construction cost. If the taxpayer "may" elect to capitalize commitment fees, the clear implication is that if the taxpayer does not so elect, the commitment fees need not be capitalized.

Does *Idaho Power Co.* affect this conclusion? In that case, the court held that the capitalization provisions of sec. 263(a) take precedence over sec. 167(a) and, therefore, the equipment depreciation allocable to the taxpayer's construction of capital facilities was to be capitalized. However, in footnote 13, the court recognized that there are exceptions to the capitalization requirement of sec. 263(a)(1); included in such exceptions were carrying charges under sec. 266. The Supreme Court specifically referred to sec. 266 as a "further exception" to sec. 263.

In any event, it appears to us that the holding of *Francis* is questionable in requiring—

1. Construction loan commitment fees to be capitalized and
2. Permanent loan commitment fees to be amortized over the period of the mortgage.

Taxpayers who have been deducting their commitment fees currently, or more conservatively amortizing them over the life of the loan for which the commitment is made, will thus find authoritative support for continuing to do so.

Editors' note: The IRS issued Rev. Rul. 81-160, revoking Rev. Rul. 56-136. Rev. Rul. 81-160 provides that commitment fees in connection with a bond sale agreement are to be prorated over the loan term.

"Preopening expenses": a hot issue

Real estate partnerships are usually formed to develop, construct, own, and operate commercial or residential property. Admission of partners normally occurs before or during the construction phase. During this period, various expenditures normally associated with the day-to-day operations of a business are incurred, such as professional fees (accounting, legal, and other consulting fees), office expenses, advertising, business promotion (such as travel), salaries (non-construction-related), and management fees. In addition, certain other costs are usually incurred that are primarily construction loan financing fees relating strictly to construction funds. In the past the entities generally considered all of these expenditures to be "ordinary and necessary" in nature and deductible under either sec. 162 or sec. 212.

Recently, the IRS has challenged the deductibility of these items by considering them to be "preopening" or "preoperating" expenses. As such, the IRS considers them nondeductible when incurred, since the enterprise has not commenced its trade or business. According to the service, the "trade or business" does not commence until the property is available for the production of income. The basis for this position is *Richmond Television Corporation*, in which the court concluded that certain expenses, primarily salaries and related personnel costs, incurred by a corporation formed to operate a TV station were not deductible at the time they were incurred because the corporation had not "obtained its FCC license and commenced the operation of its broadcasting station."

In a later Tax Court memorandum decision, *H. K. Francis*, the preopening-expense issue was raised, and upheld, against a real estate operator. The taxpayer owned rental property and contracted for the development of an apartment complex. During the construction period, he incurred various expenses, which he deducted prior to the completion of the new building. The IRS contended that since the taxpayer was not in the trade or business of operating the new project until it was completed and producing income, he was not entitled to deduct any expenses incurred before the completion date. The taxpayer argued that he was already in the trade or business through his ownership of other rental property and was entitled to the deductions, since they were ordinary and necessary. The court cited *Richmond Television* as part of its rationale and upheld the IRS disallowance of certain preopening expenses.

A similar conclusion was reached in IRS Letter Ruling 7842007. The ruling held that a partnership formed in 1972 to construct a nursing home, which was completed the following year, was not entitled to depreciation or loan-fee deductions until September 1978, since the "facility was not producing income" and the partnership "did not start conducting a trade or business" until that time.

A recent Tax Court decision makes it apparent that the issue is being raised in many other situations. In this case, a utility company formed a joint venture with two other utilities to construct a nuclear power plant. Expenses during construction for training and similar items were paid by the various utilities, since they owned the plant as tenants-in-common and elected not to be taxed as a partnership under sec. 761(a). The IRS challenged these expenses as "start up costs of a new business"—the joint venture—even though they would have been deductible by the company if it had built its own plant, and the Tax Court agreed. (See *Madison Gas & Electric Co.*)

The IRS approach is set forth in sec. 370 of the new IRS *Tax Shelters Handbook*.

Editors' note: Sec. 195 provides that start-up expenses paid or incurred after July 29, 1980, are subject to a 60-month amortization election.

Minimizing the prohibition against deductions for fines and penalties: related expenses

The sec. 162(f) prohibition against deducting fines or similar penalties as ordinary and necessary business expenses applies to civil penalties, including the amounts paid in settlement of an actual or potential liability for a civil fine or penalty (regs. sec. 1.162-21(b)(iii)). The regulations also provide that the amount of a fine or penalty does not include legal fees and related expenses paid in defending against a civil action for a fine or penalty, nor court costs assessed against the taxpayer, nor stenographic and printing charges; also, compensatory damages do not constitute a fine or penalty (regs. sec. 1.162-21(b)(2)).

Thus, even when assessed a civil penalty not deductible under sec. 162(f), the taxpayer may be entitled to a deduction for related expenses. In some such civil actions, the governmental unit will assess a separate charge for investigative and other expenses of the governmental agency. The following arguments can be advanced to support the deductibility of such costs:

- Such costs are not characterized as civil penalties.
- Expenses of the governmental agency may be analogous to court costs, which the regulations exclude from sec. 162(f).
- Such costs may be in the nature of compensatory damages.

In making settlements with a governmental agency, the agency may be willing to negotiate as to the characterization of the settlement and the allocation of the settlement between the civil penalty and other expenses. In IRS Letter Ruling 7736040, the IRS permitted a business deduction for payments to a state in connection with violation of its antitrust laws. The payments dealt with contracts for construction projects between the taxpayer and the state. A settlement with the state was carefully worded to refer to actual damages rather than payment for a fine or penalty. In spite of the obvious tax planning, the IRS honored the characterization by the parties on the ground that characterization as a fine or penalty must be made by the state or the courts. (See also *Grossman & Sons, Inc.*) In spite of IRS Letter Ruling 7736040, the IRS would probably not recognize an unreasonable allocation between civil penalties and other expenses. However, it could certainly be argued that cost reimbursement to a governmental agency is not necessarily limited to reimbursement of direct out-of-pocket costs.

Under the rationale of the letter ruling that characterization by the state or the courts is controlling, it is important that the tax adviser work closely with the taxpayer's legal counsel. For example, in addition to reimbursing the governmental agency for investigative and other expenses, the agency may assert other penalties that may be in the nature of compensatory damages that are deductible under the regulations. However, the final settlement may only be represented by a court document that does not segregate the various items, other than between civil penalties and investigative expenses. Since the final characterization by the court will apparently be controlling, it is necessary to understand the details of the civil procedure; they probably will determine the tax consequences of the ultimate settlement.

Gift-leasebacks with family trusts—a continuing problem

One of the IRS's "prime issues" is the deductibility of rental payments in a family gift-leaseback transaction. In the past, the service has disallowed claimed rental deductions on grounds that the transaction lacked a business purpose or that the transaction should be disregarded because there was no independent trustee.

In *C. James Mathews*, the Tax Court listed certain criteria for determining whether such rental payments are deductible. In holding for the taxpayer, the court noted that if the following conditions are met in a gift-leaseback transaction, the rental payments are deductible:

- The settlor must not retain substantially the same control over the property that he had before he transferred the property.
- The leaseback should normally be in writing and provide for payment of a reasonable rent.
- The leaseback (as distinguished from the gift) must have a bona fide business purpose.
- The settlor must not retain a disqualifying "equity" in the property.

The fifth circuit reversed *Mathews*. The court concluded that because of the grantor's effective control of the gifted property and leaseback, no "business purpose" existed. Hence, the arrangement and trust were disregarded for tax purposes.

Recently, in *H. A. Lerner*, the Tax Court was faced with questions regarding the tax consequences of a three-party family gift-leaseback. The taxpayer, an ophthalmologist, incorporated his medical practice by transferring solely cash in exchange for stock of the new corporation. At the same time, he transferred all his medical equipment and

furnishings to a trust created for the benefit of his children that was to terminate in 10 years and one month. Immediately upon formation of the trust, the trustee, Lerner's attorney, entered into a lease with the professional corporation leasing all the medical equipment and furnishings to the corporation. The service denied the rental payments as deductions by the corporation and determined that rental payments constituted ordinary income to Dr. Lerner.

The court held that under sec. 162(a)(3) there was no valid reason to deny the corporation the rent deduction. The equipment and furnishings used by the corporation under the lease were required for the production of income, and the evidence showed that the amount of rent paid by the corporation was reasonable. Moreover, there was no disqualifying equity because the corporation, not the grantor, was paying rent. Also, the trust had an independent trustee.

Addressing the second issue, the court held that the rental paid by the corporation was not taxable to Dr. Lerner, but was taxable to the income beneficiaries who were required to receive the income of the trust because the grantor trust rules (secs. 671-77) were not violated.

The IRS also argued that there was no business purpose for this transaction, and, therefore, the transfers should be disregarded for income tax purposes. The court, however, held that the transactions involved were not the typical gift-leaseback because the gifted property was leased to the corporation, a separate taxpayer, rather than the grantor.

The court reiterated that it would look for a business purpose when reviewing the lease but not the gift in this type of transaction. In other words, the court said, "there need be *no* business purposes for a father to transfer income-producing property to a trust for his children and have them taxed on the income produced" (emphasis added). However, there must be a business purpose for the lease, which there was in this case.

Editors' note: In Quinlivan *the eighth circuit held contrary to the* Mathews *decision, stating that "business purpose" refers to continued use or possession of the property and not "the origin of the lessor's title."*

SECTION 163

IRS victory on interest deductions could boomerang

A new tax planning technique may be the result of *B.L. Battelstein,* a fifth circuit decision in favor of the government. The case deals

with whether a taxpayer can borrow funds to pay interest on a business loan and claim a deduction under sec. 163(a).

The taxpayer was a real estate developer who entered into an agreement with a bank to finance his purchase of a piece of property. The bank agreed to finance the entire deal including interest, taxes, etc., in exchange for interest on the loan plus a 19 percent share in the net proceeds of the sale of the property. During 1973 and 1974, the bank put up the funds to cover the *ad valorem* taxes and their interest charges under the following arrangement: The taxpayer paid the taxes and interest with checks drawn on a bank account that had sufficient funds to cover these disbursements. (The taxpayer also had substantial assets of his own which could be used for the payments.) After the taxpayer paid the interest and taxes, the bank gave him a check for the same amount, which he then deposited in his general bank account.

The general rule is that when interest is due from a cash-basis borrower and is simply added by the lender to the loan principal, or is paid by a note given to the lender for the interest, the borrower is not entitled to deduct the interest cost for federal income tax purposes. Nor is an interest deduction permitted where checks are exchanged between the borrower and lender with no loss of identity of the amounts. In *N.A. Burgess* an exception to the above rules was established. That case held that interest was considered paid even though the taxpayer may have paid it with money subsequently borrowed from the initial lender, provided that (1) there are valid and legitimate reasons for the second loan other than to repay interest on the first loan, (2) the proceeds of the second loan are commingled with the taxpayer's other funds, (3) the taxpayers have funds or available resources to cover the interest payment, and (4) the lending institution loses control of the proceeds of the second loan. In *Battelstein,* the majority opinion denied the deduction on the ground that the purpose of the subsequent loans was to finance the taxpayer's current interest obligations. There was merely a postponement, not a payment, of the taxpayer's interest obligation to the lender. Accordingly, the district court's decision in favor of the taxpayer was reversed.

When the case originally came to the fifth circuit a panel of three judges split their decision for the government two to one. The court agreed to a rehearing by the full court, which resulted in a 14–10 decision for the government.

The dissenting judges agreed that for interest to be deductible it must be paid in cash or its equivalent, and that merely executing a note evidencing a future obligation or a sham transaction is not

sufficient. They felt, however, that the subsequent loans had valid purposes other than to repay interest. It was pointed out that the decision of the majority could be interpreted to deny deductions where taxpayers borrow funds needed for interest payments from other lending institutions. Furthermore, a homeowner with a line of credit from the same bank which holds his mortgage could lose the mortgage interest deduction because funds borrowed on his general line of credit may be used to make the monthly mortgage interest and principal payments—even though the homeowner has substantial sums on deposit with the bank. The dissenting judges placed great reliance on the fact that the subsequent advances to pay the interest were made at higher interest rates than the original acquisition loan, with different maturity dates, and were secured by additional liens on the property, in addition to the fact that the taxpayer had ample general cash funds and other resources to pay the interest.

In light of *Battelstein,* can a taxpayer who wants to defer the deductibility of interest payments employ the method of payment used in *Battelstein* and defer deductibility until the loan covering the interest cost is actually paid in cash or its equivalent? This would seem to follow from the rule established in this case.

Investment interest: lease escalation clauses and the 15 percent test

If sec. 162 expenses are less than 15 percent of rental income produced by a mortgaged property, the property is considered investment property for purposes of determining the deductibility of investment interest expense (sec. 163(d)(4)(A)). As a consequence of rising cost of utilities, maintenance, etc., it has become common for leases of real property to include an "escalation" clause that requires the lessee to bear part or all of these rising costs. Such a clause results in the exclusion of such expenses and the related gross income for purposes of the 15 percent test; this may cause the property to be treated as investment property with a resulting impact on the deductibility of investment interest expense. Consequently, it is necessary to review the lease(s) applicable to each property to which sec. 163(d) is applicable in tax planning, preparation of returns, etc.

If a lessor's sec. 162 deductions (e.g., management expenses, commissions, labor, supplies, repairs, traveling expenses, advertising and selling expenses, insurance premiums, etc.) are less than 15 percent of rental income produced by the property (or if the lessor is either guaranteed a specific return or is guaranteed in whole or in part against loss of income), the property will be treated as investment

property under sec. 163(d)(4)(A). For purposes of the 15 percent test, rents and reimbursed sec. 162 expenses are not taken into account (sec. 163(d)(4)(A)(i)). Deductions that are permitted under other sections (e.g., interest, taxes, losses, and depreciation) are also not considered (and apparently when such expenses are reimbursed, gross income attributable to such reimbursement is not reduced in making the 15 percent test). If such properties have been in use for more than five years, however, the lessor may irrevocably elect to have the 15 percent test not apply to such properties for the year of election. (See sec. 163(d)(6)(B) and temp. regs. sec. 12.8 (for years prior to 1972).)

An example in the proposed regulations indicates that where the lease has an escalation clause with respect to increases in a sec. 162 expense, after the increase is put into effect, all such expense and gross income, including the expense attributable to the pre-escalation period, is to be excluded under the 15 percent test (prop. regs. sec. 1.57-3(b)(4), example (4)). The exclusion of the pre-escalation expense and related income was perhaps unintended by Congress, and clients, under the proper circumstances, might choose not to follow the proposed regulations. (See prop. regs. sec. 1.57-3(b)(4), example (2).)

On the other hand, escalations of rental income that are not directly tied to specific sec. 162 expenses will not result in elimination of expense or gross income in making the test (prop. regs. sec. 1.57-3(b)(4), example (3)). Lastly, each lease is considered a separate property (and appropriate allocations of expense items must be made), unless the taxpayer elects annually to aggregate the leases (prop. regs. sec. 1.57-3(b)(1); temp. regs. sec. 12.8).

SECTION 164

Maximizing the sales tax deduction on the construction of a new residence

Sec. 164(a)(4) allows an itemized deduction for state and local general sales taxes. The term *general sales tax* means a tax imposed at one rate in respect of the retail sale of a broad range of classes of items (see regs. sec. 1.164-3(f)). Sec. 164(b)(5) states, "If the amount of any general sales tax is separately stated, then, to the extent that the amount so stated is paid by the consumer (otherwise than in connection with the consumer's trade or business) to his seller, such amount shall be treated as a tax imposed on, and paid by, such consumer."

If a taxpayer purchases and pays for the materials that are subject to sales tax in the construction of his new home, the applicable

amounts are deductible as sales tax. Problems arise if the taxpayer does not make payment directly to the retail seller but instead pays his contractor for the cost of materials, which includes sales tax. In *W. F. Armentrout* the Tax Court allowed as a deduction the sales tax that the taxpayer paid directly to the retailer, although the materials were purchased in the builder's name. In the same case, however, a deduction for sales tax on materials billed to, and paid for by, the builder was disallowed, even though the taxpayer reimbursed the builder for the taxes.

This disallowance might have been avoided by the establishment of an agency agreement between the homeowner and the builder, under which the builder purchases materials as an agent of the owner. Based on the above case law, the sales tax deduction can also be obtained by having the homeowner pay all building material suppliers directly. This can be accomplished by having all materials and supplies used on the job billed directly to the future homeowner, or by purchasing all materials and supplies in the contractor's name, with the contractor turning over all bills to the homeowner for payment by his personal check. For subcontractors who do their own purchasing, the materials suppliers' bills should be passed through to the owner, and the subcontractors' bills should not include materials or supplies. If these precautions are observed, the homeowner should have no problem deducting currently all the sales tax paid on the materials and supplies used in the construction of his new home.

The Internal Revenue Service's 1979 edition of *Your Income Tax* (Pub. 17) states that a taxpayer may add the following items to a sales tax amount determined from the tables: a boat, a plane, a home (including mobile or prefabricated), or materials bought to build a new home, if the tax rate was the same as the general sales tax rate and if the sales tax receipt or contract shows how much tax was paid. Even though this publication is not binding as law, it does reflect the service's view.

Suppose the contract for the purchase of a new home has sales tax separately stated. It appears that if the contractor provides the new homeowner with a contract that separately states the amount of sales tax paid, the homeowner may be allowed to add the amount of sales tax to the amount determined from the sales tax tables.

Sales tax deductions when constructing a building

A consumer of property may claim an itemized deduction for sales tax on property purchased. (See regs. sec. 1.164-3(e).) With effective

planning, a taxpayer who constructs a building may claim an itemized deduction for sales tax on materials used in the building. The construction charges, such as for labor, materials, and the sales tax on the materials, should be separately stated under the contract with the contractor. IRS Letter Ruling 7733068 allows a Texas taxpayer an itemized deduction under sec. 164(a)(4) for Texas limited sales tax paid by the consumer to the contractor on the agreed contract price of materials incorporated into the real property. The contract contained separate amounts applicable to the performance of services, and the furnishing of material, for the purpose of causing the customer, and not the contractor, to be the ultimate consumer of the materials physically incorporated into the realty being improved.

If the contractor hires subcontractors to perform work, the subcontractors should obtain sales tax permits. The contractor will give resale certificates to the subcontractors who will in turn give resale certificates to their suppliers. The resale certificates will permit the selling of the materials without collecting a sales tax. The tax will be collected from the consumer by the contractor who will itemize materials purchased from his suppliers and subcontractors. This will enable the consumer to claim a sales tax deduction provided each contract states separately the charges for materials and labor. This chain of certificates should not be broken.

In some states, such as California, the sales tax is imposed upon the vendor, but in nonbusiness situations a separately stated tax is still deductible. (See *Diamond National Corporation* v. *State Board of Equalization.*)

Editors' note: The allowability of the deduction and the steps required to ensure compliance for states other than Texas depends on the sales tax rules of the particular state. The key to the deduction generally involves the point of imposition of the tax. If it is imposed on the buyer, rather than the vendor, the tax is deductible by all business as well as nonbusiness taxpayers. Further, even in states where the sales tax is usually imposed on the vendor, it may be possible by careful planning to change the imposition point to the buyer.

SECTION 165

Loss deduction for abandoned goodwill of stores acquired in bulk purchase

In the past, the IRS has generally characterized purchased goodwill and other intangibles as mass assets, and prohibited abandonment

losses on the theory that the entire business must be disposed of before any lack of value could be evidenced. But a national office technical advice memorandum may augur a shift in IRS policy for such items.

In IRS Letter Ruling 7941003, the service considered the question of whether a taxpayer that had acquired a chain of supermarkets and drugstores, together with related support facilities, had acquired a "mass asset" in the form of a "going concern," and whether the taxpayer was entitled to goodwill abandonment losses upon the closing of certain of the stores acquired in the purchase. The amount of loss was based upon the "purchased goodwill" assigned to each store, determined by a subsequent valuation.

An ancillary question addressed by the service, peculiar to the taxpayer, related to the question of whether the valuation, which was not made until several years after the purchase, should have been made at or as of the time of acquisition.

Relying principally upon *Metropolitan Laundry Co.*, which held that goodwill attached to certain abandoned laundry routes was the proper subject of a loss deduction, and Rev. Rul. 68-609, which sets forth a formula approach to the valuation of intangibles where there is no better method available, the service ruled in favor of the taxpayer.

The conclusions reached in this technical advice memorandum are summarized as follows:

- The taxpayer did not acquire a mass asset when it acquired the supermarket and drugstore chains.
- The intangible assets acquired are separable and susceptible of being valued individually. Further, it is not essential to the validity of the estimate or of any chain for goodwill abandonment loss that the valuation be made at the time of the acquisition. The valuation may be made at any time provided (1) the valuation period used (i.e., years of excess earnings to be capitalized) is one that is generally accepted, (2) the valuation method is the best method available under the circumstances, (3) only such basic information is used as was available at the time of the acquisition, and (4) no assumptions are made in the valuation that would not have been properly made in making the valuation at the time of acquisition. The approach to valuation used by this taxpayer's appraiser was acceptable to the service for use in businesses where no better method is available, and *it was considered a reasonable assumption to treat the individual stores as separate identifiable businesses with definite trade areas for purposes of capitalizing excess earnings into intangible value.*

- When the taxpayer closes specific stores, and such stores have "purchased goodwill" assigned to them on the basis of a valuation, the taxpayer is entitled to abandonment losses in the amount of assigned goodwill, assuming that the details of the appraisal have been accepted on field audit and there is a bona fide abandonment of the trade areas involved.

The national office stressed that location is of paramount importance. It agreed that there was validity to the concept that a supermarket or drugstore draws its patronage from a limited, fairly well identified trade area, and that there was a limit to the distance that people will travel in order to patronize the grocery or drugstore of their choice.

The conclusions contained in this technical advice memo provide a planning opportunity for retail establishments. In situations where there is purchased goodwill and a store is closed without another being opened in the same location, the taxpayer should value intangibles by individual store and deduct the goodwill attributable to each store upon its closing.

Mortgage buy-backs by financial institutions

Because of current high interest rates, banks and other financial institutions may find it possible to improve the yield from their loan portfolios through the use of mortgage buy-backs. In a buy-back, the lender offers the borrower a discount for prepaying the mortgage before its term ends. This enables the bank to free itself of older, low-yield mortgages and replace them with new, higher-rate loans.

Because the creditor sustains a real economic loss by settling the mortgage at a discount, the compromise should give rise to an ordinary loss deductible under sec. 165(a). For example, in *Yates Holding Corp.*, the Tax Court stated that a "compromise of a debt for less than the value outstanding will generally give rise to an ordinary loss deductible under section 165(a) by a corporate mortgagee," citing *West Coast Securities Co.*, as authority. Under regs. sec. 1.61-12(a), however, borrowers will realize taxable income on the partial cancellation of a mortgage debt. But, provided that the discount offered is large enough, borrowers may still improve their overall cash position in spite of having to recognize the discount as taxable income. The advantages for the financial institution are obvious: the discount should be deductible as an ordinary loss, and it will be advantageous to compromise the debt and relend the funds at higher rates.

Indirect taxation of life insurance proceeds

Sec. 101(a) provides generally that proceeds received from a life insurance policy, if paid by reason of death of the insured, will be excluded from the gross income of the recipient.

Sec. 165(a) provides generally for a deduction for any loss sustained during the taxable year that is not compensated for by insurance and otherwise.

Most "key man" life insurance policies are acquired to protect against potential losses arising from the death of a key executive. If, during the year, the entity receiving the proceeds from the life insurance policy also sustains a loss, will sec. 165(a) override sec. 101(a), having the effect of indirectly taxing the insurance proceeds received by offsetting the loss with them?

The fourth circuit has upheld the Tax Court's decision in *Alson N. Johnson*, where the service successfully argued this priority.

The case involved a partnership formed to raise hogs. One of the partners was the "working partner," knowledgeable about the operation, while the taxpayer provided most of the working capital. Since the working partner had some health problems, the taxpayer purchased a five-year convertible-term life insurance policy on the life of his partner, naming himself as beneficiary.

The partner's death occurred in the second year of the partnership's operation. The taxpayer was unable to secure an experienced person to continue the business and, therefore, decided to dissolve the partnership. The working partner's widow agreed to pay certain partnership debts in consideration for the taxpayer's release to her of his interest in the partnership's capital assets.

The taxpayer claimed a capital loss for the depreciated value of the equipment and the buildings of the partnership that were erected on the land belonging to the working partner. The assets were unusable and of no economic value at the time of dissolution.

The Tax Court held that the death of the partner was the cause of the decision to discontinue the partnership business. The court of appeals held that it was the discontinuance of the business that occasioned the disposition of the capital assets. The capital loss was thus caused by the death of the partner and, since the death was compensated by insurance, the courts concluded that the capital loss was not deductible. Since the insurance was purchased to protect against the loss of the taxpayer-partner's investment, the proceeds from the life insurance had to be netted against any loss sustained from that investment under sec. 165(a).

It can be argued that any key-man life insurance policy to some

degree protects the interests of partners or shareholders in a business. Therefore, one must ask if the rationale of *Johnson* may be expanded to disallow an operating loss sustained by a corporation that receives proceeds from a key-man life insurance policy in that same year. It appears if a portion of the loss is directly related to the death of the insured key executive, that portion could be denied under *Johnson*.

The fact that sec. 165(a) appears to override sec. 101(a) may, therefore, result in the indirect taxation of life insurance proceeds received via denial of the loss deduction.

Foreign currency loss: ordinary or capital?

A recent technical advice memorandum considered the question of whether a foreign currency loss arising out of an indebtedness of the taxpayer should be treated as an ordinary loss or a capital loss under the following facts:

> Corporation *M*, a domestic corporation, is a worldwide manufacturer. In late 1970, *M* entered the borrowing market in country *X* because of a need for additional working capital, which it sought to borrow at the lowest rate possible. A loan with a maturity date of November 30, 1973, was received from Bank *O* on December 1, 1970. The interest rate on that loan was negotiated as a net figure to *O*, free of the U.S. withholding tax and any taxes of *X* that would apply to interest payments. It was necessary to create an offshore finance subsidiary to avoid the U.S. withholding tax of 30 percent on interest payments. In 1970, *M* formed Corporation *N* in *X* to accomplish the reduction of the withholding tax. Almost immediately after the loan was made, the dollar began to weaken in relation to the currency of *X*. This continued, and in June 1973, *M* stopped its loss in the currency by buying a forward contract in the currency of *X* from *O*. The contract was for delivery in November 1973. On November 27, 1973, *M* deposited the purchase price under the forward contract with its bank in the U.S. On November 30, 1973, that amount was transferred in the currency of *X* to *O*'s home office in *X*. *O* considered the transaction as the closing out of the outstanding loan. Thus, the purchase price of the forward contract became the cost of *M*'s borrowing. The closing of the transaction omitted *N* from the form since *M* acted as *N*'s agent to close the transaction. The loss incurred by Corporation *M* as a result of the above transaction consisted of the currency exchange loss plus the cost of the forward contract.

Pursuant to Rev. Rul. 75-104 and Rev. Rul. 75-109, a prerequisite for the recognition of a gain or loss resulting from the fluctuation of foreign currency is a closed or completed transaction in which the foreign currency has been disposed of or converted. In the present case, the prerequisite was met when *O* closed out the loan taken by *N*. Since *M* is entitled to a loss deduction for the taxable year when the loan was repaid to *O*, the character of the foreign currency exchange loss must be determined. Foreign currency has been

recognized as "property" for purposes of the tax laws and does not fall within any of the specific statutory exclusions to the definition of a capital asset under sec. 1221. Consequently, it is a capital asset under that section. However, the foreign currency borrowing in issue may come within an exception to the literal reading of sec. 1221, if it meets the requirements set out in the *Corn Products* case and the *Booth Newspapers* case.

The courts in deciding cases involving foreign currency fluctuation issues have relied upon the rationale used in the *Corn Products* case in primarily two types of situations. One involves hedging transactions and the other an extension of credit incident to a purchase of goods. In the second type, the courts have separated the foreign currency transaction from the underlying purchase. Although *Corn Products* has not been relied upon in deciding a case involving the repayment of a foreign currency loan, it appears to be equally applicable to that type of case.

According to the *Corn Products* rule, property normally considered capital in nature will be subject to ordinary income or loss treatment if it is found to be an integral part of the taxpayer's everyday business. In order for property to be an integral part of the taxpayer's business, the taxpayer's business must derive a direct measurable benefit from the property.

In the present case, the borrowing had a direct measurable effect on *M*'s everyday business: it provided *M* with the additional working capital it needed for continuing operations at the lowest possible cost. The futures contract also had a direct measurable effect on *M*'s everyday business. It was entered into to provide the currency of *X* required to repay the loan, thereby preventing further loss to *M* resulting from the deterioration of the dollar. Thus, the borrowing and the futures contract were an integral part of *M*'s everyday business. Based solely on these facts, the IRS concluded that the foreign currency loss, arising out of an indebtedness of the taxpayer, should be treated as an ordinary loss under sec. 165(a).

Editors' note: The results in this technical advice should be contrasted with the Tax Court's decision in The Hoover Co., *wherein it held that capital losses were realized where foreign currency was sold short to protect a U.S. parent's investment in foreign subsidiaries. Since the transactions were entered into to protect capital assets and not inventory or day-to-day operating profits, the loss was considered a capital one. It is interesting to note that the taxpayer did not rely upon* Corn Products *to support its position. See Rev. Rul. 78-396 for a banking transaction lacking investment purpose and thus qualifying for ordinary loss treatment.*

Participant's ordinary loss on plan termination or withdrawal of voluntary contributions

An ordinary loss was approved on an IRS audit of a plan participant's individual return. The taxpayer-participant had made substantial contributions to a thrift plan that provided employer-matching on the obligatory portion of the taxpayer's contribution and no matching on an additional voluntary contribution portion. Subsequent to enactment of ERISA in 1974, the plan was amended to permit withdrawal by a participant of his voluntary contributions. Investment losses had been sustained in the plan's trust fund portfolio, and the commuted cash amount paid to the taxpayer was smaller than his voluntary contributions.

Rev. Rul. 72-305 approved an ordinary deduction for the loss sustained by an employee who separated from service and received distribution proceeds smaller than his accumulated plan contributions, reasoning that these contributions involved a transaction entered into for profit for sec. 165 purposes. An ordinary deduction was also allowed in Rev. Rul. 72-328 for a loss sustained when a participant received worthless stock of his bankrupt employer upon termination of the contributory employees' stock bonus plan.

In the case under discussion, the taxpayer had not separated from service, and continued to participate in the thrift plan, but had withdrawn his entire cumulative voluntary contribution account. The ordinary deduction was allowed under the authority of Rev. Rul. 70-405, on the ground that the voluntary contributions constituted a supplemental plan, or separate contract. Accordingly, a closed transaction was involved, and the loss was recognized.

In view of the disappointing investment performance by many individual account plans, and the ability of self-employed persons to withdraw their voluntary contributions from an H.R. 10 plan, there may be instances where a self-employed person may wish to withdraw his entire voluntary contribution account from the plan in order to realize an ordinary deductible loss.

SECTION 166

Dealer reserves for receivables sold with recourse

A retailer, such as an appliance dealer, may sell its customer installment receivables to a finance company with the provision that the dealer will bear the loss if any customer fails to pay. Such a

dealer may establish a special bad debt reserve and make tax deductible contributions to it, since the dealer continues to face potential losses even though it no longer owns the receivables due for certain related services (e.g., a service contract covering several years, as long as it is entered into at the time of sale). The IRS has issued prop. regs. sec. 1.166-10 permitting dealers already on the bad debt reserve method to adopt this special reserve method, without its permission, within 90 days after the proposed regulations become final.

Bad debt reserve: "under addition" in post-2/28/79 year may be lost as deduction

Rev. Rul. 79-88 holds that where a taxpayer adds less to its reserve for bad debts for the current year than "called for under its normal and proper method of computing reasonable additions to the reserve," it is not entitled to a correspondingly larger deduction in any subsequent year. In essence, the ruling holds that a deductible addition for the current year shall be limited by the *additions allowed, but not less than the amounts allowable, in prior years*. (Compare sec. 1016(a)(2), which requires that the tax basis of property be reduced by the depreciation allowed, but not less than the amounts allowable, in prior years.) The ruling specifies, "[It] will not be applied to taxable years ending prior to [March 12, 1979]."

The facts of the ruling, somewhat simplified, are as follows:

> *T* consistently computed additions to its bad debt reserve under the so-called *Black Motor* formula. Under the formula, the deductible addition is the sum needed to bring the year-end balance in the reserve up to an amount equal to the product derived by multiplying the total receivables at the year end by the ratio of *(i)* the sum of net charge-offs for the six years ended with the taxable year to *(ii)* the sum of year-end receivables for the same period.
>
> In 1974, the *Black Motor* formula called for a $300 addition to *T*'s bad debt reserve. However, to avoid losing the tax benefit of a net operating loss carryover that expired in 1974, *T* added only $200.
>
> In 1975, *T* added $750 to the reserve, the full amount called for by the formula. Since $300 is deemed to have been added to the reserve in 1974, the deductible addition for 1975 is limited to $650. The following table sums up the foregoing:

		1974	1975
1.	Year-end balance in reserve called for by formula	$900	$800
2.	Balance in reserve, prior to the annual addition	600	50
3.	Addition called for (line 1 − 2)	300	750

		1974	1975
4.	Actual addition	200	750
5.	Inadequacy of addition for 1974 (line 3 − 4)	100	—
6.	Deductible addition for 1975 (line 3 − $100)	200	650

The ruling should be clarified and modified in several respects (if not revoked in all respects), including specifying—

1. Whether an under-addition to a reserve is to be deemed allowed, even though not tax-tainted; and
2. How the effective date provision applies.

Limited or general application. It is not clear whether the IRS intends that an under-addition to a reserve shall be deemed allowed only if it is tax-motivated or deemed allowed in any event.

On the one hand, the following factors indicate the ruling applies where an addition to a reserve is understated for a tax avoidance purpose:

- *T* understated the 1974 addition to the reserve in order to avoid losing the benefit of a net operating loss carryover. Citing regs. secs. 1.446-1(c)(2)(ii) and 1.461-1(a)(3), the ruling stresses that *T* cannot use the reserve method of accounting for bad debts to manipulate deductions and distort annual income.
- The ruling recognizes that regs. sec. 1.166-4(b)(2) provides, in effect, that if a prior-year addition proves to be inadequate because of a subsequent under-realization of receivables, such inadequacy is includible as a deductible addition for the current year. The ruling concludes the regulation is inapplicable to *T*'s facts since the inadequacy in the 1975 reserve resulted from *T*'s deliberate understatement of the 1974 addition, not from post-1974 events.
- Rev. Rul. 76-362 provides that "*as a general rule*, the *Black Motor* formula may be used to determine a reasonable addition to a reserve," but then concedes that a greater or lesser addition may be required "in light of facts existing at the close of the taxable year" (emphasis added). If Rev. Rul. 79-88 intends to require that the formula amount—no less in any event—be added to the reserve each year, the 1976 ruling should have been revoked. But it is not even alluded to in Rev. Rul. 79-88.

On the other hand, despite the foregoing, it is not clear that Rev. Rul. 79-88 applies only where the addition is understated for a tax-tainted reason. For one thing, the ruling fails to explicitly so limit itself. For another thing, it includes language which broadly states,

in effect, that whenever a taxpayer adds less to its reserve than the amount determined under whatever "normal and proper method" is used in computing additions, a correspondingly larger addition cannot be deducted in a subsequent year.

Effective date. It is apparent from the statement that the ruling "will not be applied to taxable years ending prior to [March 12, 1979]," and from an accompanying reference to sec. 7805(b), that the ruling is effective prospectively only. But exactly how does the prospective effective date rule apply? We infer the effective date rule will operate as follows:

- In the first taxable year ending after March 11, 1979 (including the calendar year 1979), the full amount of the called-for addition to a reserve is deductible—*including* the portion(s) that was allowable but not allowed in a taxable year(s) ended before March 12, 1979 (including the calendar year 1978).
- In the second and subsequent taxable years ended after March 11, 1979 (including the calendar year 1980), the deductible addition is limited to the addition needed to bring the year-end balance up to the amount called for by the formula, *less* the excess (if any) of the addition(s) allowable over the amount(s) allowed in a prior year(s).

Recommendation. For the year ending after March 11, 1979, it is generally advisable for a taxpayer to add to its reserve whatever amount is necessary to bring the year-end balance up to the ceiling amount. Subject to clarification or modification of the ruling, there is a risk that any deficiency in the addition for such year will not be deductible in a subsequent year.

Thor unleashes a *Black* thunderbolt as well

As surely as the Norse god Thor delivered thunderbolts from the heavens, so also has the United States Supreme Court deified the ungodly test created by the Board of Tax Appeals in *Black Motor Company*. For the first time since that case was decided 40 years ago, the Supreme Court has considered the use of the bad debt reserve formula derived from that case. The formula is a six-year moving average that takes the ratio of the average debts charged off during the current and five prior years to the average receivables outstanding at the end of each of those years, multiplied by the receivables outstanding at the end of the current year. In *Thor Power Tool Company*, a case known primarily for its inventory valuation

decision, the Court approved of the use of the *Black Motor* formula to reduce the bad debt reserve addition deducted by the taxpayer.

Sec. 166(c) provides in part that "there shall be allowed [*at the discretion of the secretary*] a deduction for a reasonable addition to a reserve for bad debts." In analyzing the authority of the commissioner under this section, the Supreme Court stated:

> Consistently with this statutory language, the courts uniformly have held that the Commissioner's determination of a "reasonable" [*and hence deductible*] addition must be sustained unless the taxpayer proves that the commissioner abused his discretion. The taxpayer is said to bear a "heavy burden" in this respect. He must show not only that his own computation is reasonable; he must also show that the Commissioner's computation is unreasonable and arbitrary. [*Footnotes omitted*]

The Court then proceeded to review the wide use of the *Black Motor* formula since 1940 by the commissioner, the courts, and the Congress, stating:

> The formula possesses the not inconsiderable advantage of enhancing certainty and predictability in an area particularly susceptible to taxpayer abuse. In any event, after its 40 years of near universal acceptance, we are not inclined to disturb the *Black Motor* formula now.

Despite the theoretical limitations on the applicability of the *Black Motor* formula, it appears that the taxpayer indeed has a "heavy burden" if he is to substantiate a deduction that is greater than would be allowed by the formula. In the past, the service has almost exclusively applied the *Black Motor* formula in bad debt reserve cases. This endorsement by the Supreme Court will undoubtedly encourage greater use of the formula by the service. It will no doubt also encourage earlier charges to bad debt reserves by taxpayers.

SECTION 167

Amortization of CATV intangibles

In recent years, questions have been raised about sec. 167(a) amortization of intangible assets acquired in the purchase of a cable television (CATV) system. In particular, the questions relate to identification and valuation of such intangibles, as well as whether they have reasonably ascertainable useful lives.

In the purchase of a CATV system, there may be at least three primary intangibles to be valued:

- The CATV franchise, which is the contractual right to operate

the CATV system locally and which is usually derived from a local governmental authority.
- The CATV subscribers, both current and potential.
- Goodwill.

Subscribers. There is particular uncertainty in identifying subscriber lists as being separate and distinct from goodwill. This is partially due to the courts' application of two different theories relating to the definition of goodwill. One theory holds that goodwill is the expectancy of continued patronage. The other, less restrictive, theory says that goodwill is the collection of intangible assets of a going concern associated with profitability or earning capacity, but which may be severed into component parts if each component has a separate and identifiable value apart from the whole.

In *Houston Chronicle Publishing Co.* the court applied this divisibility test to newspaper subscription lists and found that because the lists had a separate and distinct value and an identifiable life they were not to be classified as goodwill. Such a rationale should result in current CATV subscribers' having a separate and distinct value apart from goodwill.

The recent case of *General Television, Inc.*, on the other hand, appears to apply the expectancy of continued patronage theory to the subscribers of a CATV system. This case held subscriber value to be inextricably linked to expected patronage (i.e., goodwill). Consequently, the amortization was disallowed. There is in the opinion, however, other language relating to the earning capacity theory that leaves one in doubt about which theory was followed. Further, the district court expressed approval of the *Houston Chronicle* case but distinguished it, without explanation, on the grounds that the subscriber lists in that case were not linked to expected future patronage. The issue is further confused by the opinion of the district court on a motion for amendment of judgment, which said that the CATV subscribers in *General Television* did not evidence binding contractual relationships and were, therefore, nothing more than mere expectancies of patronage, perhaps leaving in doubt the continued validity of *Houston Chronicle.*

Franchise. The separation of intangible value from goodwill is not nearly so burdensome in the case of the CATV franchise, since this form of intangible does not involve any issue of continued patronage. The primary issue in franchise cases lies rather in ascertaining the useful life. *Chronicle Publishing Co.* was decided in favor of the taxpayer on this issue with respect to a nonrenewal-option contract. Particularly important in that case was the absence of renewal options

and the fact that the purchase price for the CATV systems was derived from income projections over a period not exceeding the original franchise periods. These valuation and useful life requisites for amortization present difficult evidentiary problems. Indeed, the valuation of the intangible is particularly crucial in proving that the intangible is a separate and distinct asset from goodwill. The proof of useful life is equally important because the failure to prove either one will be fatal to the taxpayer's case.

Conclusion. The purchaser of a CATV system acquires at least two significant intangible assets that may be subject to amortization for tax purposes, i.e., the CATV franchise and the CATV subscribers. In the case of the CATV franchise, the Tax Court decision in *Chronicle Publishing Co.* offers support on the useful-life issue. Valuation of the franchise cost was stipulated in that case.

Establishment of a valuation separate from goodwill for the connected CATV subscribers has been made more difficult as a result of the *General Television* case. It would appear that *General Television* does not represent a repudiation of, or a departure from, the principles of the *Houston Chronicle* case, but merely an isolated decision based on a (perhaps misunderstood) factual pattern to which the court confusingly applied two theories of goodwill.

Depreciation: 100 percent-declining-balance method—not necessarily a preparer's error

A taxpayer often desires to *minimize* income tax deductions because of expiring net operating losses, recent commencement of business operations, or current business reversals. Although depreciation deductions cannot be deferred, because of the "allowed or allowable" rule of sec. 1016(a)(2), they can be used most effectively by appropriate selection of depreciation methods and by changing those methods at opportune times.

Until the release of a recent technical advice memorandum, many practitioners have assumed that the slowest permissible depreciation method was straight-line. The IRS has now held, in IRS Letter Ruling 7922009, that the 100 percent-declining-balance method is a permissible declining-balance method under sec. 167(b)(2). The method, which can be adopted initially or changed to at a later date, results in a lesser depreciation deduction than the straight-line method after the first year. Under 100 percent-declining-balance, however, a significant amount of asset basis will go undepreciated unless the

taxpayer changes methods before the end of the asset's depreciation life.

A change in depreciation method is a change in accounting method and requires permission from the commissioner. Under sec. 167(e)(1), (2), and (3), however, a change from a declining-balance or sum-of-the-years-digits method to straight-line is automatic. Regs. sec. 1.167(a)-11(c)(1)(iii)(*a*), on ADR, provides an automatic switch from declining-balance to SYD and from either method to straight-line. A taxpayer who did not initially elect ADR may expeditiously obtain, under prescribed conditions set forth in Rev. Proc. 74-10, permission to change from the declining-balance to the SYD method of depreciation. Thus, the service's view that 100 percent-declining-balance is a declining-balance method under sec. 167(b)(2) is important to taxpayers wishing to minimize depreciation currently but to accelerate depreciation in later years.

Simplified reporting requirements for ADR years

The IRS has issued T.D. 7593 (1/25/79), amending certain sections of regs. sec. 1.167(a)-11 in order to simplify reporting requirements on Form 4832 for the annual election of class life asset depreciation range system. Consequently, a new Form 4832 has been issued for 1978 and should be used by taxpayers electing ADR for taxable years ending on or after December 31, 1978.

To summarize, a taxpayer is no longer required to report much of the detailed information requested on the old form. In fact, part II of the old form has been modified, and parts III, IV, and V have been deleted. Part I of the old form (Election Questions) remains unchanged.

Instead of reporting the details on Form 4832, the taxpayer is now required to specify the information, plus some additional information, in his books and records. Furthermore, if ADR is elected, the taxpayer may become part of a sampling of taxpayers requested to respond to periodic surveys that will be conducted by the Treasury Department.

A look at the new regulation and Form 4832 shows that the taxpayer must continue to specify the following:

- That it makes the ADR election and consents to, and agrees to apply, all provisions of the ADR system;
- The class for each vintage account of the taxable year;
- The first-class convention adopted for the taxable year of election;
- Whether the special 10 percent used-property exclusion rule is elected;

- Whether the asset guideline repair allowance rules are elected;
- Whether the taxpayer elects to allocate the adjusted basis of Special Basis Vintage Accounts to extraordinary retirements;
- Whether any otherwise eligible property is excluded because—
1. Rapid depreciation or amortization provisions are elected,
2. The taxpayer is a utility company that does not comply with "normalized" accounting requirements,
3. Assets were acquired from related parties where either sec. 381(a) (carryover rules) applies or the lives selected by the transferor for investment tax credit are outside the ADR range and there is no provision for investment tax credit recapture;
- Whether the taxpayer elects to exclude any "pretermination" investment tax credit property;
- If the taxpayer is an electric or gas utility, whether it elects to substitute Rev. Proc. 64-21 composite asset guideline lives for ADR class lives;
- Whether the taxpayer changed the depreciation method for any vintage account during the year;
- The year-end summary by class of asset and reserve account balances and total ADR depreciation for the year.

Furthermore, there has been no change regarding the requirement that, where it is impracticable for the taxpayer to specifically identify the vintage of each mass asset at retirement, the taxpayer must elect on Form 4832 whether to use the standard mortality dispersion curve established by the IRS or a curve based upon its own experience. In addition, the asset guideline class summary (part II) has been expanded to segregate the cost of current year's additions and first-year depreciation.

Despite the foregoing rules, the reporting requirements have been simplified because the taxpayer is no longer required to report the following information on Form 4832:

- The depreciation period selected for each vintage account;
- The amount of "first half" and "second half" property where the taxpayer elects the modified first-year convention;
- The unadjusted basis, salvage value, and amount of reduction for salvage adjustments made pursuant to sec. 167(f);
- Each asset guideline class for which the taxpayer elects the repair allowance rules and the amounts capitalized into Special Basis Vintage Accounts;
- The summary of gains recognized as a result of excess reserve account balances.

However, the foregoing information, together with any other information ordinarily required under ADR, must be reflected in the

taxpayer's books and records. In addition, the taxpayer's books and records must specify the following:

- A reasonable description of excluded property and the basis for exclusion;
- The total unadjusted basis of assets retired from each class, and the proceeds from such retirements (exclusive of assets transferred to a supplies account for reuse);
- The vintage (i.e., acquisition year) of assets retired from each class (exclusive of assets transferred to a supplies account for reuse).

Notwithstanding these new rules, failure to signify the election by filing Form 4832 (for each member of a consolidated group) for any given year will expose the taxpayer to possible IRS attempts to change the lives used for that year, even where ADR lives are used, the appropriate books and records are maintained, and ADR was validly elected for the prior or the subsequent year.

"Dual purpose" assets and the ADR system

In Rev. Rul. 80-37, the IRS revealed its position on the proper tax treatment for sales of "dual purpose assets" accounted for under the Class Life Asset Depreciation Range (ADR) system. Under the facts of the ruling, the taxpayer was engaged in the manufacture, lease, and sale of electronic data processing equipment, and elected the ADR system to account for equipment it owned and leased. The issue was whether the gain from the sale to the lessee of the asset upon lease termination should be treated as ordinary income in the year of sale or deferred under the rules governing ordinary retirements under the ADR system. (See regs. sec. 1.167(a)-11(d)(3).)

The IRS ruled that the deferral provisions of the ADR system are not applicable to manufacturers that both sell and lease equipment. Therefore, the sale resulted in immediate ordinary income. The IRS reasoned that as long as the dual purpose asset is a part of the ADR system and is producing income, the asset is subject to all the ADR rules set forth in regs. sec. 1.167(a)-11. The sale of the asset, however, dramatically changes the situation. Under a line of cases beginning with *Recordak*, a sale of a dual purpose asset is considered to be a sale of an asset in the ordinary course of business, therefore by definition not depreciable property. Thus, the service concluded that if the dual purpose asset is not depreciable property, it no longer qualifies for treatment under the ADR system and must, therefore, be removed from the ADR account with the resultant gain immediately recognized as ordinary income.

Although it may appear that the reasoning behind Rev. Rul. 80-37 is logical, a closer examination of the issue reveals that a very important consideration has been omitted in the IRS's analysis. The IRS overlooks the fact that ADR is essentially a "closed" depreciation system. Once an election is made to include an asset in the ADR system, accounting for the asset's use and disposition is completely controlled by regs. sec. 1.167(a)-11. Moreover, the regulations go so far as to delineate specific instances in which ADR assets cease to be a part of the ADR system (most notably in an extraordinary retirement); special treatment for dual purpose assets is nowhere provided for.

In any event, even assuming the IRS's position is correct, a consistent pattern of income deferral for dual purpose assets under the ADR regulations should be considered an accounting method. As an accounting method, its change would require the permission of the IRS. (Cf. mass asset retirement under regs. sec. 1.167(a)-8(e)(2).) Absent such IRS permission, the taxpayer must apparently continue to treat sales of leased ADR assets consistently.

New regs. on depreciation averaging conventions

T.D. 7763 (January 19, 1981) adopted amendments to regs. sec. 1.167(a)-11, dealing with depreciation averaging conventions under CLADR. These amendments add some further restrictions to the amendments as originally proposed. Additionally, a grandfather clause was established for property for which "substantial expenditures" (the lesser of 30 percent of final cost or $10,000,000) had been incurred prior to the effective date, which applies (as proposed) to property placed in service after November 14, 1979.

The new regulations are "considered necessary to control abusive tax shelters," according to background information presented in the treasury decision, but are not restricted to any particular activities.

The new regulations limit the depreciation deduction allowable to a taxpayer first entering into a trade or business or first acquiring property held for the production of income. Previously, taxpayers could elect an ADR convention and, for example, take a full year's depreciation on property acquired within the first six months of the year, or a half year's depreciation on property acquired at any time during the year, up to the last day. As long as the taxpayer had been in existence for the entire year, no further restriction was placed on the allowable deduction. The new regulations consider, for the averaging conventions, that a taxpayer's year starts when it first enters a trade or business or first acquires property held for the production of income.

The final regulations contain the following provisions:

- As in the proposed regulations, the purpose is to prohibit a taxpayer who has not been engaged in a trade or business or held property for the production of income from using the averaging conventions to claim depreciation for periods before it acquired the depreciable property.
- As long as a taxpayer is engaged in *any* trade or business *or* holds *any* property for the production of income, the regulations do not curtail use of the averaging conventions, except as follows.
- An employee is not in a trade or business merely by virtue of employment.
- If a minor amount of activity occurs early in the year *for the purpose of claiming a large deduction for property acquired later in the year,* the trade or business or income-producing activity will not be considered to have started, with respect to the later acquisitions, until such property was acquired.
- Short taxable years are stated in terms of months; the actual day an asset is acquired is immaterial.

The additional restriction applicable to employees corrects what some practitioners felt to be a defect in the proposed regulations. Since the "trade or business of being an employee" had been established in other areas of taxation (e.g., for purposes of deducting job-hunting expenses), the proposed restrictions did not affect employees. On the other hand, under the final regulations, if an individual holds any depreciable property for the production of income, he will meet the requirements for applying the conventions to subsequent purchases of property to be used in a trade or business or income-producing activity, as long as he did not acquire the original property for the purpose of obtaining a disproportionately large deduction later on.

SECTION 170

Charitable lead trusts: accelerating charitable deductions and . . .

A unique opportunity exists for a significant charitable deduction when there are substantial yields (and lower prices) of tax-exempt bonds. The following is an illustration of how a charitable trust can produce a large deduction in the current year for a taxpayer who normally contributes to charity.

An individual, who otherwise donates $6,000 per year to charity, establishes a trust for a period of just less than 10 years and provides

that an annuity of $6,000 per year be paid to charity and that the trust's assets be returned to the individual at the end of the trust's life. The grantor personally guarantees the annual contributions as required by sec. 170(f)(2)(B). The trust is created by transferring, say, $55,000 in trust with which the trust purchases $100,000 face amount of bonds exempt from federal, state, and local income taxes. The income generated by the trust is includible in the grantor's income, but, since the bonds are tax-exempt, the income generated is not taxable to the grantor. At the termination of the trust, the bonds revert to the grantor free of tax.

Establishing the charitable trust creates a one-time charitable deduction of approximately $44,000 and a tax benefit of approximately $31,000 to a 70 percent bracket taxpayer in the current year. (See regs. sec. 1.170A-6(c)(3).)

One advantage of this scheme is that the taxpayer gets an immediate deduction of $44,000 instead of a deduction of $6,000 per year for the next 10 years; the immediate tax saving can result in a substantial economic benefit. In addition, by combining the government's 6 percent discount rate tables with the current high bond yields, the taxpayer gets a greater charitable deduction than would normally be obtainable.

Upon expiration of the 10-year period, the taxpayer has full ownership of the bonds and can sell them and realize capital gains, hold them and receive tax-free interest and capital gains at maturity, or transfer the bonds to another charitable lead trust.

Trusts for a shorter period could be used but they would result in lower deductions: The same trust for a period of five years with a guaranteed charitable annuity of $6,000 per year results in a $25,000 charitable deduction.

It is important to stay within the 20 percent charitable contribution limitation of sec. 170(b)(1)(B)(i) since the excess contribution may not be carried over. (See sec. 170(d).) Note also that interest expense might not be deductible in the future if the grantor has incurred any interest expense that might be considered as indirectly incurred to carry tax-exempts. (See sec. 265.)

Interest income on charitable contributions of E bonds

Individuals who make sizable contributions to charity are generally advised to donate appreciated stock in lieu of cash. The taxpayer will receive a charitable contribution deduction for the fair market value of the stock while simultaneously escaping tax on the appreciation. (See sec. 170(e)(1)(B).) Cash-wise, he will come out ahead.

The same may not be true, however, for contributions of Series E bonds. In IRS Letter Ruling 8010082 a taxpayer planned to convert Series E bonds to Series H bonds to be issued in the name of a charitable organization. Normally, the conversion from an E bond to an H bond is not taxable if the H bonds are issued in the name of the owner. The service, however, cited Rev. Rul. 55-278, which held that, in the case of a father who purchased E bonds in the name of himself and his son and later reissued the bonds in the name of his son only, the accrued interest at the time of the change in ownership was taxable to the father. Thus, the private ruling held that the interest that had accrued on the E bonds before their exchange for H bonds issued solely in the name of the charitable organization was includible in the taxpayer's income upon the exchange. It should follow that reissuing an E bond in the name of a charitable organization would also trigger the inclusion of the accrued interest in income.

The ruling added that the charitable contribution deduction was the fair market value of the bonds at the time of transfer.

Excess charitable contributions by banks: the bargain sale ploy

Many banks obtain a low effective income tax rate through emphasis on income from exempt municipal bonds. In certain cases, the reduced taxable income wastes charitable contribution deductions, and some banks have established grantor charitable trusts that qualify under sec. 673 as reversionary trusts. The grantor-trust status precludes any capital gain on transfer of appreciated securities to the trust and shifts income equal to the charitable distributions away from the bank. A typical example appears in IRS Letter Ruling 7925048.

The cost and trouble of the reversionary trust might be avoided through a bargain sale by the bank of securities (appreciated or depreciated) to the charity. No charitable contribution deduction is available because sec. 582 precludes capital asset status for sec. 170(e) purposes; however, since no contribution deduction is available, the entire basis of the securities sold will be allocated to the sale element of the property. (See regs. sec. 1.170A-4(c)(2)(ii) and -4(d), example (5).)

Example. If the bank sells a $5,000 bond, with a market value of $4,500, to a charity for $2,500, a deductible loss of $2,500 results. If the basis was $4,000, a deductible ordinary loss of $1,500 can be taken, and the $500 of unrealized appreciation would not be recognized.

This discussion is equally applicable to other corporate entities with large charitable contributions in relation to taxable income.

Clifford trusts can avoid the 5 percent limit on corporate charitable contributions

Many corporations want to make charitable contributions of a fixed or minimum amount each year in order to maintain a good community image. If a corporation adopts such a policy, and its earnings fluctuate substantially, the 5 percent limit on corporate charitable deductions under sec. 170(b)(2) (despite the five-year carryforward) may result in some of its charitable contributions not providing tax benefits. In other words, if earnings drop in a particular year, the contribution for that year might not be fully deductible. Under the rule of *Singer Co.*, an "excess" charitable contribution will never be available as an ordinary and necessary business expense unless it was not a charitable contribution in the first place.

However, such a corporation may utilize a ten-year "Clifford" trust to assure that no portion of any amount it pays to charity will bear any income tax. Trust corpus could consist of marketable securities previously owned by the corporation. The securities would be transferred to the trustee for 10 years, after which title would revert to the corporation. The trust instrument in such an arrangement would allocate 100 percent of trust current income to charities to be selected from time to time by the directors or officers of the corporation.

Usually, the power to select the recipients of the income would result in the taxation of such income to the grantor under the "grantor trust" provisions. However, this type of trust (100 percent of current net income payable to charity) avoids this result. (See sec. 674(b)(4).) And, a trust (unlike an individual or corporation) is entitled to charitable contribution deductions limited only by the amount of its income. (See sec. 642(c).)

Under such an arrangement, a portfolio of fixed income securities can be selected to provide fixed annual income, all of which would be distributed to charity. (Securities that produce sec. 243 qualifying dividends should not be included, because the corporation would lose the benefit of the 85 percent credit.) Accordingly, as a practical matter, with such a trust the amount of charitable contributions can be fixed at a predetermined amount. And because no amount of the earnings will be included in the taxable income of the corporation, the effect is the same as if the amount of each contribution were fully deductible regardless of corporate earnings. The service has issued private rulings approving this type of arrangement. (See, for example, IRS Letter Ruling 7826070.)

Of course, there will be limitations on the use of the assets placed in trust; one important one is that the corporation will not be able

to pledge the trust property as collateral for business borrowings. On the other hand, a corporation with potential sec. 531 or sec. 541 problems may find this an advantage.

Editors' note: For tax years beginning after 1981, the limit is increased to 10 percent.

Minimum tax: charitable contributions of charitable lead trusts

Sec. 170(b)(2) limits the amount of the charitable contribution deduction available to corporations generally to 5 percent of its taxable income. Therefore, many financial institutions and other taxpayers have established short-term trusts to make charitable contributions where the taxpayer's contributions have consistently exceeded the 5 percent limitation. The trust, unlike the grantor, can deduct contributions up to 100 percent of its annual income. Until recently, however, this arrangement had a major drawback: the trust was potentially subject to the minimum tax because its itemized deductions (contributions) were tax preference items since they exceeded 60 percent of its adjusted gross income. (See sec. 57(a)(1), (b)(1).)

Recent legislation, however, has eliminated the charitable deduction as a tax preference item for charitable lead trusts if the grantor of the trust, and the owner of all reversionary interests in the trust, is a corporation (sec. 57(b)(2)(C)(iv)). This favorable provision was enacted because a direct charitable contribution by a corporation was not treated as a tax preference item. The legislation now exempts both direct and indirect corporate charitable contributions from the minimum tax and the alternative minimum tax.

The provision is effective for tax years beginning after December 31, 1975. Therefore, trusts that reported and paid a minimum tax because of the old rules should file a claim for refund if the relevant year is still open under the statute of limitations.

Charitable contributions: capital gain property to private foundation that distributes corpus

Sec. 170(b)(1)(D)(ii) describes a private foundation, as defined in sec. 509(a), which makes sec. 4942 qualifying distributions in an amount equal to 100 percent of contributions made to it not later than the 15th day of the third month after the end of the foundation's taxable year in which the contributions are received.

Sec. 170(e)(1)(B)(ii) exempts capital gain property from the 50

percent long-term capital gain reduction for contributions made to a private foundation as defined in sec. 170(b)(1)(D)(ii).

However, private Letter Ruling 7825004 sets forth a potential problem regarding contributions of capital gain property to such private foundations. The private letter ruling emphasizes the word "amount" when dealing with the provisions of sec. 170(b)(1)(D)(ii), which states that the private foundation must make qualifying distributions in an "amount" equal to 100 percent of contributions received.

The private letter ruling dealt with a situation in which stock with a fair market value of $42 per share on the date of contribution was contributed to a private foundation. Subsequently, the private foundation sold the shares and distributed the proceeds to qualifying organizations within the 2½-month period following the foundation's year end, in accordance with sec. 170(b)(1)(D)(ii). However, the market value of the stock declined during the foundation's holding period and selling expenses were incurred by the foundation. Regs. sec. 1.170A-9(g)(2)(iv) provides that the fair market value of contributed property, as determined on the date of contribution, is required to be used for determining whether an amount equal to 100 percent of the contribution received has been distributed. Due to the market value decline and selling expenses incurred, the amount of net proceeds distributed by the private foundation to qualifying organizations was insufficient to constitute 100 percent of the amount deemed contributed to the private foundation ($42 per share). Therefore, the private letter ruling held that the private foundation did not qualify under sec. 170(b)(1)(D)(ii), which resulted in reduction of the charitable contribution by 50 percent of the long-term capital gain that would have been recognized had the stock been sold on the date of contribution.

Thus, in order to avoid the 50 percent long-term capital gain reduction for contributions to otherwise qualifying private foundations under sec. 170(b)(1)(D)(ii), the amount distributed by the foundation to the qualifying organizations should be sufficient to equal the fair market value of property when contributed. This could be achieved by making an additional cash contribution to the foundation after year end but before the fifteenth day of the third month following the foundation's year end. The foundation would then be able to make an additional distribution within the required 2½-month period to satisfy the required distribution of 100 percent of the fair market value of the property contribution. If the additional cash contribution does not violate the taxpayer's 50 percent-contribution base amount for the applicable taxable year, it will be fully deductible.

Charitable contributions: remainder interest in a vacation home

Under sec. 170(f), a donor may not take a charitable contribution deduction for the contribution of a remainder interest in property unless such remainder interest is in the form of an annuity trust, a unitrust, or a pooled income fund, or is an interest in a personal residence or farm. What is often overlooked is that the term "personal residence" is defined to include any property used by the taxpayer as his personal residence even though not used as his principal residence. Therefore, a vacation home would qualify for the contribution of a remainder interest. (See regs. sec. 1.170A-7(b)(3).) This may be an untapped source of contributions to charitable organizations as well as an additional source of charitable contribution deductions for individual taxpayers. Donors can make contributions of remainder interests in their vacation homes to charitable organizations, retain the enjoyment of such residences during their lives, and still obtain an immediate charitable contribution deduction for the value of the remainder interest.

IRS deems a hobby a business activity—only for sec. 170(e) purposes

When *appreciated property* is contributed to a charitable organization, the full fair market value (FMV) of the property is treated as the amount of the contribution, except as limited by sec. 170(e). The appreciation in value is not taxable income in any event.

Sec. 170(e)(1)(A) requires that the amount of the contribution be reduced by the portion of the appreciation that would not have been taxable as a long-term capital gain if the taxpayer had sold the property at its FMV at the time of the contribution. Thus, if the contributed property is wholly a noncapital asset or a short-term capital asset (i.e., ordinary income property) in the taxpayer's hands on the date on which it is donated, the amount of the contribution is limited to the tax basis of the property. (An exception to this limitation is provided by sec. 170(e)(3) for "qualified contributions" of inventory and other property solely for the care of the ill, etc.)

Furthermore, even when a long-term capital asset is contributed, sec. 170(e)(1)(B) requires that the amount of contribution be reduced by 40 percent of the appreciation in value (i.e., the taxable portion of a recognized long-term capital gain) under certain circumstances. Suffice it to say here that this adjustment concerns a donor who contributes (*a*) in excess of 30 percent of adjusted gross income, (*b*)

to private foundations, or (*c*) tangible property that the charitable organization puts to a use unrelated to its exempt purpose or function.

An analysis of the language, the structure, and the legislative history (particularly the 1969 Tax Reform Act amendments) of sec. 170 leads to the indisputable conclusion that Congress has intentionally and expressly provided taxpayers with an incentive for "frequently and continuously" contributing long-term capital assets instead of selling them and pocketing the after-tax gains. More specifically, subject to the 30 percent AGI and the other exceptions indicated in the preceding paragraph, Congress has expressly authorized taxpayers to deduct the full FMV of contributed long-term capital assets and to avoid capital gain taxation of 40 percent of the appreciation in value.

Nevertheless, the IRS issued Rev. Ruls. 79-256 and 79-419, which are apparently designed to inhibit timid taxpayers from making contributions of long-term capital assets with "frequency and continuity." Applying a "flawful" rationale, the IRS ruled that frequency and continuity of contributions, per se, converts three different properties into properties held primarily for sale to business customers—*solely for purposes of sec. 170(e).*

The holding in Rev. Rul. 79–256, concerning contributions of ornamental plants by a horticultural hobbyist, best illustrates the service's Alice-in-Wonderland approach to the meaning of sec. 170(e). The facts given in the ruling are as follows:

> For a number of years, *T* raised ornamental plants, "as a hobby." Annually, he donated to various charities a large number of such plants, after having held them for more than the long-term holding period prescribed in Sec. 1222(3) for a capital asset. In 1978, the FMV and cost basis of *T*'s contributions in plants totalled $2,000 and $250, respectively.

The IRS rationalized that the plants constituted ordinary income property because of the frequency and continuity with which they were contributed; therefore, *T*'s deduction is limited to $250.

IRS rationale. Sec. 170(e)(1)(A) and regs. sec. 1.170A-4(a)(1) provide that the term *ordinary income property* applies if any portion of the gain on the property, if it had been sold by a donor at its FMV at the time that it was contributed, would not have been long-term capital gain. The term includes, for example, property held by "the donor" primarily for sale to customers in the ordinary course of his trade or business. (See sec. 1221(a).) Thus, the code and the regulations require that, to determine whether the contributed property is ordinary income property, the donor be placed in the position of "a seller" of such property. Even though a donor is not engaged in a

trade or business, "the frequency and continuity of the contributions" may be substantially equivalent to "the activities of a dealer selling property in the ordinary course of a trade or business." Thus, said the IRS, *T*'s continuous production and "disposition" of the plants are equivalent to the activities of a commercial nursery business.

Critique. In the final analysis, the IRS is saying that, for the determination of whether a contribution consists of ordinary income property, the code and regulations require that the donor be regarded as a hypothetical seller. But the code and regulations specify that such a determination be based on the type of gain that would result from a hypothetical sale by the donor himself. Frequency and continuity of contributions, by themselves, do not justify equating an amateur horticulturist with a professional nurseryman.

Extended to its logical conclusion, the illogical frequency-and-continuity rule would mean that an investor who frequently and continuously contributes securities should be treated as a dealer in securities. Yet it is well established that an investor (or even a professional trader) who sells securities is not equivalent to a dealer in securities. (See regs. sec. 1.471-5 and *N. S. Seeley.*)

Moreover, contrary to congressional intent, the service's frequency-and-continuity rule would effectively limit taxpayers to making "infrequent and sporadic" contributions of properties that are otherwise clearly long-term capital assets in their hands.

IRS rationale. "The contributions were not made after a period of accumulation and enjoyment by [*T*] of the property contributed. On the contrary, the contributed property was produced . . . in bulk and distributed to various donees."

Critique. The ruling states as a fact that *T* made the contributions "after having held the donated plants for the long-term holding period for a capital asset under section 1222(3)." Therefore, it is not apparent why the plants were not held by *T* "after a period of accumulation and enjoyment" sufficient to qualify them as long-term capital assets.

IRS rationale. The treatment provided under sec. 170(e) does not imply that a taxpayer is engaged in a trade or business for the purposes of any other section of the code.

Critique. With this statement the ruling virtually self-destructs. It cites no authority—presumably because there is none—for explicitly holding that *T* will be treated as a commercial nurseryman solely for sec. 170(e) purposes. Presumably, for purposes of sec. 183 (limiting hobby loss deductions), the IRS would rule the reverse—i.e., *T* is an

amateur horticulturist rather than a commercial nurseryman. Just as a rose is a rose is a rose for horticultural purposes, so "a hobby is a hobby is a hobby" for tax purposes.

IRS abuse of administrative function. The two rulings are clearly not in accordance with the law. Obviously, they discourage taxpayers from taking advantage of the tax incentives that Congress expressly provided for making contributions of long-term capital assets. The IRS itself, in Publication 561, *Valuation of Donated Property,* acknowledges, "Our Federal Government recognizes that donations to [charitable] organizations have contributed significantly to our Nation; and our tax laws are designed to encourage such giving."

Under sec. 1221(3), ordinary income property includes "a copyright, a literary, a musical or artistic composition, a letter or memorandum or similar property" that is contributed by a "taxpayer whose personal efforts created such property." Perhaps sec. 1221(3) should be expanded to comprehend ornamental plants and like-kind properties created by the contributor's personal efforts; but that is a matter of tax policy for Congress to resolve through the legislative process, and not for the IRS to effect through a strained construction of the code and the regulations.

SECTION 171

Bond premium: ordinary deduction or capital loss

With the recent fluctuations in interest rates, the prices of both tax-exempt and taxable bonds have been fluctuating widely. Bonds issued in a period of high interest rates will bear a premium when they are acquired in times of low interest rates. This bond premium is determined under sec. 171(b)(1) by the difference between the basis (for determining loss on sale or exchange) of the bond and the amount payable at maturity or earlier call date. Although this bond premium must be amortized (and is nondeductible) on tax-free bonds, amortization of premium on taxable bonds is optional. (See sec. 171(c).) This presents an opportunity to claim a current ordinary deduction for the premium under sec. 171(a)(1), rather than claiming a capital loss upon redemption.

The annual amortization is equal to either the method of amortization regularly employed by the taxpayer (if reasonable) or the prescribed method. The prescribed method is explained in regs. sec. 1.171-2(f)(2)(i). It is an amount which bears the same ratio to the

premium as the number of months in the taxable year during which the bond is held by the taxpayer bears to the number of months from the beginning of the taxable year (or date of acquisition if within the taxable year) to the date of maturity or earlier call date. A fractional part of a month is disregarded unless it is more than half a month, in which case it is treated as a full month.

Sec. 171(d) defines a bond to include, "any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivision thereof)." The definition does not include obligations that constitute stock in trade of the taxpayer or any obligation held by the taxpayer primarily for sale to customers in the ordinary course of business.

In a case in which a taxpayer can elect to amortize bond premium, the election must be made in the return for the first taxable year for which amortization is to be taken. A corporation can only elect to amortize the premium on fully taxable bonds. (It must amortize partially tax-exempt bond premium.) For a taxpayer other than a corporation, the election may be made with respect to the following classes:

1. Fully taxable bonds,
2. Partially tax-exempt bonds, or
3. Both fully taxable and partially tax-exempt bonds.

The election is made by deducting the appropriate amount of bond premium in the first taxable year to which the election applies. If the election is made, the taxpayer should attach a computation of the deduction to his tax return. The election applies to all bonds within a class for that taxable year, and all bonds of that class acquired in subsequent years. Permission must be obtained from the IRS to revoke this election. (See regs. sec. 1.171-3.) The amortization deduction is treated as an ordinary deduction.

SECTION 172

NOLs of individuals—relinquishment of carryback period after the 1978 act

Sec. 172(b)(3)(C) allows a taxpayer entitled to carry back a net operating loss (NOL) for any taxable year ending after December 31, 1975, to irrevocably elect to relinquish the entire carryback period.

With the enactment of every piece of new tax legislation, traditional tax planning concepts must be challenged. For example, recent

legislative changes relating to the maximum and minimum tax can affect traditional planning regarding NOL carrybacks.

The '78 act augments the minimum tax with a new alternative minimum tax (sec. 55). The taxpayer will pay this alternative minimum tax only to the extent that it exceeds the regular tax. The alternative minimum tax is computed by adding to taxable income (negative income if appropriate) itemized deductions exceeding 60 percent of adjusted gross income and the 60 percent deduction claimed for long-term capital gains. For this purpose, deductions for medical expenses, state and local income taxes, and casualty losses are excluded. The total of these three items is the alternative minimum tax base. In calculating the tax, a $20,000 exemption is allowed; the next $40,000 is taxed at 10 percent; the following $40,000 is taxed at 20 percent; and the excess beyond $100,000 is taxed at a flat rate of 25 percent.

A taxpayer carrying a 1978 NOL forward, so as to eliminate his entire adjusted gross income, is not likely to incur alternative minimum tax liability. Because the NOL is applied against adjusted gross income before itemized deductions, the "no tax benefit" rules under sec. 57 prevent the occurrence of excess itemized deductions. Since the taxpayer will not have any taxable income, it is only if net long-term capital gains exceed $33,333 that the alternative minimum tax will become payable (due to the $20,000 exemption).

Now, suppose the same taxpayer can carry his loss back. He eliminates his entire adjusted gross income in the carryback year. The taxpayer is subject to the tax law in effect for the year to which the carryback is applied. If the loss is carried back to 1975, and the taxpayer had items of tax preference in that year, he will have to recompute his minimum tax.

In 1975, items of tax preference included the 50 percent deduction for net long-term capital gains, but there was no provision taxing excess itemized deductions. The taxpayer would be entitled to an exclusion of $30,000, the regular tax, and a carryover of tax paid in the prior seven years equal to the tax less credits for a year over the sum of the items of the tax preference in excess of $30,000. After the above adjustments to the tax base, the minimum tax was computed at 10 percent, and added to the regular tax. It would appear in many situations that an NOL incurred in 1978 should be carried back to 1975, generating an immediate refund of income taxes at no increased cost in minimum tax.

The '76 act, however, made dramatic changes to the minimum tax rules. The preference item for excess itemized deductions was added, the exclusion was reduced to the greater of $10,000 or half of the regular tax, the tax carryover from prior years was eliminated, and

the rate increased from 10 percent to 15 percent. If an NOL is to be carried back to 1976, the situation must be evaluated in light of these changes. Assume the taxpayer eliminated his entire 1976 adjusted gross income with the carryback. Any tax preferences incurred in excess of $10,000 for that year are now taxed at 15 percent. It is likely that an additional minimum tax liability will be incurred, and the benefit from the carryback reduced. Thus, the taxpayer might want to consider carrying his NOL forward.

Taxpayers carrying an NOL to 1977 will have to look again. The '76 act introduced the concept of having each dollar of tax preference items convert one dollar of earned income (subject to maximum tax of 50 percent) to unearned income (subject to a top rate of 70 percent). If the taxpayer had substantial earned income in 1977, the effect of increasing excess itemized deductions by decreasing adjusted gross income could be detrimental; thus, the carryback is best relinquished.

But if a taxpayer had substantial earned income as well as items of tax preference in 1977, it may be beneficial to carry his NOL back. He paid a higher rate of tax in 1977 due to the "poisoning" of earned income by the preference items. The '78 act mitigated this taint in the maximum tax rules: Effective for sales or exchanges after October 31, 1978, the preference element of long-term capital gains will not offset income subject to the 50 percent maximum tax. The '78 act also reduced individual tax rates to help cope with inflation. As such, even if a taxpayer must pay an additional minimum tax by carrying an NOL back to 1977, his overall tax burden might be lightened by reducing 1977 income, when the rates were higher.

There are many other factors to consider when deciding if an NOL carryforward is more beneficial than a carryback. If a loss is carried back, tax credits taken in prior years might be reduced, and perhaps lost through expiration of the carryforward period. The time value of money must also be kept in mind. An awareness of the different alternatives available for carryback or carryforward will assist in the right planning decisions.

SECTION 174

Accounting methods: change for R&E costs

Until recently, the service has maintained that a taxpayer who has elected to expense research and experimental expenditures pursuant to sec. 174 may not change over to capitalizing such costs if there is a net operating loss (NOL) carryover. The service has now unofficially

modifed this position to permit such a change, but any increase in taxable income in the year of transition resulting from the change in method may not be offset by the NOL deduction.

Example. In 1979 a corporate taxpayer with an NOL carryover of $100,000 changed its method of accounting for research and experimental costs from expensing to capitalization. It would have realized $10,000 of income without the change; but as a consequence of capitalizing R&E (net of any amortization permitted during 1979), the taxpayer realized $60,000 of taxable income. The NOL may be used to offset only $10,000 of income in 1979. This rule apparently does not apply in years following the year of transition. Thus, in our example, the $90,000 remaining NOL carryover may be used in 1980 to offset all of the corporation's income, including that generated by capitalizing rather than expensing R&E expense.

It is not clear whether the service is requiring a representation that the taxpayer will generate sufficient income without respect to this change in method to fully absorb the loss carryover as a prerequisite for granting permission to change.

SECTION 183

Postponement of "hobby loss" determination

A taxpayer who turns an avocation into a secondary part-time business must contend with the threat of a "hobby loss" disallowance. Unless the enterprise soon becomes profitable, the IRS may attempt to disallow the losses under sec. 183(a) on the grounds that the business is not an activity engaged in for profit.

Sec. 183(d) contains a statutory presumption that the activity *is* engaged in for profit if the gross income exceeds the deductions in at least two of the most recent five taxable years (two out of seven years in the case of certain equestrian activities). However, if the business has been in existence for only two or three years, all of which have been unprofitable, the statutory presumption offers no immediate assistance.

Fortunately, there is a remedy available to a taxpayer in that situation who is faced with a proposed loss disallowance, but who anticipates eventually satisfying the two-out-of-five-years test. The taxpayer can file with the district director a written statement of election to postpone the determination until after the close of the fourth year of operation. If, at that time, at least one profitable year has been reported, the determination will be further postponed until after the end of the fifth year.

However, if none of the first four years are profitable, the taxpayer will not be able to satisfy the test and the deficiency, plus interest, will be assessed at the end of the fourth year.

This elective postponement is authorized by sec. 183(e). The procedure for making the election is set forth in temp. regs. sec. 12.9, which also provides the format of the statement of election. A taxpayer may make the election at any time within three years of the due date of the return for the first year in which he engaged in the business, but not later than 60 days after receipt of written notice of the proposed disallowance of the losses. That is, the election must be made within 60 days of the date of issuance of the revenue agent's report and accompanying "30-day letter." If the taxpayer is going to appeal other proposed adjustments, the statement of election may be filed with his written protest.

Postponement of a hobby loss determination will extend the assessment period until a date two years after the due date of the return for the fifth year in which the taxpayer has engaged in the business (sec. 183(e)(4)). However, the extension applies *only* to the proposed deficiency arising from the disallowance of the hobby loss. It does not extend the assessment period with respect to any other items on the return.

SECTION 189

Planning for realty-construction-period interest and taxes

Sec. 189, which provides for the amortization of real-property construction-period interest and taxes, offers some distinct planning opportunities. Since regulations have not been issued either in proposed or final form, the provisions of sec. 189 are open to interpretation and may be used to a taxpayer's advantage.

First, interest may presumably be expensed upon the completion of the construction period. A "construction period," as defined by sec. 189, is the period beginning on the date on which construction of "the building or other improvement" begins and ending on the date on which that item of property is ready to be placed in service or is ready to be held for sale (sec. 189(e)(2)).

For taxpayers involved in residential or multiple-unit commercial construction projects, the concept of "item of property" will be controlling in regard to deduction or amortization of any interest costs. The difference can be very substantial. Since the term "item

of property" is not used in sec. 189(e), it would appear that every separate unit within the construction project could qualify as an item of property, thus resulting in an immediate interest deduction for the completed units. The problem is to determine the amount of interest allocable to the completed units. One method that seems to be acceptable is to allocate the interest according to the ratio of the number of units completed to the number of units commenced within the taxable year, multiplied by the interest incurred for the entire year of construction. For rental properties, a taxpayer could allocate the interest charges according to the ratio of months the units were actually rented to the total rental months available in a calendar year.

Example. X obtains a construction loan of $2 million at 17 percent to build a 100-unit apartment complex. Construction commences January 1, 1980, with 50 units being completed on July 1, 1980, and 10 more completed each month for the balance of the year. The interest charge of $340,000 for 1980 is allocated to completed units as follows:

Months completed	Units completed	Months rented	Total months rented
July	50	6	300
August	10	5	50
September	10	4	40
October	10	3	30
November	10	2	20
December	10	1	10
	100		450

The total available rental months are 1200 (100 × 12). The amount of interest to be expensed would be $127,500 (450/1200 × 340,000). If the total interest were amortized over six years as required for construction beginning in 1980 (see sec. 189(b)), the interest deduction would be $56,667 for 1980 and each of the following five years.

Thus, by treating each unit as a separate item of property, significant tax benefits can be achieved.

SECTION 219

IRAs: seventh circuit liberalizes rules for year of job change

A seventh circuit decision, *Foulkes*, would allow some taxpayers to take individual retirement account (IRA) deductions in a year in which they leave a job with pension plan coverage and forfeit all their pension benefits.

Suppose an individual works for several years at Company *A*, which

has a pension plan. Early in 1981, he resigns, and since he did not work at *A* long enough for benefits to become vested, he loses all pension plan rights when he leaves the company. Then he takes a job at Company *B*, which has no pension plan. Under these conditions, the code as well as the Tax Court would not permit him to make IRA contributions until 1982, since he was literally an "active participant" in a pension plan for part of 1981. (See sec. 219(b)(2)(A).)

The court in *Foulkes* conceded that the literal language of sec. 219 excludes such a taxpayer from eligibility from IRA contributions for the year of job change. The court, however, relied on congressional intent in its opinion; it pointed out that by providing the deduction, Congress sought to equalize the tax benefits of those not covered by qualified plans, and encourage retirement savings. The court concluded that disallowance of the deduction in this case would defeat this purpose. The court also believed that the intent of the law is to prevent people from benefiting from both tax deferred company pension benefits and IRA contributions in the same year; but there is no double benefit if all rights under the company plan are forfeited. Thus, the court held that the IRA deductions should be permitted, despite code and regulation language to the contrary.

Note that the same decision would not apply if the sequence were reversed: That is, if the taxpayer properly made an IRA contribution early in the year, then transferred to a company with a pension plan and stayed in the new job until year end, the IRA deduction for that year would be disallowed.

The conflict in the courts on such a basic question requires swift resolution. And, even if the congressional purpose rule of *Foulkes* prevails, there are many other unresolved issues, such as the effects of the break-in-service rules and post-year-end contributions.

SECTION 243

Avoiding loss of the dividends-received deduction if the corporation has an NOL

Corporations receiving domestic dividends are entitled to a dividends-received deduction, which is normally limited to 85 percent of taxable income. This limitation does not apply if the corporation sustains an NOL for the taxable year in which the deduction arises; in other words, the 85 percent limitation applies only if the corporation realizes a taxable profit after the dividends-received deduction. If the corporation incurs a loss before taking the dividends-received de-

duction, or if the dividends-received deduction creates an NOL, the limitation does not apply.

Thus, corporations that are close to the profit or loss point should make pre-year-end computations to test the effect of the 85 percent limitation. Partial loss of a full dividends-received deduction may be avoided by a slight increase in deductions or a slight reduction in income.

Example. If corporation *X* has taxable income of $7,000 before the dividends-received deduction, including $8,000 of dividend income, taxable income is computed as follows:

Taxable income before NOL and special deductions	$ 7,000
Less 85% of dividends received (8,000 × .85)	(6,800)
Taxable income	$ 200

Since there is taxable income, the dividends received must be recomputed.

Dividend income	$ 8,000
Business operating loss	(1,000)
	7,000
Limitation (85% of $7,000)	$ 5,950

The result of this recalculation is an increase in taxable income of $850, with a corresponding increase in tax of $145.

If corporation *X* had a net operating loss carryover of $2,000, the loss would result in an NOL of $1,800. In this situation, the dividends-received deduction would *not* be limited to 85 percent of taxable income.

If corporation *Y* has income of $50,000, which includes $100,000 of dividend income, then taxable income is computed as follows:

Taxable income before NOL and special deductions	$50,000
Less 85% of dividends received	(85,000)
Taxable income	($34,000)

In the example, an NOL is created by the dividends-received deduction. The NOL not only precludes limitation of the deduction but can also be carried backwards or forwards as if the loss had been created through business operations.

SECTION 265

New dividend and interest exclusion subject to same limits as tax-exempt income

To stimulate savings, Congress tacked on to the Crude Oil Windfall Profit Tax Act of 1980 (H.R. 3919) an amendment to sec. 116 that allows individuals to exclude up to $200 ($400 in the case of a joint

return) of dividends and interest from gross income. This amendment is effective for taxable years beginning in 1981 and 1982. The amendment will allow the $400 exclusion to apply on joint returns regardless of whether the husband or wife earned the dividends and interest.

That's the good news; now the bad: act section 405(b), entitled "Clerical and Conforming Amendments," has expanded the nondeductible provisions of sec. 265(2) to cover:

> Interest on indebtedness incurred . . . to purchase or carry obligations or shares, or to make deposits or other investments, the interest on which is described in Sec. 116(c) to the extent such interest is excludible from gross income under Sec. 116.

Sec. 265 formerly denied an interest expense deduction only for any indebtedness to carry tax exempt municipal bonds. The expanded version of sec. 265 will also deny an interest expense deduction if, for example, borrowed funds are placed in savings accounts, bonds, notes, certificaies, etc., that produce interest income excludible under sec. 116. For another example, assume *T* owns certificates of deposit that he wants to maintain for liquidity purposes. Because he does not want to touch these certificates, he borrows money from the bank to purchase a valuable painting he has always wanted. *T* will probably have a difficult time convincing the IRS that sec. 265(2) should not apply to the interest being deducted on this loan.

The wording of sec. 265 does suggest a way some taxpayers can avoid its scope. Sec. 265(2) is applicable only to *interest income* excluded under sec. 116, but the exclusion covers interest and dividends. If the exclusion can be attributed entirely to dividends, all of the interest income would have been reported and sec. 265(2) would not apply. Until regulations are issued for the amended sec. 265(2) and sec. 116, however, there will be no way of knowing if the exclusion can be taken entirely out of dividends.

Sec. 265: bank's pledge of tax-exempts to secure public deposits does not result in disallowance of interest expense

Under the laws of most states, a bank that accepts deposits from the state or a political subdivision thereof must secure such deposits through a pledge of U.S. government, U.S. agency, state, or local municipal obligations. Examining IRS agents often raise the issue of whether sec. 265(2) operates to disallow a deduction for interest paid on a public funds time deposit secured by such a pledge, particularly

when the bank has in its investment portfolio obligations of the depositor municipality. Using the guidelines of Rev. Proc. 72-18, an agent may attempt to establish a direct connection between the time deposits accepted by the bank and its investments in tax-exempt securities. If the deposits are part of the bank's ordinary day-to-day business, the national office should support the taxpayer in a technical advice request by holding that Rev. Proc. 72-18 cannot be applied to a situation covered by the provisions of Rev. Proc. 70-20.

Under section 3.09 of Rev. Proc. 70-20, a direct connection between deposits and tax-exempt investments must be evidenced by, for example, a contractual arrangement between the parties or a correlation between the percentage of a municipality's obligations purchased by the bank and the percentage of the proceeds from the sale of such obligations deposited by the municipality. If the facts do not indicate the existence of such a direct connection, the national office will hold sec. 265(2) inapplicable. Also, section 3.09 provides that it will ordinarily be inferred that a direct connection does not exist in cases involving, *inter alia*, bank deposits.

SECTION 267

Sec. 267 may apply to divorce settlements

The Tax Court has concluded in *C. L. Siewert*, probably the first case of its kind, that a husband and wife entering into a divorce agreement are related parties within the meaning of sec. 267, even though the property settlement is contingent on the granting of a divorce. It was the service's position that, because of the contingency, the divorce preceded the sale, and the property settlement did not take effect until the divorce was final, at which point the taxpayer was no longer married. The court rejected this argument and held that the exchange occurred simultaneously with the entry of the final divorce decree. Therefore, at the time of the exchange of property, the taxpayer and his wife were related parties within the meaning of sec. 267.

Congress's purpose in enacting sec. 267 was to prevent related parties with identical financial interests from generating tax losses when in fact the parties had suffered no real economic loss. In light of *Siewert*, it appears that the courts will apply sec. 267 whether the exchange results from a voluntary sale, a forced sale, or a bona fide exchange.

The court noted the arguments against applying sec. 267 to exchanges made in connection with divorce settlements and was well

aware that some commentators have suggested that sec. 267 does not apply to sales transactions in connection with divorces. Although the parties in *Siewert* were dealing at arm's length, the court agreed with the fifth circuit's conclusion in *J. H. Merrit:* that simplicity was a valid congressional rationale for a blanket approach that relieved the taxing authorities of numerous complex decisions in family transactions. The Tax Court also relied on *J. P. McWilliams*, concluding that sec. 267 contains an absolute prohibition and not a presumption against losses on sales between members of certain groups designated in the statute.

Tax advisers should keep this Tax Court's decision in mind in determining the income tax consequences of divorce.

Losses: sec. 267 as a tax planning tool

Sec. 267 disallows, *inter alia*, deduction of losses from sales or exchanges between certain related parties. The disallowance is automatic, without regard to the intent of the parties or the factual situation surrounding the sale or exchange. In order to mitigate this often harsh result, sec. 267(d) provides that to the extent of the disallowed loss, gain shall not be recognized on a future sale or exchange by the purchaser. Because of this latter relief provision, sec. 267 may occasionally be used advantageously as an income and estate tax-planning tool.

Sec. 267 may have significant value as a planning device when the following conditions are present:

- A capital asset has declined in value but shows strong potential for recovery and future appreciation;
- The purchaser is a related party as defined in sec. 267(b); and
- The owner of the asset has a fairly substantial but illiquid estate and only modest income. (This might apply, for example, to an elderly, retired taxpayer.)

In such a situation, a capital asset that has depreciated in value might be sold to a related party for its present fair market value (thus avoiding any gift tax liability). The loss on the sale will be disallowed by sec. 267, but future appreciation in the hands of the purchaser will be sheltered from tax to the extent of the disallowed loss.

There is an obvious pitfall to such an arrangement. The seller forfeits a capital loss deduction or carryforward. If the asset's value never rises to the level of the original purchase, the disallowed loss will never be recovered and will have been sacrificed needlessly. However, in situations where the capital loss is of little or no use to its present owner—for example, because his income is very low or

he already has substantial capital loss carryforwards—a related-party transaction may be advantageous for both income and estate tax purposes. The following example illustrates these advantages.

A retired widower has annual income of approximately $15,000, most of which consists of dividends on low-yielding securities. His assets are as follows:

	Value
Personal residence	$150,000
Life insurance policy (face value)	150,000
Personal property	50,000
Marketable securities (tax basis of $400,000)	250,000
Total estate	$600,000

Assume the taxpayer is not in a position to take advantage of any built-in losses in his securities portfolio since either he already has substantial capital loss carryovers or there are insufficient built-in gains in his portfolio. He is also not in a position to make gifts of any of his securities since he relies on them as a source of income. An ideal technique in such a situation may be a related-party sale of some or all of the portfolio. If one of his securities had a cost basis of $80,000 and a present fair market value of $40,000, a sale to his son for $40,000 (cash or interest-bearing note) would have the following results:

- The first $40,000 of capital gain realized by the son on a future sale will not be recognized because of sec. 267(d).
- At the same time, the father has only sacrificed a capital loss of little or no use to him. He retains income-producing property (the cash might be reinvested to yield a higher return), and he removes possible future appreciation in the stock from his estate.

It must be noted that a similar result to the son would have been reached under the rules of sec. 1015 if a gift had been made. Thus, the technique discussed above is most appropriate when the taxpayer is either unwilling or unable to make a gift of his property.

Sec. 267 trap for shareholder-partners

When a cash-basis individual taxpayer owns, directly or indirectly, over 50 percent of a corporation using the accrual method of accounting, any interest, salary, bonuses, or other expenses due the individual must be paid within 2½ months of the corporation's year end to be deductible. If these expenses are not paid within that time, the corporation's deduction is lost forever. Sec. 267 also disallows losses on sales and exchanges between a corporation and an individual who owns, directly or indirectly, over 50 percent in value of the outstanding stock.

Sec. 267(c)(3) provides that an individual is considered as owning stock owned, directly or indirectly, by his partner. This can be a trap since there are no *de minimis* rules as to the stock ownership or partnership interests. Consider the following example.

Individuals *X* and *Y* are unrelated and each owns 26 percent of Corporation *A*. The remaining 48 percent of *A* is owned by other unrelated individuals. In addition, *X* and *Y* each owns a 1 percent interest in a real estate venture operating as a limited partnership. Since *X* and *Y* are partners in the real estate venture, each is deemed to own his partner's shares of *A*. Thus, *X* and *Y* would *each* be deemed to own 52 percent of *A* and the 2½-month rule would be applicable to any amounts due to them. This would also be true if, for example, *X* owned 50 percent and *Y* owned 2 percent of the *A* stock.

Attribution of a partner's stock to the individual will make sec. 267 applicable to *all shareholders* when all of the shareholders also own small interests in the same tax shelter partnership. This is true regardless of the ownership of the stock or size of the partnership interests.

Even co-ownership of a small rental property, if the co-ownership arrangement constitutes a partnership, may cause sec. 267 to apply. For example, sec. 267 is normally not applicable if two unrelated individuals each own 50 percent of the corporation. However, sec. 267 applies to both shareholders if they also co-own real estate and the investment is considered a partnership for tax purposes. Compare *Hallbrett Realty Corp.*, where accrued interest was held to be deductible with respect to a mortgage co-owned by two individuals who were both 50 percent shareholders; the predecessor of sec. 267 was not applicable because the individuals were not partners.

Shareholders of closely held corporations should be aware of the problems that may result from their investments in the same tax shelters or from other partnership investments. It may be appropriate to avoid such investments or arrange the ownership so as to avoid the constructive ownership rules of sec. 267(c). If shareholders also co-own real estate, it may be possible to keep activities at a minimal level so that the co-ownership arrangement does not rise to the level of a partnership. (See regs. sec. 1.761-1(a).)

SECTION 274

Conventions in Mexico and Canada no longer subject to limitations

The tax rules (sec. 274(h)) applying to deductions for conventions held outside the United States have now been made more restrictive, except that they have been liberalized with respect to Canada and Mexico. These changes made by P.L. 96-608 are effective generally for conventions beginning after 1980. The provision permitting deductions for not more than two foreign conventions has been eliminated. Also, prohibitions on deductions will not apply to a

foreign convention if it is "as reasonable" to hold the convention overseas as in North America. Moreover, the new law completely eliminates restrictions on conventions in Canada and Mexico, which will now be subject to the same tax rules as conventions in the U.S.

The foreign convention restrictions now provide that no person (or his employer) may deduct expenses for his attendance at *any* foreign convention unless it is as reasonable to hold it outside North America as to hold it here. The foreign convention rules do not apply to any of the 50 states, Puerto Rico, the Virgin Islands, Canada, or Mexico. They continue to apply to nearby areas (such as the Bahamas and the Caribbean), to cruise ships, and to all continents other than North America.

Shareholder repayment agreements for distributions other than compensation

A repayment or "hedge" agreement between a closely held corporation and its officer-shareholders that requires repayment of amounts disallowed as unreasonable compensation can be a valuable tax-planning tool. However, it has been uncertain whether such arrangements also could be effective for commissions, travel, entertainment, and rent payments since, in Rev. Rul. 69-115, the service sanctioned only *salary* hedge agreements. Two technical advice memorandums (IRS Letter Rulings 7811004 and 7811005), however, point out that the service will recognize the validity of repayment agreements covering disallowed travel and entertainment expenses.

In one situation, the three sole shareholder-directors of a corporation passed a resolution calling for repayment by an officer of payments to him that are subsequently disallowed as a deductible expense to the corporation. The other situation involved an agreement between an officer and his wholly owned corporation, which specifically required him to reimburse the corporation for disallowed travel and entertainment expenses. In both situations, the examining agent proposed to disallow the deductions claimed by the officer-shareholders for the amounts repaid to the corporations pursuant to their legally enforceable agreements. The national office evidently could find no valid distinction between salary-hedge agreements and agreements covering other types of payments. Citing Rev. Rul. 69-115 and *V. E. Oswald,* it held that the officer-shareholders were entitled to a deduction under sec. 162(a) for the year in which repayments were made under the agreements.

Query: Can an *Oswald*-type agreement be used as a hedge against the IRS treatment of a loan to a shareholder of a closely held

corporation as a dividend? Can a repayment agreement be adopted to provide that any excess payment of salary, any nondeductible T&E expense, or a loan treated as a dividend must be repaid to the corporation "if it is properly treated as deductible by the shareholder for federal income tax purposes," thereby preserving more options to the shareholder in this troublesome and contentious area? Note that some practitioners have taken the position that the mere presence of an *Oswald*-type agreement increases the likelihood that the disallowance issue will be raised by an examining IRS agent. In addition, some courts have held that a hedge agreement is a factor tending to show that compensation paid was unreasonable. (See, e.g., *Castle Ford, Inc.*)

Entertainment facilities after the 1978 act

Section 361 of the '78 act amended sec. 274 to provide that no deduction is allowed for expenses incurred with respect to a facility used in conjunction with an activity that is considered to constitute entertainment. (See sec. 274(a)(1)(B).) However, the following deductions can still be taken with respect to such facilities:

1. Interest, taxes, and casualty losses.
2. The out-of-pocket costs of entertaining.
3. The costs of operating an entertainment facility for certain statutorily excepted purposes (regs. sec. 1.274-2(e)).

Effective January 1, 1979, depreciation, rent, utility charges, maintenance and repair expenses, insurance premiums, salaries for caretakers and watchmen, and losses from sales or dispositions are no longer deductible with respect to entertainment facilities. However, it appears that Congress only intended to disallow these expenses *to the extent* that a facility was used for entertainment. Both the committee reports and the General Explanation of the Revenue Act of 1978 strongly suggest that Congress intended that where a facility is used partially for entertainment and partially for other business purposes, the expenses should be allocated between the two on a reasonable basis.

The conference committee report states that deductions are not affected unless the property is used in connection with entertainment, and that expenses of an automobile or an airplane used on business trips will continue to be allowed. Further, the general explanation provides that the disallowance rule "does not apply *to the extent allocable* to that portion of the facility . . . which is not an entertainment facility" (emphasis added). It further provides that expenses incurred with respect to automobiles or airplanes are allowable *to the*

extent allocable to travel undertaken primarily for the furtherance of trade or business even if the taxpayer engages in some entertainment activities during the business trip.

These explanations indicate that Congress intended to continue the existing rule of the regulations which provides that expenses attributable to the use of a facility for other than entertainment purposes are not expenses with respect to an entertainment facility. (See regs. sec. 1.274-2(e)(3)(iii)(*b*).) Consequently, where a facility is being used part of the time for business purposes and part of the time for entertainment, depreciation, operating expenses, etc., should be allocable on a reasonable basis.

To the extent that a facility is treated as an entertainment facility for purposes of disallowing the deductions with respect to it, the facility is treated as an asset that is used for personal, living, and family purposes (not an asset used in the trade or business). (See regs. sec. 1.274-7.) The committee reports indicate that under this rule, the investment tax credit would not be available on the acquisition of such a facility. In many cases, this problem is academic, since the facilities are real estate for which the investment credit is not available anyway. However, in the case of items such as yachts or equipment used with respect to an entertainment facility, this rule may have adverse consequences. If, however, depreciation on a facility is allocated according to the extent of business use other than entertainment, the property should partially qualify for the investment credit. This is consistent with the present regulations under sec. 48 which provide that if, for the taxable year in which property is placed in service, depreciation is allowable only with respect to a part of such property, only the proportionate part of the property with respect to which such deduction is allowable qualifies for the investment credit. (See regs. sec. 1.48-1(b)(2).)

SECTION 280A

Vacation home used for less than 15 days may generate deductions

Sec. 280A provides specific tests which must be satisfied before a taxpayer may claim a loss on the rental of a vacation home. Generally, if the personal use of the home is less than the limit defined in sec. 280A(d), the home will be treated as property maintained for the production of rental income. If that limit is exceeded, however, the home is classified as a "residence" for the year and deductions are

limited. Sec. 280A(d)(1) provides that a home will be a "residence" if used personally by the taxpayer for a number of days which exceeds the greater of—

- 14 days, or
- 10 percent of the total number of days for which the home is rented.

Sec. 280A(g) provides a special rule for vacation homes used by the taxpayer "as a residence" during the year and rented for less than 15 days during the year. In this case the rental income is not included in gross income, and no expenses are deductible unless they are otherwise allowable (e.g., interest and taxes).

This special rule does not apply to the situation in which the home is rented for less than 15 days *and* is also used for personal purposes less than 15 days. In this case sec. 280A(g) would not apply, as the unit would not be considered a "residence" in accordance with sec. 280A(d). The allocated portion of expenses and depreciation would be offset against rental income and the property could generate a taxable loss. The interest and taxes allocated to personal use would of course be reported as an itemized deduction. These rules may have special relevance where the property is acquired late in the year.

Corporate distributions and adjustments

SECTION 301

Bootstrap acquisitions require careful planning

The "bootstrap" method of acquiring control of a corporation by the use of the corporation's own assets can be very useful. The procedure generally involves the purchase of a small amount of stock from the seller with the corporation redeeming the remainder of the seller's stock.

The *Ferm R. Zenz* case is an authority for this type of transaction. In *Zenz*, this method was used primarily because the purchaser wanted to eliminate the accumulated earnings of the corporation. The classic motive for use of this method is that the purchaser lacks the funds to make the acquisition. Interestingly, in *Zenz* the IRS contended that the redemption was "essentially equivalent to the distribution of a taxable dividend" to the *seller*. The sixth circuit did not agree.

A different approach was taken by the IRS in *H. F. Wall* and *Joseph R. Holsey*. In these cases, the redemption was considered by the IRS to be a constructive dividend to the remaining shareholders since their interest in the corporation was increased by the use of corporate funds. The IRS was upheld in *Wall* because the remaining shareholders were personally liable to make the acquisition but subsequently transferred this liability to the corporation. In *Holsey*, however, the court did not consider the remaining shareholder to have received a constructive dividend since he had only an option to acquire the remaining shares and the option was transferred to the corporation, which then exercised it.

The *Herbert Enoch* case, which had points in common with all of the above cases, illustrates the careful planning required. *Enoch* involved an initial acquisition as in *Zenz*, rather than the buy-out of

other interests as in *Wall* and *Holsey*. The major asset of the corporation acquired in *Enoch* was an apartment complex. The purchase price was $1,500,000, which the seller said could be paid in part with corporate assets, including the proceeds of a refinancing arrangement on the apartments. The taxpayer-purchaser borrowed $255,000 of the purchase price personally, and this debt was assumed by the acquired corporation. This amount, along with corporate funds, was put into an escrow account from which the purchase and redemption were accomplished. The purchaser bought one share of stock for approximately $72,000; the remaining 19 shares were redeemed.

The Tax Court held that the redemption of the remaining shares did not result in a constructive dividend to the purchaser. The court concluded that the circumstances surrounding the transaction indicated that the taxpayer's only obligation was to purchase one share of stock. The corporation, not the taxpayer, had the obligation with respect to the remaining 19 shares that it redeemed. Therefore, the corporation was not assuming the taxpayer's liability to purchase the stock. However, the repayment of the $255,000 loan by the corporation was considered to be a dividend to the taxpayer because it relieved him of a personal liability. This was true even though the one share of stock that he acquired personally had a purchase price of only $72,000.

Incidentally, the dividend treatment to the seller as proposed by the IRS in the *Zenz* case, which was decided under the 1939 code, should not now be a problem because sec. 302(b)(3) of the 1954 code provides for non-dividend treatment where there has been a complete termination of a shareholder's interest (Rev. Rul. 55-745). However, the problems of binding commitments to purchase, or assumed liabilities, must still be carefully considered in any proposed "bootstrap" acquisition.

Editors' note: A constructive dividend resulted where a corporation redeemed stock of taxpayer's former wife where the taxpayer had an unconditional obligation to purchase it under the divorce settlement. (See John K. Gordon.*)*

SECTION 302

"Bail out" of corporate funds through charitable donations . . .

Several courts have recently held that where stock of a closely held corporation donated to a charitable institution was later redeemed

(for appropriate consideration) by the corporation, the redemption proceeds were not taxable to the donor as a dividend. Thus, the taxpayer realized the benefit of a charitable deduction for the value of the stock donated (not disputed by the IRS), and avoided ordinary income tax that would have been imposed on the redemption proceeds (a distribution essentially equivalent to a dividend) if the stock had first been redeemed by the corporation and the proceeds then had been contributed to the charity.

In *Walter R. Carrington*, the commissioner, relying on the "step transaction" approach, contended that the gift must be disregarded "because it was merely an intermediate step in the taxpayer's overall plan . . . [to avoid] the imposition of a dividend tax on the distribution." The taxpayer had transferred 51 percent of the stock of his wholly owned corporation as a gift to a church. Within eight days, the corporation redeemed the stock from the church. However, the court stated that the main criterion was whether the taxpayer "parted with all dominion and control over the donated property." The court concluded the criterion was satisfied, noting that there was "neither evidence of, nor suggestion that there was a prior obligation on the part of the church to redeem this stock."

In *Phillip Grove*, "despite the absence of any prearranged agreement between" a taxpayer and a donee institution, the institution followed a pattern of redeeming shares donated by a taxpayer with his closely held corporation between one and two years after they were donated. The donee was required to first offer the shares to the corporation for purchase before disposing of them. It was found that there "was no informal agreement between [the taxpayer and the institution that the latter] would offer the stock in question to the corporation for redemption or that, if offered, the corporation would redeem it." The court ruled that in the absence of such an obligation, the "step transaction" doctrine could not serve to recast the transactions as a redemption by the corporation of the taxpayer's stock and as a gift of the proceeds by the taxpayer to the institution. This was because "the gift was complete and irrevocable when made."

Other taxpayers have had tentative plans for the future repurchase of donated stock revealed to the donee. Yet, this fact did not by itself constitute "any agreement or commitment and was not so construed" by the parties. It was found that the taxpayers "relinquished complete dominion and control over" the donated shares (*Clinton C. Dewitt* and *Daniel D. Palmer*).

Thus, there is an excellent tax-planning opportunity available to the stockholder of a closely held corporation who has charitable impulses. These cases emphasize the reluctance of the courts to ignore substantive transactions despite an overall intent to reduce tax

liability. However, a careful reading of the cases involving this issue is recommended. Before advising clients of this tax-planning opportunity, the tax adviser should be familiar with the IRS's position and the guidelines that the courts have established as a prerequisite for favorable treatment.

Editors' note: The redemption of stock from a charitable organization to satisfy a pledge will not constitute a dividend to the shareholder where the charity had the power to reverse the redemption. (See Robert A. Wekesser.*) See also Rev. Rul. 78-197, wherein the service ruled that a taxpayer with voting control over a corporation who donates shares of stock to a tax-exempt entity followed by the redemption of such shares will realize income only if the tax-exempt entity is legally bound or can be compelled to redeem.*

. . . but "bail out" technique may not apply to family transactions

Rev. Rul. 78-197 holds that the proceeds of a redemption of stock will be treated, under facts similar to those in the case of *Daniel D. Palmer,* as income to the donor only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption. *Palmer* involved a gift of stock of a corporation to a private foundation, followed by the prearranged redemption of the stock from the foundation. The donor had voting control of the corporation, and was also the controlling trustee of the private foundation. The IRS contended that the transaction was a redemption of the stock from the donor (treated as a dividend) followed by a gift of the redemption proceeds to the foundation. The Tax Court rejected this argument, and followed the form of the transaction: Since the foundation was not a sham, the transfer of the stock to the foundation was a valid gift, and the foundation was not bound to go through with the redemption at the time it received the shares. The court acknowledged that the donor had planned the redemption in advance and that he controlled both the corporation and the foundation.

Recently, the national office of the IRS was requested to issue a private ruling on the following facts, based on Rev. Rul. 78-197 and the *Palmer* case:

> A father owned 60 percent of the stock of a small manufacturing corporation. The balance was owned equally by his adult son and daughter. The father wanted to turn management over to the son and freeze his own interest. He also wanted to make a substantial gift to his son and daughter in order to treat each equally, but did not want the daughter to be subject to the risks of the

business. Therefore, the father proposed to give each child an additional 20 percent stock interest. The father's remaining common would be exchanged for preferred. The corporation planned to redeem the daughter's stock. The daughter's redemption would qualify as substantially disproportionate under sec. 302(b)(2). The taxpayer relied on Rev. Rul. 78-197 for the proposition that the redemption of the daughter's stock received as a gift from her father, as part of the same plan, was a redemption by the daughter and not a redemption by the father followed by a gift of cash.

The national office refused to follow Rev. Rul. 78-197, and recast the proposed transaction as a redemption of part of the father's common stock, taxable as a dividend, followed by a gift of the cash proceeds to the daughter. This was notwithstanding that the daughter was under no obligation to have her stock redeemed, the corporation had no power to compel her to surrender her shares for redemption, and the father had no legal control over the daughter. The service's position is puzzling, since it is hard to understand how a transaction in which the donor, the trustee, and the controlling shareholder of the corporation are the same person is more arm's-length than a transfer between a father, an adult daughter, and a corporation controlled by an adult son. Perhaps the service regrets its acquiescence in *Palmer*.

The national office narrowly interprets Rev. Rul. 78-197 to apply only to those transactions where the gift is to a private foundation and the donor has not breached his fiduciary duty as trustee. According to the national office, the key to *Palmer* is the donor's fiduciary duty to the private foundation. However, this point is not mentioned in Rev. Rul. 78-197.

Editors' note: See IRS Letter Ruling 8027070, wherein the service approved a plan which provided that shares in a closely held corporation were to be given to charity immediately prior to a redemption of other shares from the donor-stockholder to qualify the redemption under sec. 302(b)(2). Further, in IRS Letter Ruling 8123069, appreciated property can be used to effect the redemption without adverse consequences of sec. 311 if the proper requirements are met.

Stock redemptions from estate: sec. 302(b)(3) and waiver of attribution rules

When a corporation buys its own stock from a shareholder, the transaction is called a "redemption." The shareholder, whom the code calls a "distributee," may be taxed as he would have been had he sold the stock, or he may be treated as having received a dividend,

depending on the applicability of secs. 302 and 303. While sec. 303 applies only to a deceased stockholder who owned substantial amounts of the corporation's stock, sec. 302 can apply to any distributee. Sec. 302(b) describes those redemptions that are treated as a sale of stock. Included therein, as subsection (b)(3), is a redemption that terminates the interest of the shareholder—that is, a redemption of all of the shareholder's stock after which he ceases to have any interest in the corporation.

Because of the attribution rules of sec. 318, in determining whether a redemption is a sale or a dividend, the distributee is treated as owning certain stock owned by family members and related entities, along with his own stock. Attribution from related entities cannot be waived, but attribution from family members can, in the case of a complete termination of stockholder and employee relationships, by filing with the IRS a statement prescribed by sec. 302(c)(2). Thus, under sec. 302(c)(2) it is possible to avoid counting the shares owned by family members in determining whether all of the shareholder's stock is redeemed under sec. 302(b)(3).

Although a shareholder can utilize sec. 302(c)(2) to cause the redemption of his stock to be treated as a sale, is this same option available to his estate?

In the case of *Lillian M. Crawford*, a wife and her husband owned one-third of a corporation's stock, and their sons owned the remaining two-thirds. When the husband died, his will left everything to his wife. The corporation redeemed all of the wife's stock and all of the husband's estate's stock at the same time. Both filed sec. 302(c)(2) statements. The IRS took the position that the estate is not a "distributee" who can file this statement, and the attribution rules made the transaction a dividend to the estate. The Tax Court held that, at least under these facts, an estate can file the statement. The IRS dismissed its appeal to the ninth circuit and announced its nonacquiescence.

Whether an estate should be permitted to waive the attribution rules is not settled since the *Crawford* decision is on one side and the nonacquiescence is on the other. However, even if the IRS position is correct, dividend treatment would be avoided if the transaction is arranged as follows:

- The husband's stock is distributed to the wife;
- The wife's own stock and her inherited stock are redeemed at the same time; and
- The wife files the sec. 302(c)(2) statement.

If the surviving spouse is not a beneficiary of the decedent, this possibility would not be available, of course.

It is important to carry out the redemption plan expeditiously, particularly if the survivor is aged or is injured in the same accident that caused the other spouse's death. If the surviving spouse dies before the redemption, it may not be possible to have a sec. 302 redemption that is not taxed as a dividend.

Editors' note: The Tax Court has followed Crawford *as to attribution waiver by a trust* (Rodgers P. Johnston Trust). *The fifth circuit has permitted the filing of a waiver by an estate five years after the date of death* (H. B. Rickey, Jr.).

Sec. 302(b)(3) redemptions: avoiding retention of an "interest in the corporation" and . . .

A retiring officer/shareholder of a family-owned corporation often wants to remain involved in the business after retirement. This is especially so when the founder of the business steps down and relinquishes operational control to younger family members. However, when retirement is coupled with a redemption of the retiree's stock, continued participation in the corporation's affairs can present serious tax problems.

Under sec. 302(a), unless the redemption distribution qualifies as either—

- A distribution not essentially equivalent to a dividend,
- A substantially disproportionate redemption, or
- A complete redemption of the shareholder's stock,

it may be treated, in whole or in part, as a dividend rather than a payment in exchange for stock. Assuming that some or all of the remaining shareholders are family members, the application of the sec. 318(a) stock ownership attribution rules will generally preclude qualification under either of the first two categories of distributions treated as exchanges. (See *Maclin P. Davis.*) Consequently, the retiring shareholder must ensure that the requirements of the third category—the "complete redemption"—are met.

Although the stock attribution rules also apply to a complete redemption, sec. 302(c)(2)(A) provides that they will be waived if—

- Immediately after the distribution, the distributee has *no interest in the corporation* other than as a creditor (any interest as an officer, director, or employee is specifically prohibited);
- The distributee does not acquire any such interest in the corporation within 10 years from the date of distribution; and

- The distributee files an appropriate agreement to notify the IRS if a prohibited interest is acquired.

Faced with the constraints of sec. 302(c)(2)(A), the retiring shareholder must significantly curtail his or her relationship with the family-owned corporation. To assume the role of "executive officer emeritus" invites the IRS to assert that the distributee has retained an interest in the corporation. If the IRS successfully maintains that position, the sec. 318(a) rules will apply. The distribution will then fail to qualify as a complete redemption, with the resulting adverse tax consequences.

What, if any, activities may the retiree engage in with respect to the corporation without endangering the tax status of the redemption distribution? Case law, rulings, and informal discussion with IRS national office personnel suggest some guidelines:

- As usual, each case is viewed in the context of its own facts and circumstances.
- In general, if the redemption merely shifts legal ownership to other family members while the "retired" distributee retains effective direction and control as an active "consultant," the service will contend that an interest has been retained.
- A contract to provide substantial management services to the corporation should be avoided, particularly, if (1) the corporation is the only client; (2) the contract termination provisions are not arm's-length and favor the "retiree"; or (3) compensation is related to the corporation's financial performance. (See *Jack O. Chertkof.*)
- An activity that cannot directly be engaged in by the retiree also cannot be engaged in indirectly through a controlled corporation or partnership. (See *Chertkof, supra.*)
- In the case of a multitier corporate structure, the prohibition against retaining or acquiring any interest in the corporation extends to any interest in the parent or subsidiary of the redeeming corporation. Thus, the retiree cannot avoid the problem by restricting his or her activities to another entity within the corporate group. Similarly, no interest may be acquired in a new corporation that is the successor to the redeeming corporation. (See regs. sec. 1.302-4(c).)
- Without giving any details of the arrangement, the IRS has ruled that a five-year advisory and consulting agreement between a family-owned corporation and a redeemed shareholder constituted a retained interest. (See Rev. Rul. 70-104.)
- The Tax Court has held that a retired former shareholder who performed services as an independent contractor did not have

a disqualifying interest in the corporation. The retiree, who was also a CPA, performed services similar to those that would have been performed by any other outside accountant. (See *Est. of Lennard.*) However, the IRS has withdrawn its acquiescence in that case and substituted its nonacquiescence.

Under *Lennard,* a redeemed shareholder possessing the requisite professional qualifications would be permitted to perform those services normally performed by outside professionals. However, the IRS national office has informally suggested that compensated "independent" management consulting to the corporation is risky business, especially if it relates to corporate policy or strategy. If undertaken at all, it should be done infrequently and a substantial amount of similar work should also be done for other clients.

- Serving as trustee of a corporate pension plan was not a disqualifying interest, where the redeemed shareholder was not a participant in the plan. (See *Est. of Lennard, supra.*)
- Even *uncompensated* advisory services to the family-owned corporation may be challenged as a retention of control (i.e., an interest in the corporation) if they—
  1. Are performed regularly or frequently;
  2. Involve policy formulation;
  3. Involve direction of employees; or
  4. Otherwise resemble the continued management of the business or some portion of it.
- The mere post-retirement retention of free office space in a building owned or leased by the corporation will not be viewed as a disqualifying interest if it is compensation for *past services.* However, if the facts and circumstances indicate that it is compensation for *services to be performed,* the IRS can be expected to contend that it constitutes an interest in the corporation.

These general guidelines suggest that—

- If a "retiring" officer/shareholder of a family-owned corporation intends to retain a visible and active post-retirement role in corporate management, it may be advisable to defer or seek an alternative to the redemption of his or her stock.
- If redemption of the stock is the primary consideration, any post-redemption involvement in the affairs of the corporation should be either—
  1. As an infrequent, bona fide independent contractor or trustee in a nonpolicy-making role; or
  2. As an uncompensated, low-profile "elder statesman" giving infrequent and informal counsel.

SECTION 304

Use of new holding company to avoid sec. 304—current "no ruling" area

Several IRS letter rulings have been issued allowing the use of a new holding company to avoid the application of sec. 304 (redemptions through related corporations). Such transactions usually take the form of a sec. 351 transfer of closely held stock to a new holding company in exchange for common or preferred stock or both and, in some cases, cash or other boot. In conjunction with the exchange, the new holding company assumes any indebtedness of the exchanging shareholders incurred on acquisition of the closely held stock. See, for example, IRS Letter Rulings 7907115, 7924013, 7934075, and 7951149. Note that in IRS Letter Ruling 7951149 the new holding company transferred, in addition to stock, $1 million in cash to one of the exchanging shareholders.

Since these transfers and assumptions are with a *new* corporation, the IRS has ruled that sec. 304 does not apply and that the transactions are governed exclusively by sec. 351, with the result that any gain realized escapes recognition except to the extent of any boot received, as provided by sec. 351(b). Moreover, because the stock transferred to the new holding company is usually a capital asset in the hands of the exchanging shareholders, the boot received is taxed as capital gain. Further, since the acquisition indebtedness assumed by the new holding company is associated with the transferred stock, sec. 357(b) is not applicable, and the general nonrecognition rule of sec. 357(a) applies to the assumption. On the other hand, if sec. 304 were applied, the receipt of boot and assumption of acquisition indebtedness would be treated as a distribution in redemption of stock subject to the provisions of sec. 302. See Rev. Rul. 73-2, Rev. Rul. 78-422, and IRS Letter Ruling 7907111, applying sec. 304 to the receipt of boot and the assumption of acquisition indebtedness where an *existing* controlled corporation was used to effectuate the transfer.

The theory adopted by the national office to conclude that sec. 304 is inapplicable to the *new* holding company transfer case is based on a liberal reading of regs. sec. 1.304-2(a), which provides the following:

> If a corporation, in return for property, acquires stock of another corporation from one or more persons, and the person or persons from whom the stock was acquired were in *control of both* such corporations *before* the acquisition, then such property shall be treated as received in redemption of stock of the acquiring corporation. [Emphasis added]

Since a new company is used to effectuate the acquisition, the transferor shareholders are not "in control of *both* such corporations *before* the acquisition."

It now appears that the IRS has suspended the issuance of rulings if either boot is transferred or acquisition indebtedness is assumed by the new holding company. If only stock is transferred by the new holding company, the IRS will continue to rule that sec. 351 applies and that any preferred stock received by the transferor shareholders will not be treated as sec. 306 stock, since stock issued pursuant to a sec. 351 exchange does not meet the definitional requirements of sec. 306(c), unless the stock exchanged is also sec. 306 stock. (See Rev. Rul. 77-108.)

Editors' note: It is understood that the service is contemplating either a ruling or legislation that would prevent the acquisition of the indebtedness by the holding company.

SECTION 305

Failure to adjust conversion ratio may result in taxable stock dividend

The provisions of sec. 305 will often result in taxable dividend treatment to a shareholder as a result of a transaction in which he is not a direct participant. This anomaly results principally from the rules of sec. 305(b) and (c) which treat as a stock dividend, potentially subject to sec. 301, a variety of transactions that result in an increase in any shareholder's proportionate interest in earnings or assets.

In this regard a recapitalization or, alternatively, a redemption not qualifying under sec. 302(a) must run the gauntlet of sec. 305. Thus, in Rev. Rul. 78-60, the service ruled that a redemption, pursuant to an annual redemption plan, that constituted a dividend to the redeeming shareholder also resulted in a dividend, under sec. 305(b)(2), to the nonredeeming shareholders. The applicability of sec. 305(b)(2) was based upon the coexistence of a receipt of property by some shareholders (the redeeming shareholders) coupled with an increase in the proportionate interests of the nonredeeming parties who were deemed to have received a taxable stock dividend.

Notwithstanding the above, the potential reach of sec. 305 is restricted by virtue of the application of the "isolated transaction" doctrine. Thus, in order for a redemption or recapitalization to yield a constructive stock dividend the transaction must be undertaken

pursuant to a plan to periodically increase a shareholder's interest. (See regs. sec. 1.305-3(b)(3).) In most cases, the absence of such a plan will serve to oust sec. 305's jurisdiction. (See Rev. Rul. 75-93.)

Reliance on the absence of a plan, however, is not available where the potential stock distribution results from the increase in the conversion ratio of convertible stock or debt. Where such an increase is accompanied by a distribution of property to other shareholders, the holders of such stock or debt will be deemed to have received a taxable dividend roughly equal to the value of the property distributed to the other shareholders. (See Rev. Rul. 75-513.)

In IRS Letter Ruling 8045082 an interesting variation of the "conversion ratio" rule was presented. There, a bank distributed a stock dividend to its common shareholders. The bank also had convertible preferred outstanding but that stock did not contain a provision protecting it against dilution. Thus, no compensating adjustment was required to be made to such stock to reflect the reduced value per share of the bank's common.

This combination of facts, however, violated the conversion ratio rule in a manner exactly opposite to that depicted in Rev. Rul. 75-513: The burden of taxability would fall not on the holders of the convertible preferred but instead on the common shareholders whose proportionate interests increased as a result of the prior stock dividend. The ruling therefore indicates that where convertibles are outstanding, a failure to adjust their conversion ratio in response to a stock dividend distributed to the other shareholders is just as damaging as the more typical case in which such ratio is adjusted to reflect a concomitant property distribution to the remaining shareholders—except here it's the common shareholders who get hit with the tax. In the event, the provisions of sec. 305 were ultimately blunted by the corporation's belated distribution of additional stock to the preferred shareholders. The better approach, of course, is to provide for antidilution features (for nontaxable distributions) in the terms of convertible instruments at the time of their issuance.

SECTION 306

Tax trap: charitable contribution of sec. 306 stock

Rev. Rul. 80-33 limits the amount of a charitable contribution of sec. 306 stock to the shareholder's basis in the stock rather than the stock's fair market value. In the case addressed by the ruling, the shareholder was unable to show that there were no tax avoidance motives in the

issuance of the preferred stock; therefore, the issue was deemed to be sec. 306 stock, and its fair market value was reduced by the amount of ordinary income that would have been recognized had the stock instead been sold. (See sec. 170(e)(1)(A) and regs. sec. 1.170A-4(b)(1).)

Gain on the sale of sec. 306 stock is taxed as ordinary income to the extent of the corporation's current and accumulated earnings and profits. Thus, if there is sufficient E&P, the entire gain is ordinary income, and the amount of the contribution is limited to the shareholder's basis.

From a practical standpoint, there are a few points to consider in applying this ruling. First, while sec. 306 stock usually is thought of as being preferred stock received in a recapitalization or other tax-free reorganization, common stock can also be sec. 306 stock. This would be the case if the new common stock were received in a tax-free exchange for old stock (preferred or common) that was sec. 306 stock (sec. 306(c)(1)(C)). Second, there is ordinary income only to the extent of the corporation's E&P. This amount may not be available, since E&P for tax purposes differs from financial statement retained earnings. Third, there is an exception to the sec. 306(b)(4) ordinary income treatment if no tax avoidance purposes can be shown.

Many taxpayers donate substantial amounts of stock to charity each year. In some situations, the taxpayers do not realize that they are donating sec. 306 stock. In order to avoid both taxpayer and preparer negligence penalties, the tax accountant should inquire in appropriate situations, about whether a charitable contribution of preferred or common stock consists of sec. 306 stock. If the stock turns out to be sec. 306 stock, the practitioner should make reasonable efforts to determine if tax avoidance motivated the issuance of the stock. If tax avoidance motives exist, the practitioner should try to determine the amount of E&P in order to measure the ordinary income that would have been recognized if the stock had been sold. This potential ordinary income should then be used to reduce the amount of the charitable contribution. There should be adequate documentation of these inquiries and determinations.

Avoiding sec. 306 stock classification by use of a new holding company

A common way to pass control of a closely held corporation to the "next generation" shareholders and to freeze the value of the stock of the older generation for estate tax purposes is to have the older generation exchange part or all of its common stock for new nonvoting

preferred stock pursuant to a tax-free recapitalization. In planning this type of transaction, care must be taken to avoid having the preferred stock classified as "section 306 stock."

Pursuant to sec. 306(c)(1)(B), preferred stock received in a qualifying reorganization will be sec. 306 stock if the effect of the transaction is substantially the same as a stock dividend. In making this determination, regs. sec. 1.306-3(d) provides that the preferred stock will not be sec. 306 stock if cash received in lieu of such preferred stock would not have been treated as a dividend under sec. 356. In testing cash distributions under sec. 356, Rev. Ruls. 75-83 and 74-515 provide that the principles of sec. 302(b) are to be used, but apparently without using the attribution rules of sec. 318. (See IRS Letter Rulings 7748016 and 7815041.) Therefore, if the old generation surrenders all of its common for preferred so as to qualify a hypothetical cash distribution for sec. 302(b)(3) (termination of interest) treatment, or if it surrenders enough stock to qualify the hypothetical cash distribution for sec. 302(b)(2) (substantially disproportionate redemption) or sec. 302(b)(1) (not essentially equivalent to a dividend) treatment, the preferred stock will not be sec. 306 stock.

Another way to achieve the desired results and take the entire transaction outside the scope of sec. 306 altogether is to have all the shareholders transfer their stock to a newly created holding company in a sec. 351 transfer. The shareholders can receive any combination of common and preferred they desire without the threat of sec. 306 stock classification on the preferred. This result is achieved since stock issued in a sec. 351 transfer cannot be classified as sec. 306 stock; it does not meet the definition requirements of sec. 306(c). However, note that if the stock transferred to the new corporation is sec. 306 stock, the new stock received in exchange will continue to be sec. 306 stock. (See Rev. Rul. 77-108.) In order to avoid a sec. 351-sec. 368(a)(1)(B) overlap that would subsequently trigger the possible application of sec. 306(c)(1)(B), the new corporation should issue some nonvoting stock so that sec. 368(a)(1)(B) cannot apply and the transaction will be treated solely as a sec. 351 transfer.

A number of IRS letter rulings have been issued confirming the above approach. (See IRS Letter Rulings 7737023, 7738059, 7743063, 7752086, and 7809018.) In addition, IRS Letter Ruling 7742039 held that where the holding company issued solely voting stock in a sec. 351 transfer so as to create the overlay situation with sec. 368(a)(1)(B), any voting preferred-received will not be considered sec. 306 stock if the holding company has no earnings and profits during the year of transfer, since the exception contained in sec. 306(c)(2) would apply.

SECTION 312

Future tax-free dividends through Treasury stock acquisitions

The term *earnings and profits* is used extensively in the tax law dealing with corporations. Its principal significance lies in the area of subchapter C, where it governs the federal income tax treatment of dividends or other distributions received on corporate stock. (See sec. 316.) Generally, such distributions are deemed to come from current or accumulated earnings and profits. To the extent that such distributions exceed earnings and profits, the excess serves to reduce the taxpayer's basis in his stock. Distributions in excess of basis are taxed as long-term capital gains if the stock has been held for more than one year. (See sec. 301(c).)

In *Jarvis* it was held that in a stock redemption treated as an exchange a proportionate part of the capital was considered to stand behind each of the shares redeemed. This was the proper charge to the capital account under what is now sec. 312(e). The balance of the distribution was thus charged to earnings and profits, even though it exceeded the ratable share attributable to the stock redeemed. The IRS originally acquiesced to *Jarvis;* however, the acquiescence was later withdrawn and a nonacquiescence substituted. (See Rev. Rul. 70-531.)

Rev. Rul. 70-531 held that the term *capital account* as used in sec. 312(e) includes more than just the shareholders' contributed capital as construed in *Jarvis;* capital account also includes the unrealized appreciation attributable to the assets owned by the distributing corporation, i.e., the excess of the fair market value of the corporate assets over the adjusted basis of those assets. As a result of the Rev. Rul. 70-531 formula for determining the part of a redemption distribution that is "properly chargeable to capital account," the redeemed shares' pro rata portion of earnings and profits is first determined and subtracted from the amount of the distribution, and the remainder of the distribution constitutes the proper charge to capital account (including the portion allocable to the unrealized appreciation) under sec. 312(e).

In *Anderson,* however, the Tax Court held that the formula approved in *Jarvis,* rather than the formula prescribed in Rev. Rul. 70-531, should be applied in determining the proper charge to capital account in a redemption distribution and the resultant charge to earnings and profits of the redeeming corporation. The Tax Court held that the formula set forth in Rev. Rul. 70-531 was contrary to the statutory language of sec. 312(e), which requires computation of

the charge to capital first, followed by a charge of the balance of the distribution to earnings and profits.

The IRS agreed in Rev. Rul. 79-376 to accept *Jarvis*. Accordingly, Rev. Rul. 70-531 was revoked, and the service announced its acquiescence to *Jarvis* and *Anderson*. This invites some new creative tax planning for successful closely held corporations.

Example. Corporation *X* was organized on January 1, 1955, by stockholders *A* and *B*, both of whom put in $100,000 of capital. Over the years the corporation has been successful, and its earnings and profits have grown to $400,000 at December 31, 1979.

There has been substantial unrealized appreciation in certain real property owned by the corporation.

A, who is now 65 years of age, sells 100 percent of his stock to the corporation for $500,000, payable 29 percent down with a long-term note for the balance. *B*, who is only 45 years old, is left as the sole stockholder of *X*.

On January 2, 1980, the corporation borrows $200,000 against the appreciated real estate and uses the proceeds to pay a dividend to *B*. The acquisition of *A*'s stock reduced *X*'s E&P to zero under Rev. Rul. 79-376. Assuming no current earnings in 1980, *B* would treat the $200,000 distribution in 1980 as follows:

Basis in stock	$100,000
Less portion of distribution applied against basis	100,000
Remaining basis in stock	—
Balance of distribution—capital gain	100,000
Less 60% capital gain exclusion	60,000
Taxable to *B*	$ 40,000

Thus, shareholder *B* obtained $200,000 from his corporation, with only $40,000 includible in his taxable income.

SECTION 331

How far can the tax benefit rule go in expense recoveries?

The circumstances under which recoveries of previously deducted expenses will be included in gross income under the tax benefit rule seem to be constantly expanding. Of course, if a continuing taxpayer sells, for cash, items that it had previously deducted, no one will quarrel with the requirement that this recovery be included in gross income. However, the area to which the rule is being applied has grown well beyond that case.

The first logical area for a wider application of the principle occurred when a company was going out of business through a sec. 337 sale. Rev. Rul. 61-214 held that the proceeds from any previously

expensed items did not fall within the scope of sec. 337. For some time taxpayers vigorously contested Rev. Rul. 61-214 in litigation, but the service's victory in the sec. 337 area now seems to be complete. (See, e.g., *D. B. Anders.*)

The decision in *Tennessee Carolina Transportation, Inc.*, represents the service's latest territorial aggrandizement. In that case, the service successfully maintained that the tax benefit rule applied to a subsidiary company that distributed all its assets in a liquidation governed by secs. 332 and 334(b)(2). Undoubtedly, the application of the tax benefit rule to sec. 334(b)(2) liquidations will be contested for some time, following the pattern of the sec. 337 litigation. The service has recently reaffirmed its position that the rule applies in this situation. (See Rev. Rul. 77-67.) If, ultimately, the service is uniformly successful, no reason is seen why it will not apply the tax benefit rule to almost any type of corporate liquidation other than one within the scope of sec. 381(a)(1) (i.e., sec. 334(b)(1) liquidations). See Rev. Rul. 74-396, which also holds that the tax benefit rule applies to sec. 331 and sec. 333 liquidations.

Taxpayers with significant amounts of expensed items should be aware that a future contingency may exist. More important, parent corporations in a sec. 334(b)(2) liquidation should be alert to assign a portion of their stock basis to assets that they are able to expense immediately in order to offset the cost of applying the *Tennessee Carolina* holding to the liquidated subsidiary.

Editors' note: Recent cases indicate that a conflict exists on this issue between the ninth circuit and other circuits. In Bliss Dairy, *the ninth circuit reaffirmed its position that the tax benefit rule does not require recapture of previously expensed items by liquidating corporations (prepaid feed expenses). On the other hand, the seventh circuit applied the tax benefit rule to those deducted items that still have economic value (refund of property taxes). (See* Hillsboro National Bank.*)*

SECTION 333

Shareholders' post-sec. 333 sale of assets: *Court Holding* threat

A corporation planning to sell its assets and liquidate may do so under sec. 337 without recognition of gain. It is sometimes suggested that in an appropriate case a corporation may find a sec. 333 ("one month") liquidation followed by the shareholders' sale of the assets more

advantageous than the sec. 337 route. The advantage suggested is that under a sec. 333 liquidation the shareholders may report the gain on the sale of the assets under the installment method, whereas under a sec. 337 liquidation, in effect, the entire gain from sale of the assets by the corporation is taxed to the shareholders upon liquidation.

A practitioner should proceed cautiously before taking the sec. 333 route. Under sec. 337, in ascertaining whether a sale occurs on or after the date on which a plan of liquidation is adopted, the fact that negotiations for sale may have been commenced by either the corporation or its shareholders, or both, is disregarded. However, if sec. 337 is not availed of, the distribution of appreciated property followed by its immediate sale can lead to controversy over the identity of the real seller—the shareholders or the corporation. If the corporation is held to be the seller, the gain is taxed twice, once at the corporate level and again at the shareholder level.

Cumberland Public Service Co. and *Court Holding Co.* indicate the split of decisional law that can be expected on the factual question of who made the sale. The problem is compounded in the closely held corporation situation because the corporate officers and the shareholders are generally identical and because there is a natural reluctance to liquidate prior to a firm offer.

Thus, it is apparent that where the shareholders contemplate selling the assets received in a liquidation, sec. 337 provides a safe harbor from the double-tax threat. On the other hand, as indicated above, there may be an advantage to adopting a sec. 333 plan of liquidation. A decision must be made as to which plan is to be followed, since sec. 337 is not available to a corporation that has elected to liquidate under sec. 333.

A practitioner should proceed cautiously before advising the use of the sec. 333 route if there is any question as to whether a subsequent shareholder sale of the assets can be attributed to the corporation. If the purported shareholder sale is attributed to a corporation liquidated under sec. 333, the tax consequences can be costly. As already indicated, the gain on the sale will be taxed to the corporation and again (net of the corporate tax thereon) to the shareholder. Moreover, since the corporation's earnings and profits are taxed to the shareholders as a dividend (rather than as a capital gain) under sec. 333, the second tax on the gain will be imposed at ordinary rates since earnings and profits will be deemed to have been increased by the amount of the gain.

Editors' note: In a recent case, Aaron Cohen, *shareholders of a closely held corporation incurred substantial tax liabilities by running*

afoul of this doctrine. In Cohen, *the corporation negotiated the sale of unimproved realty (the sole asset), liquidated before transfer of title, and conveyed the realty four days later. The IRS, invoking the* Court Holding Co. *doctrine, asserted that the corporation made the sale, thereby creating earnings and profits that would result in the liquidation gain being taxed as ordinary income to the distributee shareholders. The Tax Court upheld the IRS by stating that, because of the facts of the case, application of the "imputed" seller rule was even more strongly mandated in* Cohen *than it had been in* Court Holding Co. *In addition, the court rejected the taxpayers' attempt to revoke the sec. 333 election. The decision resulted in capital gain tax to the corporation on the sale and tax at ordinary rates to the shareholders.*

Further, a prearranged exchange of property received in a sec. 333 liquidation does not qualify for sec. 1031 treatment. (See Rev. Rul. 77-337.)

Non-pro-rata liquidations

The liquidation of a corporation owned by more than one shareholder has never invoked IRS scrutiny where different kinds of assets were distributed to the shareholders. As long as each shareholder received a distribution commensurate in value with his stock, it did not matter that some shareholders received some assets and other shareholders received other kinds of assets. Recognizing this fact, transactions were structured under sec. 333 so that a shareholder with a high basis in his stock or a shareholder that was an exempt organization would receive cash distributions or post-1953 securities, and the other shareholders would receive real property or other assets.

The service, however, in IRS Letter Ruling 7750059, has concluded that in a sec. 333 liquidation, each shareholder must receive a pro rata interest in each and every asset (and liability assumed), and if a shareholder does not receive such a pro rata distribution, the transaction will be recast as if he did receive such a distribution and then exchanged such assets for a portion of the assets that he actually received.

Although the full reach of this doctrine is not yet clear, it is believed that it would equally apply in a situation where an 80 percent-owned subsidiary is liquidated under sec. 334(b)(1) and distributes a business to its parent and vacant land, etc., to the 20 percent minority shareholder. Apparently, the service would construe the transaction as if the parent and the minority shareholder each got a pro rata portion of the business assets and the vacant land, and then

the parent sold its portion of the vacant land to the minority shareholder for 20 percent of the business assets. The result of such a view would be to impute a gain or loss to the parent where none in fact previously existed. Liquidations under secs. 331 and 334(b)(2) should not be affected by this position since the shareholders will have a stepped-up basis in the assets so that even if they do not receive a pro rata distribution of all the assets, the deemed exchange will not result in any gain or loss.

The rationale for the service's position is based on Rev. Rul. 69-486 (which did not involve a liquidation) where a trustee made non-pro-rata distributions of assets in kind to the beneficiaries pursuant to their agreement even though he had no authorization to make such a distribution. The service apparently feels that state law requires the shareholders to receive their pro rata distributions of assets in kind and that any other distribution must of necessity have resulted in an agreement among the shareholders to divide up the property in a different manner; hence, an exchange at the shareholder level.

While the full implication of such a position would be that a split-up must be pro rata, and that boot distributed in a corporate reorganization also must be pro rata (cf. Rev. Rul. 66-224), the service apparently has not yet extended the doctrine to such situations.

Editors' note: The service's authority for the letter ruling appears questionable, since the ABA Model Business Corporation Act, after which many state statutes are patterned, does not appear to require a pro rata distribution in kind.

The service has followed Letter Ruling 7750059 in Rev. Rul. 79-10, involving a complete liquidation under sec. 331. Letter Ruling 7839012, however, approves a non-pro-rata distribution under secs. 332 and 334(b)(1) in a case where state law specifically authorized such distributions.

SECTION 334

Recapture provisions in a sec. 334(b)(2) liquidation

R. M. Smith, Inc., is an important development in the continuing controversy over the effect of the recapture provisions in a sec. 334(b)(2) liquidation. According to *Smith*, the recapture provisions affect basis in two ways: The additional tax liability incurred by the

depreciation and investment credit recapture provisions is part of the cost of the assets acquired; and the recapture provisions affect basis in a delayed sec. 334(b)(2) liquidation through the computation of the interim period earnings and profits.

Consider a simplified illustration: *A* corporation purchases all of the stock of *B*, a calendar-year corporation, for $500,000. The stock is acquired on January 1 and *B* is liquidated on the following December 31. *B*'s only assets are fully depreciated machinery. The liquidation causes $500,000 in depreciation recapture, which represents *B*'s entire income. The tax payable on *B*'s final return is assumed to be $260,000 (50 percent of $500,000, plus $10,000 investment credit recapture). In effect, *A* acquired *B*'s assets for $760,000—the $500,000 cost of the stock plus the related tax liability of $260,000. Under *Smith*, the basis of the assets would be $1 million, computed as follows:

Cost of the stock	$ 500,000
Liabilities assumed (recapture tax liability)	260,000
Interim earnings and profits:	
Depreciation recapture	500,000
Less recapture tax liability	(260,000)
	$1,000,000

The recapture taxes are a positive basis adjustment as an assumed liability, but they are also a negative factor in the interim earnings and profits adjustment. Also note that the only positive adjustment in the interim earnings and profits calculations is the depreciation recapture, since investment credit recapture is not an income item.

Of course, *Smith* does not fit exactly within this simplified fact pattern. In *Smith*, the interim earnings and profits were computed under a proration formula that allocated a fraction of taxable income, net of tax liability, to the acquired subsidiary's final short-period return. The fraction was 2/9 because the stock was acquired at the end of the seventh month of the acquired corporation's taxable year and the liquidation was two months later. Such a proration procedure obviously puts a premium on careful timing of the stock acquisition and the liquidation. For example, delaying the liquidation beyond the end of the acquired corporation's taxable year may avoid proration of depreciation recapture, a positive earnings and profits adjustment. The service is expected to pursue the position that the subsidiary's earnings and profits are not affected for sec. 334(b)(2) purposes by the recapture of investment credit and depreciation incurred up to the date of the purchase of the stock. (See technical advice memorandum 7750009, issued August 30, 1977, to the Wilmington, Delaware, district director.)

The *Smith* holding that the recapture provisions are an integral part of interim earnings and profits may give the purchaser additional basis in the typical situation where a profitable subsidiary is acquired. However, it may also result in smaller basis under other circumstances. For example, if the acquired company has a lot of new equipment, there may be significant investment credit recapture and relatively little depreciation recapture. Since investment credit recapture can apparently only have a negative impact on interim earnings and profits, *Smith* could be detrimental to the taxpayer under these circumstances.

Editors' note: Smith *has been affirmed by the third circuit upon another aspect of the basis allocation problem. The service in* Smith *did in fact argue that no upward adjustment in earnings and profits was permitted for recaptures.*

More on recapture provisions in a sec. 334(b)(2) liquidation

A recent audit of a surviving parent corporation's income tax return, subsequent to a "Kimbell-Diamond" liquidation of a purchased subsidiary under sec. 334(b)(2), has confirmed IRS policy for the interplay of depreciation recapture and the basis adjustments prescribed in regs. sec. 1.334-1(c)(4) for the subsidiary's stock in the parent's hands.

Depreciation recapture under sec. 1245 and sec. 1250 does not increase interim earnings and profits for purposes of subdivision (c)(4)(v)(*a*)(2), except for depreciation allowable during the interim period between the date that control of the subsidiary was obtained by the parent's stock purchases and the date of liquidation. The IRS disagrees in this respect with the case of *First National State Bank of New Jersey*. Although no acquiescence or nonacquiescence has been published, it is understood that an unfavorable "action on decision" was issued by IRS Chief Counsel on this case.

The service does agree that the depreciation recapture constitutes a liability to which the subsidiary's assets are subject when received by the parent in liquidation, for purposes of the flush material (last sentence) in sec. 334(b)(2)(B). This depreciation recapture is computed by reference to the actual fair market value of the appreciated depreciable assets in the subsidiary's hands, under sec. 1245(a)(1)(B)(ii), not the substituted basis determined under regs. sec.

1.334-1(c)(4)(vi)(*a*). However, such substituted basis is used to compute the potential depreciation recapture accruing during the interim period between acquisition of control and the liquidation date.

The IRS had previously treated the depreciation recapture as "subject to" debt, which should be added to the basis of each depreciable property after such basis is determined from allocation of the entire basis pool under sec. 334(b)(2) (flush material). The current IRS position is that the depreciation recapture should be added to the total basis pool and, therefore, be spread over all of the assets received in liquidation, rather than just the specific items of depreciable property that gave rise to the recapture. The former interpretation seems preferable, inasmuch as the recapture is treated as debt rather than interim earnings and profits.

Once the total basis of each class of depreciable property has been determined, the IRS may argue that a portion is, in fact, nondepreciable as "going concern value" under the authority of *VGS Corporation* and *Concord Control, Inc.* This position may be taken by the IRS even though the acquired business shows no above-normal earning power. The reasoning is that the equipment installed and interrelated carries a premium total value over the sum of what might be separate values for individual pieces of equipment.

During the same examination, the allocation of the total basis pool on a strict pro rata fair market value base would have produced a basis greater than the face amount for receivables and inventories. Relying on Rev. Rul. 77-456, this premium basis allocation to receivables was eliminated and reallocated to other property, including the inventories. The IRS reasoned that inventories can appreciate over cost but receivables can never be worth more than their face amount.

An unresolved question involves the interplay of sec. 312(k), which treats excess accelerated depreciation as earnings and profits, with regs. sec. 1.1502-32(b)(1). The intent of Congress in enacting this earnings and profits adjustment, originally as sec. 312(m), was to reduce the number of instances where "return of capital" dividends were being paid. The consolidated-return regulation treats the undistributed earnings and profits of the subsidiary corporation as an addition to the basis for the parent's stock in the subsidiary. There is no dividend effect as long as the consolidated-return filings continue because intercompany dividends would be eliminated in any event. However, the increased basis in the subsidiary's stock does increase the basis for assets computed under a sec. 334(b)(2) liquidation. This consolidated-return basis adjustment is confirmed in item (8) of Letter Ruling 7839030.

Subsidiary's debt to parent: pitfall to avoid

In a liquidation of a subsidiary under secs. 332 and 334(b)(2), a distribution from the subsidiary received with respect to debt owed the parent is not a distribution in liquidation and hence not subject to the provisions of sec. 334(b)(2) (regs. sec. 1.334-1(c)(1)). Thus, if a subsidiary discharges such debt with property, the subsidiary does not recognize gain or loss on the property (sec. 332(c)), and the parent has a carryover basis under sec. 334(b)(1). (See Rev. Rul. 69-426.) It is not certain that this ruling properly interprets the statute in this respect, but it certainly cannot be ignored.

As a general rule, it would seem desirable to have the subsidiary specifically discharge its debt to the parent with cash rather than appreciated property. If appreciated property is used, the parent has a potential gain if the property is sold, a result that is generally the reverse of the objective of a liquidation under sec. 334(b)(2). At the same time, any cash distributed in liquidation would take a basis equal to face value.

It is interesting to speculate whether it would be possible to distribute property with a value less than basis to discharge the debt, opening the possibility of a subsequent loss sale by the parent. The reasoning in Rev. Rul. 69-426 would seem to lead to that result.

It appears that under some circumstances it might be desirable to discharge such indebtedness with appreciated property with recapture potential. For example, sec. 1245(b)(3) and regs. sec. 1.1245-4(c)(3) seem to indicate (no doubt unintentionally in this case) that no sec. 1245 recapture would be required. The price of this possible avoidance of recapture is a lower depreciable basis (current taxable income versus future tax deduction).

The above comments only explore some possibilities. The actual composition of the assets of a subsidiary would have to be evaluated in each case, since it appears that the taxpayer's objectives might be achieved in some cases by paying such debt in cash, and in others by paying such debt with property. If the subsidiary is liquidated without specifying the assets allocable to the debt, it appears that a portion of each asset would be considered as having been distributed for that purpose.

Subsidiary liquidations: avoiding sec. 334(b)(2)

Often, in business acquisitions, one corporation will acquire all the stock of another corporation in a taxable transaction and then immediately liquidate the new subsidiary; the primary purpose of

the stock acquisition is to obtain the acquired corporation's assets. Under these circumstances, sec. 334(b)(2) provides that the purchase price of the stock, with certain adjustments, will become the basis of the assets acquired. Since the purchase price of the stock usually exceeds the acquired corporation's basis for its assets, the result is a stepped-up basis for depreciation.

In one case, however, sec. 334(b)(2) created the opposite result. In *Kansas Sand and Concrete, Inc.*, Corporation *A* acquired all the stock of *B* in a taxable transaction on September 28, 1964. On December 31, 1964, *B* was "merged" into *A* in accordance with the provisions of Kansas law. Since *B*'s tax basis for its assets exceeded the purchase price of its stock, it would be advantageous to have *B*'s basis carry over to *A*. This would be the natural result in a statutory merger under sec. 368(a)(1)(A).

It appears that this transaction was purposely structured to avoid the application of sec. 334(b)(2). However, regs. sec. 1.332-2(d) indicates that even though a transaction may be a merger under the applicable state law, if it also meets the requirements of a subsidiary liquidation, then sec. 332 will control.

One way of avoiding the "step-down" in basis under sec. 334(b)(2) is to merge the parent "downstream" into its subsidiary after the acquisition. This should result in no change in the basis of the subsidiary's assets and a carryover in basis of the parent's assets.

Another possibility is to arrange for a tax-free acquisition of the stock or assets of the acquired corporation, with the stock of the acquiring corporation, in a "B" or "C" reorganization. In a "C" reorganization, the basis of assets would carry over; a "B" reorganization followed by an immediate liquidation is usually treated as a "C" reorganization with the same result. Of course, this approach may be impractical if the stockholders of the acquired corporation will take only cash.

The application of sec. 334(b)(2) may also be avoided by keeping the subsidiary in existence for two years and then liquidating it into the parent. If the difference between book value and purchase price is significant, it would usually appear to be more advantageous to depreciate the higher basis in a separate corporation for a two-year period rather than lose the benefit entirely. Even if the additional depreciation created or increased a net operating loss in the subsidiary, that loss carryover can be used by the parent on a subsequent liquidation under sec. 332 if sec. 334(b)(2) does not apply. It should also be remembered that depreciation and investment credit recapture under secs. 1245 and 1250 apply to liquidations controlled by sec. 334(b)(2).

Sec. 334(b)(2) basis: use of "phantom" corporation to squeeze out minority shareholders

In order to eliminate minority shareholders in certain acquisitions, the following technique has been developed. Assume that Corporation *P* has acquired by purchase 35 percent of the stock of Corporation *T* and wants to obtain the rest of the *T* stock, which is widely held. Accordingly, *P* organizes *S* Corporation with cash and its investment in *T*. Thereafter, *S* merges into *T* and *P* receives *T* stock for its *S* stock, and *T* minority shareholders receive cash under the applicable state merger law.

Under the rationale of Rev. Rul. 67-448 and Rev. Rul. 73-427, the transitory existence of *S* is disregarded and *P* is treated as purchasing *T* stock. Hence, assuming the appropriate time limitations are satisfied, *P* should be entitled to liquidate *T* and compute its basis in *T*'s assets pursuant to the provisions of sec. 334(b)(2).

However, in Rev. Rul. 78-250, it was held in effect that the cash received by *T* shareholders in a merger with *P*'s newly created subsidiary would be treated as a redemption subject to the provisions of sec. 302. A possible distinguishing factor is that the ruling held that the net result of the overall plan was that the minority shareholders of *T* received cash from *T* for their shares after which they were no longer shareholders in *T*. It is believed that the cash for the purchased stock emanated from *T* in the ruling as opposed to being contributed by *P* as in the example described above.

The distinction may be important; that is, it may be crucial to determine the source of the funds utilized to purchase the minority shares. If, as in Rev. Rul. 78-250, the acquisition is treated as a redemption, the subsequent liquidation of *T* may not, acccording to the IRS, fall within the purview of sec. 334(b)(2) because the acquisition of 80 percent of the shares may not have occurred by "purchase." This is apparently the IRS position based on its litigating position in *Madison Square Garden Corp*. The decision of *Madison Square Garden* was, in effect, that if (1) *P* purchased less than 80 percent of the stock of *T*, (2) *T* redeemed some of its stock, (3) *P* then purchased additional stock to reach the 80 percent level, and (4) *T* adopted a plan of liquidation, then basis should be determined under sec. 334(b)(2). (Compare Rev. Rul. 70-106.) While the facts described above are not squarely within *Madison Square Garden*, the second circuit's rationale should still be precedent to determine basis in our example under sec. 334(b)(2).

Hence, if, as appears probable, the service's determination of purchase or redemption is determined by the source of the funds, i.e., the acquiring company or the target company, the funds to effect

the purchase should clearly be provided by the acquiring company in a purported sec. 334(b)(2) liquidation if a conflict with the service is to be avoided.

Editors' note: The service continues to disagree with Madison Square Garden *and has issued a nonacquiescence. (See Letter Ruling 8021001.)*

Traps for the unwary department: liquidation of a subsidiary's subsidiary

Rev. Rul. 80-358 highlights a formalistic trap for the unwary. In that ruling, *P*, a corporation, "purchased" all of the stock of *S*, another corporation, on September 30, 1975. *P*'s acquisition qualified as a purchase under sec. 334(b)(3). On the date of purchase *S* owned all the stock of *T*. On December 31, 1976, *P*, pursuant to a plan of complete liquidation, liquidated *S* within the meaning of secs. 332 and 334(b)(2). The basis of the stock of *T*, in the hands of *P*, was determined under sec. 334(b)(2). On January 3, 1977, *P*, pursuant to a plan of complete liquidation adopted on that date, liquidated *T* within the meaning of sec. 332.

Rev. Rul. 80-358 holds that the basis of the assets of *T* in *P*'s hands after the liquidation is a carryover basis under sec. 334(b)(1) rather than a cost basis under sec. 334(b)(2). In reaching this conclusion the IRS points out that the stock of *T* was not purchased by *P* within the 12-month period described in sec. 334(b)(2)(B)(ii) since *P* is considered to have owned the stock of *T*, by virtue of the application of sec. 318(a), on September 30, 1975, the date *P* purchased the stock of *S*, and to have "purchased" under sec. 334(b)(3) the stock of *T* on December 31, 1976, the date *S* was liquidated.

If faced with such situation, it is best to liquidate *T* into *S* after *P*'s purchase of *S*'s stock. Such liquidation will be tax free under sec. 332. The basis of the *T* assets in *S*'s hands will be a carryover basis under sec. 334(b)(1). Thereafter, a timely liquidation of *S*, now holding *T*'s assets, will result in a step-up in *P*'s basis of the assets of both *S* and *T*.

Choice of stepped-up or carryover basis treatment denied while form is recognized

In *Chrome Plate, Inc.*, the court held that if an individual purchases all of the stock of a company (*X*) and transfers that stock to a new company (Newco) for all of Newco's stock, followed by the liquidation

of *X* into Newco, the transaction does not qualify under sec. 334(b)(2) because it violates all the purchase rules of sec. 334(b)(3). The result in *Chrome Plate* merely confirms what tax practitioners always felt was the correct answer.

In IRS Letter Ruling 7944039, the service, in circumstances similar to *Chrome Plate,* also denied sec. 334(b)(2) treatment and classified the transaction as a sec. 351 transfer followed by a liquidation under secs. 332-334(b)(1). In doing so, the service distinguished a long line of IRS authority. (See Rev. Ruls. 67-202, 67-272, 75-139, 76-123, and 78-130.) All of these rulings stand for the proposition that a nontaxable acquisition of stock followed by a liquidation as part of a plan is treated as a tax-free asset acquisition rather than two separate transactions under secs. 351 and 332. Apparently, the IRS was concerned that treatment of the entire transaction as a tax-free asset acquisition would be inconsistent with *Yoc Heating Corp.*, in which the purchase of the stock of an operating company for cash and its reincorporation eight months later into a new company was held not to qualify as a tax-free reorganization (lack of continuity of shareholder interest) but rather to result in a stepped-up basis for the acquiring company upon its receipt of the acquired company's assets.

The result is that now the taxpayer has the choice of whether or not he wants a step-up in basis in the assets or a carryover basis with a carryover of tax attributes. (See sec. 381(a).) If assets are transferred directly to the new company, the principle of *Yoc Heating Corp.* applies, and a step-up in the assets' basis results. On the other hand, by contributing stock to the new company and liquidating immediately thereafter, the taxpayer achieves a carryover basis. There is nothing unique about this choice, since a taxpayer can also set up a new company to purchase the *X* stock and then either liquidate upstream (sec. 334(b)(2)—stepped-up basis) or merge downstream (sec. 368(a)(1)(A)—carryover basis). (See Rev. Rul. 70-223.) The letter ruling, however, is helpful for clients who have not formed a new company to make the stock purchase but rather have already purchased the stock directly and want to reincorporate with either a stepped-up or carryover basis.

Perhaps the true significance of the letter ruling is that the IRS is saying that the two individual steps (the form of the transaction) will be recognized unless they can be collapsed into a tax-free movement of assets that qualifies as an "A," "D," or "F" reorganization. Thus, the liquidation of a company preceding its reincorporation (that is, the sec. 332 liquidation followed by a sec. 351 transfer of assets) will also be given substance, since the IRS cannot argue, based on its adoption of the *Yoc Heating Corp.* principle, that the transfer of the

assets directly to the new company is a reorganization. Thus, part of the assets may be retained in the parent company, and not all the assets have to be reincorporated.

Alternatively, sec. 334(b)(2) can still apply even though part or all of the assets are retransferred to a new company. There had always been doubt about the application of sec. 334(b)(2) when it is followed by an immediate sec. 351 transfer. The only hurdle that now would preclude such application would be the case of *Telephone Answering Service,* in which the court held that liquidation treatment is denied if there is no complete liquidation, whether or not the transaction qualifies as a reorganization. (Also see Rev. Ruls. 60-50 and 76-429.) However, the letter ruling suggests some slippage of the *Telephone Answering Service* principle, since a liquidation certainly was recognized in the ruling, even though the assets moved no closer to the principal shareholder.

SECTION 346

Partial liquidation of a subsidiary

Consider the problem of having a transaction qualify as a partial liquidation under sec. 346 where the business being disposed of is conducted by a subsidiary. There are five possible methods of effecting the liquidation:

1. The subsidiary sells the business assets and liquidates; then the parent distributes the net proceeds to its shareholders in redemption of a portion of their stock.
2. The subsidiary liquidates; then the parent sells the acquired assets and distributes the net proceeds to its shareholders in redemption of a portion of their stock.
3. The subsidiary liquidates; then the parent distributes the acquired assets in kind to its shareholders in redemption of a portion of their stock.
4. The parent sells the subsidiary's stock and distributes the net proceeds to its shareholders in redemption of a portion of their stock.
5. The parent distributes the subsidiary's stock to its shareholders in redemption of a portion of their stock.

With respect to distributions under methods 1, 2, and 3, it is understood the service will rule that such distributions to the shareholders qualify as a distribution in partial liquidation (assuming that a contraction or termination of business within the meaning of sec. 346(a)(2) or sec. 346(b) has occurred).

The service will not rule that the distribution under method 4 qualifies under sec. 346, regarding this as an unsettled area. In fact, if the service were to take a position on the question, it would probably hold, following the rationale of *H. L. Morgenstern*, that the sale of stock of a subsidiary does not constitute a contraction or termination of a business of the parent.

As for method 5, if the distribution cannot qualify as a spin-off under sec. 355, it will most likely be treated as equivalent to a dividend under sec. 302(d), unless the transaction can qualify as a redemption that either is substantially disproportionate or terminates a shareholder's interest (sec. 302(b)(2) or (3)). Note that should the provisions of sec. 302 apply and appreciated property be distributed, the parent may have recognized gain under sec. 311(d).

Editors' note: In Rev. Rul. 75-223, the IRS ruled that distributions under methods 1 and 2 qualify as a contraction of business under sec. 346(a)(2). Method 5, however, was held to be a corporate separation and, accordingly, governed by sec. 355. The service has recently ruled that method 4 will not constitute a distribution in partial liquidation (Rev. Rul. 79-184).

Problems with partial liquidations of holding companies

The IRS is holding fast to a position that makes it difficult for a holding company to obtain partial liquidation treatment when it distributes assets of a liquidated subsidiary. Sec. 346(b)(2) requires that after a distribution purporting to be a partial liquidation the liquidating corporation be actually engaged in a business conducted by it for at least five years. The IRS, to the surprise of many practitioners, takes a firm position that the activities of a retained subsidiary may not be attributed to the parent for purposes of satisfying the active trade or business requirement for partial liquidation treatment under sec. 346(b)(2). For example, if *H* (a holding company) has no assets other than 100 percent of the stock of corporations *A* and *B* (operating companies), the IRS would not allow partial liquidation treatment under sec. 346 if *H* were to liquidate *A* and distribute its assets in a partial liquidation. That is, *H*'s retention of *B* would not satisfy sec. 346(b)(2).

This position is in direct contrast to sec. 355, which specifically provides that the activities of the controlled subsidiary of a holding company may be considered in order to satisfy the active trade or business requirement. (See sec. 355(b)(1)(B).) There appears to be no logical reason for this difference in treatment.

In Rev. Rul. 75-223, the service rules that the activities of a subsidiary, if liquidated into its parent under secs. 332 and 334(b)(1), may be used to satisfy the active business requirement of the parent in a partial liquidation. The service's position was based on the application of sec. 381, which in effect allows a carryover of the business history of the subsidiary to the parent so that the parent is viewed as if it has operated the business of the subsidiary directly. (See also Rev. Ruls. 77-376 and 79-184.)

Accordingly, in the above example, if *H* were able to liquidate *both* subsidiaries, *A* and *B*, and then distribute the assets of *A* in a partial liquidation, the business of *B* could satisfy the five-year test of sec. 346(b)(2). However, there may be situations where the liquidation of *B* is not practical (e.g., nontransferrable licenses).

In the event that the holding company has some related or commonly controlled corporations, it may be possible for the holding company to acquire an affiliate in a tax-free reorganization, thereby bringing into play the provisions of sec. 381 for purposes of attributing the five-year business of the affiliate to the holding company.

If none of these approaches work, it might be possible to qualify the liquidation as a "contraction" under sec. 346(a) in order to permit partial liquidation treatment, despite the failure to satisfy the five-year rule; however, the contraction route is subject to more discretion on the part of the service.

SECTION 351

Sec. 351 gains favor as an acquisition tool

The IRS recently issued a private ruling (IRS Letter Ruling 7915011) that demonstrates that sec. 351 can be used as an effective tool in planning a tax-free or partially tax-free acquisition, which might not otherwise qualify as a reorganization under the service's continuity-of-interest guidelines.

The private ruling dealt with a case in which shareholders *A*, *B*, and *C* owned all the outstanding stock and debt securities of corporation *P*. *P* had apparently been formed specifically to acquire all the outstanding stock of unrelated target corporation *T*. As the first step in the acquisition, *P* purchased for cash 51 percent of *T* by open-market purchases and a cash tender offer. Then, in order to acquire the remaining 49 percent of *T*'s outstanding stock tax-free, *P* formed a new subsidiary, *S*, which was merged into *T*, with *T* being the surviving company. As a result of the merger, *T* became a wholly owned subsidiary of *P*, and the minority *T* shareholders

received common stock of *P*. Contemporaneously with the merger, *A*, *B*, and *C* transferred their *P* debt securities to *P* in exchange for additional *P* common stock. The notes transferred by *A*, *B*, and *C* represented more than 10 percent of the fair market value of the *P* stock and securities held by them prior to the exchange.

On the basis of these facts, the IRS held that the formation and merger of *S* into *T* would be disregarded for federal income tax purposes, and the transaction would be viewed as a transfer by the minority shareholders of their *T* stock directly to *P* solely in exchange for *P*'s stock. Since these minority shareholders transferred property to *P* simultaneously with the transfers by *A*, *B*, and *C*, the minority shareholders (along with *A*, *B*, and *C*) were in "control" of *P* following the exchanges; therefore, all of the transfers were nontaxable under the provisions of sec. 351. In accordance with Rev. Proc. 77-37, the IRS concluded that the transfers by *A*, *B*, and *C* were not made merely to qualify the transfers by the minority shareholders of *T*, since the value of the property transferred was at least 10 percent of the value of their *P* stock and securities.

Inasmuch as *P* had previously purchased 51 percent of *T*'s stock for cash, the transaction apparently had to be structured as a sec. 351 exchange in order to obtain a ruling. (For advance ruling purposes, the service requires at least a 50 percent continuing interest by the former shareholders before a tax-free sec. 368 reorganization ruling will be issued. Having acquired 51 percent for cash, there could not have been more than a 49 percent continuity of interest; therefore, a sec. 368 ruling could not have been obtained.)

The ruling is significant for three reasons:

- It reflects the fact that the service will not apply its reorganization continuity-of-interest requirements to a sec. 351 transaction.
- It permits an existing shareholder of an acquiring corporation to qualify property transfers by other outside transferors if the service's 10 percent sec. 351 guidelines are met.
- Its rationale seems to suggest that if at least 80 percent of the target corporation's stock had been obtained in the taxable tender offer then the remaining 20 percent could be obtained from different shareholders in a tax-free sec. 351 transaction without disqualifying a later sec. 334(b)(2) liquidation designed to "step up" the tax cost of the target corporation's assets.

A variant of this transaction employing a reverse cash merger rather than a preliminary tender offer had been favorably ruled on in IRS Letter Ruling 7839060. (This earlier ruling is interesting in that the acquiring corporation told the IRS that it was considering a possible sec. 334(b)(2) liquidation of the target company. It also said

that it would not consummate such a liquidation without obtaining a subsequent ruling from the IRS that such a liquidation would not violate the sec. 351 rulings.)

The use of sec. 351 to qualify acquisitions as either wholly or partially tax-free is expected to expand in the future as tax specialists become more familiar with the flexibility it affords.

Stock sold by an underwriter in connection with transfer to controlled corporation

Under sec. 351(a), property may be transferred to a corporation solely in exchange for its stock without recognition of gain, provided the transferors (as a group) are in control of the new corporation immediately after the exchange. For this purpose, sec. 368(c) sets the level of control required at 80 percent. Under a literal interpretation of the statute, it would seem that the "immediately after" requirement would be satisfied by a momentary holding of the stock by the transferors. However, the attitude of some courts and the IRS is to consider immediate loss of control by a sale or other disposition as an integral part of the plan of incorporation, which disqualifies the tax-free status of the incorporation. Thus, where the facts indicate that the steps of incorporation and disposition of stock are, in effect, interdependent transactions, the entire transaction becomes vulnerable.

The IRS modified its position in a situation where one-half of the authorized stock of a newly formed corporation was sold to the public within two weeks of the initial offering by an underwriter (Rev. Rul. 78-294). The facts stated in the ruling are that a new corporation was formed pursuant to an agreement whereby the corporation exchanged half of its authorized stock with the original transferor for property and obtained a commitment from an underwriter that would use its best efforts to sell the other half of the authorized stock to the general public (best efforts underwriting). The underwriter sold the stock within two weeks of the initial offering with no change in the terms of the offering. The service concluded that the offering was necessary to raise additional capital and was an integral part of the plan of incorporation. The 80 percent control requirement under sec. 351 was held to be met. The IRS reasoned that the sale occurred with a purpose consistent with "orderly procedure" within the meaning of regs. sec. 1.351-1(a)(1) and, therefore, the public investors should be treated along with the original transferor as transferors for purposes of sec. 351. The IRS added that the determination of whether other public stock offerings involving best efforts underwriting qualify

under sec. 351 must be made on the basis of an analysis of all the facts and circumstances of those transactions.

The above ruling also holds that where the underwriter purchases the stock at the time of initial offering with the intent to resell it to the public (firm commitment underwriting), the transaction is completed at the time of initial offering because the underwriter (1) retains risk of reselling and (2) is not legally obligated to resell. Therefore, at such time, the original transferor and the underwriter hold 100 percent of the stock and meet the control "immediately after" requirement. (Cf. *American Bantam Car Co.* and *Hartman Tobacco Co.*) Therefore, firm commitment underwriting, as opposed to best efforts underwriting, apparently poses no sec. 351 problems.

Sec. 351: form and substance

The subchapter C area is replete with situations in which the time-honored canon of tax law, "substance controls form," is not recognized. Thus, in many cases, the formal steps selected for accomplishing a given result are determinative even though this approach may yield different tax results for transactions accomplishing identical objectives. (Cf. Rev. Ruls. 70-107 and 70-224 regarding the assumption of liabilities in a subsidiary "C" reorganization.)

In Rev. Rul. 77-449, the service chose to wink at substance when it approved the so-called double 351 exchange. In this ruling the service held that successive transfers of the same property by a parent to its subsidiary and from there to the latter's subsidiary would be viewed separately for purposes of sec. 351. Thus, even though the transfers were clearly undertaken pursuant to a single plan, the service accorded independent significance to the first subsidiary's transitory ownership of the property.

Since the publication of the ruling, there has been much speculation about its scope. Practitioners have wondered whether its conclusion was limited solely to its facts or whether the principle would be applicable if a particular transaction deviated from the facts in the ruling.

Despite ominous rumblings to the contrary, the service, in IRS Letter Ruling 7942009, has provided strong indications that the rationale of the ruling will apply in cases that conform to the result achieved there although not to its form. In the letter ruling, a taxpayer incorporated a division (Newco); included among the assets transferred to Newco was sec. 38 property. As part of the plan, the stock of Newco was then conveyed to a holding company subsidiary, all of whose stock was owned by the taxpayer.

In order to avoid investment credit recapture under the "mere change in form" exception to sec. 47(a), it is, of course, necessary that assets take a carryover basis *and* that the transferor retain a substantial interest in the business whose form has changed. The interest retained may be indirect, through the transferor's ownership in other entities, if such latter entities acquire a carryover basis in the interest obtained from the original transferor (regs. sec. 1.47-3(f)(5)(ii)). In the letter ruling the service held, without extensive discussion, that this exception to recapture was applicable.

In so ruling, however, the service tacitly *approved* the qualification of the initial property transfer under sec. 351, despite the fact that the transferor was no longer in control of the transferee after it conveyed its stock to the holding company! Approval under sec. 351 was a necessary precondition for the sec. 47 exemption, for without it Newco could not have succeeded to a carryover basis in the sec. 38 property (sec. 362(a)).

It seems that the service invoked sec. 351, despite the prompt loss of control, on the theory that the result accomplished was identical to that which would have been achieved if the procedure followed in Rev. Rul. 77-449 had been followed. Accordingly, this ruling provides practitioners with an indication that formal deviations in the "double drop-down" pattern will be tolerated, as well as providing a refreshing example of a case in which the substance of a series of events was given significance in subchapter C.

Sec. 351: avoiding sec. 302 and sec. 304 for capital gain bailouts

Sec. 351 is a useful vehicle for incorporating partnerships, sole proprietorships, and divisional operations, and for transferring property to a controlled corporation without gain. However, tax planners may also be able to employ sec. 351 to form a holding company to effect a redemption bailout at capital gains rates, thus avoiding the scrutiny of secs. 302 and 304. The source of this application of sec. 351 is none other than the IRS national office—at least under the facts as set forth in IRS Letter Ruling 7912048.

In that ruling, Oldco was owned by an estate and six individuals, some of whom were members of the decedent's family. In an incorporation transaction under sec. 351, the shareholders of Oldco transferred their Oldco stock to Newco in exchange for Newco stock. The individual shareholders each received Newco stock in proportion to their interest in Oldco; the estate, however, received a propor-

tionately smaller block of Newco stock plus cash. Newco had borrowed the cash necessary to pay for the shares transferred by the estate.

If the estate had received cash and stock from Oldco in a redemption transaction (i.e., without the sec. 351 transfer to Newco), the distribution would, under the facts of the letter, have been treated as essentially equivalent to a dividend (taxable at ordinary income rates) under sec. 302(b)(1).

However, the individual shareholders in fact received nonrecognition treatment for the Newco shares received under sec. 351(a). Under sec. 351(b), the gain to the estate, as measured by the excess of the fair market value of the Newco stock plus cash received over the adjusted basis of the Oldco stock surrendered, was recognized as a capital gain limited to the amount of cash received in the transaction. Under sec. 358, the estate's basis in the Newco stock was increased by the amount of gain recognized on the transfer and decreased by the amount of cash received.

It is important to note that the IRS decision to treat the transaction under sec. 351 rather than under sec. 304 (the ruling specifically states that sec. 304(a)(1) does not apply to the transaction) appears to turn on the fact that, as a newly organized corporation, Newco would have no earnings and profits during the year the transaction took place. (See secs. 302(d), 301(c)(1), and 316.) An attempt, however, to use a previously existing company to effect the bailout would undoubtedly find the IRS taking the opposite side in the sec. 351 versus sec. 304 conflict in order to tax, as a dividend, the cash portion of the distribution to the extent of the earnings and profits of Newco. (See Rev. Rul. 73-2, and *Est. of H. McK. Haserot.*)

SECTION 355

IRS clarifies "business purpose" doctrine for corporate separations

Unless a valid business purpose is established, no ruling can be obtained that a division of two businesses, operated through either a single or several controlled corporations, is tax-free. (See regs. sec. 1.355-2(c).) Recent IRS letter rulings clarify the circumstances under which two commonly asserted business purposes will be recognized by the IRS.

Shareholder dispute. A serious dispute among shareholders may compel the division of a corporation's businesses. As evidenced by

Rev. Rul. 69-460, the IRS has required the dispute to be one that seriously affects normal business operations. To provide a sufficient business purpose to obtain an advance ruling, taxpayers formerly were required to demonstrate irreconcilable differences resulting in a total and complete separation of the shareholders' interest. Any continuing relationship, either through overlapping stock ownership in the two corporations or continued business dealings, casts doubt on the need for separating the operations. Accordingly, a shareholder dispute established a valid business purpose only if the disputing shareholders' ownership was completely separated and no further business dealings were contemplated among them.

Now, however, IRS Letter Ruling 8013037 suggests that complete separation may no longer be required to establish a valid business purpose for a tax-free division based on a serious dispute. In that ruling, *A* and his son *B* had differences with the other shareholders of an existing corporation (Distributing). Accordingly, the following plan was adopted:

- Distributing will distribute all of the voting preferred stock of Controlled, a recently formed subsidiary, to *A* in exchange for 97,117 of *A*'s 491,677 shares of Distributing.
- Distributing will distribute all of the voting common stock of Controlled to *B* in exchange for 3,800 of *B*'s 3,933 shares of Distributing.

The IRS ruled that the formation of Controlled constituted a valid "D" reorganization and that distribution of Controlled stock to *A* and *B* in exchange for "some of their Distributing stock" was tax-free pursuant to sec. 355, despite the continued ownership of *A* and *B* in both Distributing and Controlled.

In another ruling (IRS Letter Ruling 8007033), the IRS permitted a tax-free separation of a corporation even though Distributing continued to rent essential real property from Controlled. After separation, the companies also rented equipment from one another and shared incidental administrative services. In addition, the shareholder receiving Controlled stock entered into a consulting agreement and a covenant not to compete with Distributing. This ruling acknowledged that there are instances in which it is impossible to divide an operating company without some subsequent intercompany dealings.

Key employee ownership. Retention of key employees by providing them with an opportunity for stock ownership is another valid business purpose supporting a corporate separation. Separation is usually necessary in such a case because otherwise the cost of stock would be prohibitively high to the key employees.

At one time, for advance ruling purposes, the service interpreted Rev. Rul. 69-460 as requiring a showing that a key employee insisted on an equity interest in a parent or subsidiary corporation and would resign if not given one. Further, the corporation was required to have been prepared, pursuant to a plan, to sell stock to the employee upon the separation of the corporation.

Two recent sec. 355 rulings merely require that key employees be shown to have evinced an "intent to investigate other employment opportunities, if their demand for isolated investment is not met" (IRS Letter Ruling 7951032), or that separation is necessary "in order to prevent competition from enticing away" a key employee (IRS Letter Ruling 8014047). The underlying facts of these rulings suggest that there was neither an imminent threat by employees to leave nor a corporate plan to sell them an interest in the remaining business. Such a plan, however, must have been an important motive for the corporate division. Thus, these rulings suggest that a business purpose need not be in response to an immediate problem to be valid for advance ruling purposes.

All of these rulings provide opportunities to separate businesses in areas in which the IRS previously was hesitant to recognize the "business purpose" of the separation. A careful analysis of the rulings will help clarify the service's interpretation of the business purpose concept.

. . . and recognizes inseparability of corporate and shareholder business purposes

Although the business purpose doctrine pervades the entire spectrum of subchapter C transactions, it has been most vigorously applied to spin-offs and reorganizations; the requirement of a business purpose for qualification under secs. 355 and 368 is well settled.

For some time, the IRS has interpreted this requirement to mean that the business purpose motivating a transaction be a *corporate* business purpose. It has vigorously and successfully resisted attempts to qualify transactions supported only by *shareholder* business purposes. (See *Est. of M. L. Parshelsky; R. B. Gada;* and regs. sec. 1.355-2(c).)

This view is supported in *J. V. Rafferty*, as amplified in Rev. Rul. 75-337. In *Rafferty*, the service successfully argued that an attempted spin-off motivated solely by the shareholder's personal estate planning objectives would not satisfy the business purpose requirement ingrained in sec. 355. On the other hand, the ruling approved a transaction that served a dominant corporate purpose and, in the

process, incidentally accomplished shareholder estate planning goals. The service seemed to be saying that the incidental satisfaction of shareholder purposes will not taint a transaction so long as the transaction is primarily motivated by purposes germane to the corporation's objectives. Thus, the ruling was consistent with the service's historic approach to the problem.

However, in the recent Letter Ruling 8035014, the service articulated what may well be a signal change in its conception of business purpose. The ruling approved as a recapitalization under sec. 368(a)(1)(E) a transaction admittedly motivated by a shareholder's desire to reduce the size of his taxable estate. In sanctioning tax-free reorganization treatment, the service agreed that this transaction also served the corporation's legitimate desire to minimize the burdensome redemption requirements that would have arisen on the shareholder's death if the recapitalization were not effected. Thus, a sufficient corporate purpose was served.

Nothwithstanding the finding of such a corporate purpose, the ruling seems to suggest that the IRS may have liberalized its views in this regard to some extent. The service not only recognized the inherent inseparability of shareholder and corporate purposes in a closely held corporation context but also approved as a reorganization a transaction clearly prompted by a dominant shareholder purpose. It remains to be seen whether the reasoning the IRS applied in the memo will be adopted as its litigation position. Of special interest will be the utility of these views in spin-off transactions where the traditional insistence on a corporate purpose has been most strictly applied.

Sec. 355 spin-off during consolidated return years

Where, during a consolidated return period, the stock of a subsidiary is transferred to another member of the group in a transaction governed by sec. 355, a problem arises if an excess loss account exists with respect to the transferred stock.

If a second-tier subsidiary that has an excess loss account is spun off from its parent, and sec. 355 applies, there is a disposition under regs. sec. 1.1502-19(b)(1)(i), "on the day such share is transferred to *any person*" (emphasis added). Thus, the triggering of the excess loss account will occur even though the subsidiary has not left the group, and there is no provision that would allow a deferral of such amount.

It could be argued, however, that the transfer was a dividend and that a dividend transaction is excluded from the recapture-of-excess-

loss rules under regs. sec. 1.1502-19(d)(1). But, where a transaction falls within the dividend distribution rules as well as the sec. 355 rules, it is not clear which set of rules takes precedence.

Another argument may be that the transfer is, in effect, a distribution in cancellation of some of the first-tier subsidiary's stock. Even under that argument, the problem still exists, but the recapture amount is deferred until some future time.

Avoiding sec. 355 in a corporate division of a single business

In January 1977 the IRS published proposed amendments to the regulations under sec. 355 that are still not finalized. Among other things, the proposed amendments acknowledge the correctness of the *Coady* and *Marett* decisions insofar as those decisions held that sec. 355 can encompass a transaction involving a vertical division of a single business. (Also see Rev. Rul. 64-147.) This change in policy may not always be favorable for taxpayers.

Example. All of the outstanding stock of corporation *Y* is owned by two unaffiliated corporate shareholders, 35 percent by corporation *W* and 65 percent by corporation *X*. *Y* has for a number of years (more than five) been engaged in the bottling of soft drinks at plants located in states *A* and *B*. A divergence of management philosophies has developed between *W* and *X*, and a division of the business of *Y* is contemplated to allow both shareholders to pursue their own interests. In order to accomplish this objective, it is proposed that the bottling plant in state *B* be transferred to a new subsidiary of *Y*, corporation *Z*, solely in exchange for 100 percent of *Z*'s common stock, followed by a distribution of all the stock of *Z* to *W* in exchange for all of *W*'s stock in *Y*. *W*'s adjusted basis in its *Y* stock is considerably less than the stock's current fair market value.

Under *Coady*, *Marett*, and the proposed regulations, it appears that this transaction falls within the scope of sec. 355. Furthermore, the provisions of sec. 355 are not elective—if a transaction is one described in that section, its provisions will be applicable.

Assuming that sec. 355 applies, *W* recognizes no gain or loss upon receipt of *Z* stock in exchange for its *Y* stock, and its basis in the *Z* stock is the same as that in the *Y* stock exchanged under sec. 358(a). If *W* liquidates *Z* pursuant to a plan of liquidation adopted within two years of its acquisition of *Z*'s stock (but not as part of the plan for the distribution of the *Z* stock by *Y*; see sec. 355(a)), *W*'s basis in the assets received is the same as that in its *Z* stock before the liquidation under sec. 334(b)(2), since its acquisition of the *Z* stock would constitute a "purchase" under sec. 334(b)(3).

A more important consideration than the tax-free distribution of *Z*'s stock to *W* might be *W*'s desire to obtain a stepped-up basis in the bottling plant assets to their fair market value upon a liquidation of Z. This is especially true if such a step-up in basis could be obtained at a reasonable tax cost.

The planned distribution of *Z*'s stock to *W* would also meet the definition of a stock redemption under sec. 302(a). If the transaction qualified as a redemption, *W* would be treated as having disposed of its entire interest in *Y* and would recognize a capital gain on the exchange. Thus, if the transaction were characterized as a redemption, *W* could obtain a stepped-up basis in its Z stock at the cost of a recognized long-term capital gain. Then, upon a subsequent liquidation of Z pursuant to a plan of liquidation adopted within two years of its acquisition of Z's stock, *W* would have a higher basis to allocate among the assets received in the liquidation than under the sec. 355 tax-free alternative. However, if a transaction is described in both secs. 302(a) and 355, presumably sec. 355 would control. (See, for example, Rev. Rul. 77-11.)

Although sec. 355 appears to have exclusive control over transactions described in both it and another section of the code, it may be possible to avoid sec. 355 if a taxable transaction is sought. If Z had been immediately liquidated by *W* as part of the plan calling for the distribution to it of the Z stock in exchange for its *Y* stock, such a prearranged liquidation might be effective in disqualifying the transaction for sec. 355 treatment. (See sec. 355(a)(1)(B).)

Thus, in appropriate circumstances a tax-free transaction under sec. 355 may not be the most favorable form for accomplishing the division of a single business. Sec. 355 would appear to have exclusive control over transactions described both in it and in another section of the code. If a taxable transaction would be advantageous, however, it may be possible to obtain the desired tax consequences through careful advance planning.

Note that trying to solve the problem by having *W*'s 35 percent interest in *Y* redeemed directly for the *B* bottling plant will trigger recapture income under secs. 1245 and 1250.

Reorganizations: booting the IRS with *Wham*

IRS Letter Ruling 7928003 is a technical advice memo issued by the IRS national office on a transaction qualifying under sec. 355 as a tax-free spin-off. In the ruling, as part of the creation of the controlled corporation that constituted a reorganization under sec. 368(a)(1)(D) and sec. 355, a $3 million note was received by the distributing

corporation from the controlled corporation. This liability arose out of an interdivisional loan, i.e., intracompany advances to the business that was incorporated. The IRS held that the note was boot under sec. 356.

In *Wham Construction Co., Inc.*, the government argued that the creation of a $160,000 liability from a new wholly owned subsidiary to the transferor corporation constituted other property (boot) and that the full amount of the gain was taxable to the transferor under sec. 351(b). The liability arose from intracompany advances by one division of the transferor to the other, the latter being incorporated in a sec. 351 exchange. In *Wham* the court held for the taxpayer on the grounds that the account payable represented a mere loan to the new subsidiary from the transferor for which the transferor could only receive a return of capital. The court found that there was a pre-existing debt between the two divisions and that on incorporation the new subsidiary assumed this liability. The government had argued that there could not be a debt between two divisions of the same corporation because the same party would be both obligor and obligee on the obligation.

If the intracompany payable is reflected on the opening balance sheet of the transferee corporation, the IRS may contend that the receivable in the hands of the transferor corporation constitutes boot. In that case, the taxpayer should use the *Wham* case in rebuttal.

Payroll and the active business requirement

One of the most troublesome issues in the area of corporate stock distributions is the active business requirement of sec. 355(b). It is especially troublesome where the controlled corporation does not have employees on its payroll but instead shares employees with other members of the group, sometimes reimbursing them and sometimes not. If certain steps are taken, however, the tax-free benefits of a split-off under sec. 355 can be obtained even if the controlled corporation does not have any employees on its payroll. Moreover, the active business requirements of sec. 355(b) can be met even if the controlled corporation without employees does not reimburse related corporations for the use of their employees and officers in the conduct of its business. (See Rev. Rul. 80-181 amplifying Rev. Rul. 79-394.)

In Rev. Rul. 79-394, a corporation, *P*, owned all the stock of another corporation, *Y*, which was engaged in renting real estate. *Y*'s business required considerable day-to-day management and operational functions involving acquiring and servicing the real estate

which it leased. *Y* had no salaried employees, but its activities were performed by employees of *X* corporation (also wholly owned by *P*) who were under the control of *Y*'s officers. *Y*'s officers were also officers of *P* and *X*. *Y* reimbursed *X* for services performed by *X*'s employees and also reimbursed *P* and *X* for services performed by their officers. *P* proposed to distribute *Y* stock to one of *P*'s shareholders under the provisions of sec. 355. After the distribution *Y* would directly employ most of those employees who had performed services for *Y* before the distribution.

Rev. Rul. 79-394 states that the presence or absence of formal employees by the controlled corporation is only one of the several factors to consider in order to determine whether *Y* met the active trade or business requirement of sec. 355. The fact that *Y* reimbursed *X* and *P* for the services of their employees and officers was one favorable factor for the sec. 355 determination.

Rev. Rul. 80-181 expands the IRS's position by holding that *Y*'s failure to reimburse *X* and *P* for services performed by their employees and officers would not be crucial to a determination of whether *Y* was actively engaged in a business. If *Y* did not reimburse *X* and *P* for services rendered by their employees, income would merely be allocated to *X* and *P* in an amount equal to an arm's length charge for the services rendered pursuant to sec. 482.

It appears that under the new ruling a controlled corporation can pass the active trade or business test despite the lack of salaried employees or reimbursement to others' employees if sufficient management and operational activities are carried out. Of course, work assignment and salary allocation records should be retained wherever possible.

Related business activities during five-year period

In determining whether the active trade or business test of sec. 355(b) is satisfied, a taxpayer may be able to salvage the benefits of the statute even though at first blush it appears the five-year test is not met. This point is illustrated in IRS Letter Ruling 8028086 in which a corporation was given favorable treatment under sec. 355 on the pro rata distribution of stock of a wholly owned subsidiary. The approach taken in the ruling is interesting because it reveals that consideration was apparently given to the overall business of the subsidiary rather than to any one particular line of business.

In the facts presented, the distributing corporation was engaged directly, and through subsidiaries, in the manufacture and sale of

computer printers. The ruling states that the controlled corporation "has been engaged in the electronic gaming industry, which includes, among other things, the sale of electronic slot machines to casinos, as well as to charitable organizations." By referring to the electronic gaming industry in general, the ruling suggests that an activity in which a corporation has been engaged for less than five years may be considered by the IRS to be an element of a single multiactivity business in which the corporation has been active for the requisite five years, provided that the combined activities may be reasonably viewed as a single business. For example, a corporation which discontinued the manufacture of washing machines after three years and immediately commenced the manufacture of dryers, which it continued for two years, apparently could qualify under the active trade or business test of sec. 355(b) because its overall business was the manufacture of laundry equipment.

Editors' note: The ruling discussed above may or may not signal a change in the service's position. For example, see Rev. Rul. 57-190, wherein the service ruled that the operation of a Ford dealership, followed by the operation of a Plymouth dealership, on the same premises did not meet the five-year requirement.

SECTION 367

Liquidations: acquisition of U.S. assets from foreign investors

It is currently quite fashionable for foreign corporations to acquire property and businesses in the U.S. in view of the sharp drop in value of the dollar against some foreign currencies. Nevertheless, there is also a growing trend on the part of U.S. investors to reacquire domestic business ventures from foreign interests. For example, assume a U.K. corporation owned by foreign interests owns and operates a resort hotel in Florida consisting of land, building, equipment, etc. Under sec. 882, substantially all of its income is deemed effectively connected with the conduct of a U.S. trade or business and is annually subject to federal income tax. A small portion of its income is noneffectively connected foreign-source income. A U.S. corporation proposes to acquire the stock in the U.K. company at a price substantially in excess of the tax basis of its assets. The U.K. company was organized in 1960 and has substantial accumulated earnings and profits. The acquisition of stock will be made through

a newly organized U.S. subsidiary. After the acquisition, the U.K. corporation will be liquidated and the hotel properties will be held directly by the U.S. subsidiary.

What are the U.S. tax consequences upon the liquidation of the U.K. corporation? While it is not possible to consider all tax aspects of this transaction, several of them are particularly noteworthy since they might be easily overlooked. Normally, on the liquidation of a corporation whose stock is owned 80 percent or more by a U.S. parent, no gain or loss is recognized, even though the value of the distributed assets exceeds the basis of the stock in that subsidiary (sec. 332). However, for this purpose, the foreign subsidiary must be recognized as a corporation for U.S. tax purposes.

Toll charge. Sec. 367 deals with the requirement of obtaining an advance ruling, *inter alia,* on the liquidation of a subsidiary where one of the parties to the transaction is a foreign corporation. Under sec. 367, the service can disregard the corporate status of a foreign entity if certain requirements are not satisfied. Sec. 367(b) provides that where a foreign subsidiary is liquidated into a U.S. parent, no ruling is required that the foreign entity is recognized as a corporation provided that certain conditions set forth by IRS regulations are met. Regs. sec. 7.367(b)-5 provides, in substance, that in order for the nonrecognition provisions of sec. 332 to apply, the U.S. parent company that receives a distribution in complete liquidation of the foreign corporation must include in its gross income all of the earnings and profits attributable to its stock in that entity. A question immediately arises as to whether all of the earnings and profits from inception (e.g., 1960) must be included for purposes of the toll charge or only those earnings and profits accruing since the date of acquisition. It would appear from this regulation that all earnings and profits accumulated prior to the acquisition of the stock in the U.K. corporation would be taxable as a deemed dividend to the U.S. subsidiary. To the extent that the earnings and profits of the U.K. corporation are attributed as a dividend to the U.S. subsidiary, it appears that under sec. 245, an 85 percent-dividend-received deduction would be allowed to the U.S. corporation, since the U.K. corporation was engaged in a trade or business within the U.S. for at least the three preceding years and at least 50 percent or more of its gross income was effectively connected with the conduct of trade or business in the U.S. For purposes of our illustration, assume that the U.K. corporation paid no dividend during its existence. Since all of the income of the U.K. corporation has always been effectively connected with the conduct of a U.S. business, the 85 percent-

dividend-received deduction should apply to the entire deemed dividend from the U.K. corporation under regs. sec. 7.367(b)-5. Although secs. 243(a)(1) and 245 refer to dividends received rather than distributions in liquidation, the 85 percent-dividend-received deduction would still be applicable to the deemed dividend. (Sec. 245(b) permits a deduction of 100 percent of the amount of dividends from a foreign subsidiary where certain requirements are met, but the 100 percent dividend deduction would not apply in this case since all of the gross income of the U.K. company is not effectively connected with the conduct of the U.S. business, and the dividends attributable to earnings prior to the date of acquisition could not meet the test that they must be paid from a taxable year of the U.K. corporation during which the domestic corporation that received the dividends owned directly or indirectly throughout such year all of the outstanding stock of the foreign corporation.)

Depreciation recap. Assuming the bases of the assets received in liquidation of the U.K. subsidiary are determined pursuant to sec. 334(b)(2), and the fair market value of the hotel property exceeds the tax bases of the assets, the taxpayer will be faced with a potential recapture of depreciation under secs. 1245 and 1250. (Cf. sec. 1245(b)(3).) With respect to the hotel building, recapture of depreciation under sec. 1250 would apply only if the U.K. corporation had elected accelerated depreciation after December 31, 1963. With regard to the equipment, etc., recapture would apply to all amounts claimed (without regard to whether accelerated methods were used) for all depreciation after 1961. Any recapture of depreciation would be added to the earnings and profits of the U.K. corporation (less any federal and state taxes payable thereon) and, accordingly, would be includible for purposes of the toll charge referred to under regs. sec. 7.367(b)-5. However, if the appraisal value of any of the hotel assets is no greater than their tax basis, the problem of recapture of depreciation becomes academic to that extent. Note that our comments with respect to recapture of depreciation on a sec. 334(b)(2) liquidation are equally applicable to a recapture of any investment tax credit.

Holding period. Another question is the date the holding period begins for the property received on liquidation. This period could begin on the date the stock is acquired or the date the underlying assets are acquired in liquidation. The period apparently begins to run from the date that the U.S. subsidiary acquires more than 80 percent of the stock in the U.K. corporation. (See *Cabax Mills* and Rev. Rul. 74-522.) While an argument can be made that the period

begins to run from the date each block of stock is acquired before meeting the 80 percent stock-ownership test, the problems in attempting to assign property values to various blocks of stock frequently become unwieldy. Accordingly, from a practical standpoint, the more-than-80-percent stock-ownership test should generally be applied in determining the holding period of the underlying assets.

With the continuing growth of the U.S. economy and the present policy of discouraging foreign investment, it is likely that more U.S. investors will be turning to acquisitions, many of which will be negotiated with foreign interests. In many instances, the interaction of sec. 367 with other provisions of the code will play an important part in negotiating the sales price and in determining the overall cost to the U.S. investor.

Income recognized upon incorporating a foreign branch

Under the IRS position in Rev. Rul. 78-201, when a U.S. corporation incorporates a foreign branch operation in a foreign country, the U.S. transferor is required to include in income as ordinary foreign-source income the sum of the net branch losses previously incurred, if any, in order to obtain a favorable ruling under sec. 367(a)(1). This toll is exacted from a taxpayer to ensure that the avoidance of federal income tax is not one of the transaction's principal purposes.

The IRS has now gone one step further and in Rev. Rul. 80-163 has held that the U.S. corporation must include in income the entire amount of the losses, even if the amount is greater than the gain that would be recognized if the transferred assets were sold in a taxable sale or exchange. Therefore, a taxpayer may be advised to incorporate such a branch without sec. 367 approval if the amount of gain is reasonably certain not to exceed the entire amount of the branch's net losses prior to incorporation.

Another situation in which a taxpayer should consider not seeking sec. 367 approval involves the liquidation of a U.S. subsidiary of a foreign corporation. In the past the IRS has treated this transaction as though the liquidating corporation were transferring its assets from the United States to a foreign corporation, thus requiring an appropriate tollgate with respect to certain types of tainted assets, such as inventory. As is shown in Letter Ruling 8020003, the IRS has now concluded that if the taxpayer does not obtain a sec. 367 ruling and the foreign corporation is not engaged in business in the United States there are no immediate federal income tax consequences.

Thus, a taxpayer may well be advised not to obtain an IRS ruling under sec. 367 with respect to such a transaction. (But see Rev. Rul. 76-90, holding that a taxpayer may not take advantage of its failure to obtain a sec. 367 ruling not to recognize gain on the sale of an asset prior to its liquidation into its foreign parent.)

Sec. 367 doesn't apply to domestic incorporation of CFC stock

The IRS recently made public a private ruling (IRS Letter Ruling 7930095), which holds that sec. 367 is inapplicable if a domestic corporation acquires the stock of a controlled foreign corporation (CFC) in a "B" reorganization and if the transaction also qualifies as a sec. 351 exchange. In the ruling, the IRS held that a transfer by *X*, a U.S. corporation, to its wholly owned U.S. subsidiary, *Y*, of 98 percent of the stock of foreign corporation Z would constitute a tax-free exchange under sec. 351 and that the transaction was not covered under sec. 367. For this proposition, the service cited Rev. Rul. 70-433. Although not specifically stated in the private ruling, it is apparent that the transaction also qualified as a reorganization under sec. 368(a)(1)(B).

The ruling is interesting because, if the transaction qualified solely as a "B"reorganization, then, under temp. regs. sec. 7.367(b)-7(c), *X* would have been required to include in its gross income the earnings and profits of Z attributable to it under sec. 1248. Presumably, the IRS would maintain that the sec. 1248 taint inherent in the Z stock would carry over to *Y* subsequent to the sec. 351 exchange. This being the case, it is surprising that the temporary regulations make a distinction between "B" reorganizations and sec. 351 transfers.

New regs. allow tax-free repatriation of foreign earnings

The IRS recently issued a novel private ruling (IRS Letter Ruling 7933068) that suggests that the new sec. 367 regulations can be used to the advantage of all parties involved in a disposition of stock in a controlled foreign corporation (CFC).

Example. Assume, as in the private ruling, that unrelated domestic corporations *M* and *N* both own 50 percent of the outstanding stock of corporation *O*, a CFC. *O* has accumulated earnings and profits, half of which are attributable to *M* under sec. 1248 and half of which are attributable to *N*. Assume further that *N* has expiring foreign tax credits in an amount that would be absorbed by a dividend distribution from *O*'s lightly taxed E&P. Consequently, a plan

is formulated in which *N* transfers to *M* its 50 percent stock interest in *O* solely in exchange for voting stock of *M*.

Under temp. regs. sec. 7.367(b)-7(c)(1)(i), this transaction would qualify as a sec. 368(a)(1)(B) reorganization provided that *N* includes in its gross income the sec. 1248 amount attributable to its *O* stock. Therefore, by complying with the sec. 367 regulations, *N* would be able to use its expiring foreign tax credits and would receive a basis in the *M* corporation stock equal to its basis in the *O* stock surrendered, increased by the amount recognized under sec. 1248. *M* could then arrange for *O* to distribute a dividend to it in an amount equal to *N*'s sec. 1248 amount and completely exclude it from income pursuant to temp. regs. sec. 7.367(b)-12(d) and sec. 959(a) of the code. (See also regs. sec. 1.959-1(d).)

The private ruling is interesting because it is the first one to discuss the tax consequences of dividend distributions after a sec. 1248 inclusion under the temporary sec. 367 regulations. The private ruling makes it clear that a transaction consummated under these temporary regulations will not be subject to the adverse tax consequences of Rev. Rul. 71-388, in which the IRS held that the E&P of a corporation involved in a sec. 1248 transaction could be taxed twice.

A detour around the "same country" exception

It has been rumored that the service may do away with the "same country" exception of Rev. Proc. 68-23 when it promulgates regulations under sec. 367(a).

The same country exception is found in sec. 3.02(1)(a)(iii)(B) of Rev. Proc. 68-23. It states that a favorable sec. 367 ruling will be issued upon the transfer of a foreign corporation's stock to another foreign corporation if the transferee is incorporated in the same country as the transferor and the transferee is a controlled foreign corporation. Also, the transferor must meet the requirements of sec. 954(c)(4)(A)(i) and (ii), and the corporation must be controlled by the transferee.

Generally, such transactions are undertaken in order to impose a foreign holding company above a foreign operating subsidiary. The benefit obtained from such configuration is that the dividend distributions by the operating company, which, prior to the transaction, was directly owned by the domestic transferor, now are included in the income of the foreign transferee and are not currently taxed to the domestic transferor under subpart F.

In order to obtain the same configuration without transferring the stock of the foreign operating company to a foreign holding company, the following should be undertaken. The first step is for the domestic transferor to create a new foreign holding company by way of a cash capitalization in the same country in which the foreign operating

company is incorporated. (See Rev. Rul. 68-43.) In turn, the newly created foreign holding company creates a wholly owned subsidiary incorporated in the same foreign country. Thereafter, the foreign operating company transfers all of its assets to the subsidiary of the newly formed foreign holding company in exchange for the voting stock of the new foreign holding company. The transaction no longer is governed by sec. 367(a) but is now governed by sec. 367(b) and the service's temporary regulations.

The transaction qualifies under sec. 368(a)(1)(C) as a tax-free reorganization. Accordingly, the earnings and profits of the foreign operating company become the earnings and profits of the new subsidiary of the new foreign holding company, and the stock received by the U.S. domestic corporation in the new foreign holding company has the sec. 1248 amount, the all-earnings-and-profits amount, and the additional-earnings-and-profits amount attributed to it. These amounts may be included in the income of the domestic corporation upon a subsequent disposition of the stock of the new foreign holding company.

SECTION 368

Corporate recapitalization by an executor

Modifying the capital structure of a closely held corporation by a recapitalization is often motivated by estate-planning considerations. One objective may be to shift future growth to a younger generation and thereby reduce the estate tax burden of the controlling shareholder. The typical recapitalization pattern in such cases involves the issuance of both common and preferred stock. The common stock, having the growth potential, eventually goes to the younger family members. The controlling shareholder generally receives preferred stock, which is relatively easy to value and which may put a ceiling on the valuation in the gross estate.

Another estate-planning objective of a recapitalization may be to transfer voting control to children or other relatives who are active in the business. Such recapitalization would typically result in voting common and nonvoting preferred stock being issued. The former would ultimately go to the family members active in the business who would assume management control. The nonvoting stock would go to family members who are to have an equity interest but no

control of the corporation. The controlling shareholder has considerable flexibility as to how the shares will pass to other family members or relatives and when such ownership will shift. The transfers may be made by sales, *inter vivos* gifts, bequests at death, or combinations thereof.

While the precise form of the recapitalization may vary, a recapitalization during the controlling shareholder's lifetime often has certain drawbacks. The recapitalization usually results in preferred stock and the requirement of dividend payments that may be a cash drain to the corporation and taxable income to the high-bracket shareholder. It further requires current valuations of the preferred and common stock and may result in valuation disputes with the IRS. If the recapitalization anticipates a gift program, it may entail a current gift tax. The tax incentives for *inter vivos* gifts seem generally reduced by the new unified estate and gift tax provisions.

In many cases, shifting appreciation to the younger generation during the shareholder's lifetime is not the primary objective. In such a situation, consideration might be given to recapitalizing the corporation after the shareholder's death through a provision in his will. To illustrate, assume a father owns 100 percent of a corporation that has only common stock outstanding. The father has a son who is active in the business and a daughter who is inactive in the business. The father prefers not to relinquish any ownership currently; nor does he want to recapitalize the corporation because this might require paying dividends. In the event of his death, the father wants each child to receive equity interests of equal value. However, since the son is the only child active in the business, the father wants the appreciation and control, after his death, to accrue to the son.

The father's objectives might be achieved by provisions in his will that the executor recapitalize the corporation with two classes of stock of equal value. The new class of voting common would be bequeathed to the son, while the new class of nonvoting preferred would be bequeathed to the daughter. The will could also provide a degree of flexibility for contingencies. For example, the executor might be directed not to recapitalize the corporation if the son ceased to be active in the business or if both children became active in the business.

This approach was discussed informally with the IRS national office. They indicated that the executor should be able to obtain a favorable ruling that the reorganization would qualify as a tax-free recapitalization under sec. 368(a)(1)(E). Since the son would receive all common and the daughter all preferred stock, the IRS also indicated that the daughter's preferred stock should not be considered sec. 306 stock.

Business "value capping" techniques

Consideration might be given to other "value capping" techniques, including—

- Formation of a family holding company that is the sole stockholder of the operating company or companies, and whose preferred stock is taken by the father and whose common stock is taken by the son in a sec. 351 exchange.
- Gift by the father to the son of the corporate stock.
- Gift by the father of a life estate or term of years in the corporate stock to a charitable lead trust and a remainder interest to his son.
- Sale by the father to his son of his stock for the son's installment note, sometimes coupled with a bequest in the father's will of the unpaid note balance to the son.
- Sale by father to son of the stock for a private annuity agreement.

The holding company technique avoids the hazard of an invalid reorganization if the IRS later determines that there was a disparity in value between the common stock surrendered by the father and the preferred stock received by the father. There would, of course, be the same taxable gift to the extent of that disparity. The holding company may also have independent business purposes if the family is operating with multiple corporations. Some business operations must be conducted by the holding company if qualification under sec. 6166 or 6166A for installment estate tax payments is desired.

The outright stock gift to the son fixes the value because only the value at the time of the gift is taxed again in the father's estate as an "adjusted taxable gift"—provided the father survives for at least three years after the gift. Note that a large federal gift tax may result here.

The charitable lead trust variation on the stock gift substantially reduces the taxable gift to the son, particularly if the father is an older taxpayer. Sec. 170(f)(2)(B) prevents an income tax deduction for the value of the charitable trust's interest. However, sec. 2522(c)(2)(B) approves a charitable deduction for gift tax purposes if the lifetime or term-of-years interest is in the form of a guaranteed annuity, unitrust, etc. This lead trust variation involves dividend payments to the charity and thus is also useful if a potential sec. 531 penalty has created the potential indirect gift problem when the father forgoes preferred stock dividends.

The installment sale fixes the value at the agreed price and defers capital gain tax to the father until actual principal payments are received from the son on the note. The deferred installment profit will, however, be taxable to the son for the year in which the estate

distributes the note to him. That is, the son has made a disposition of the note within the meaning of the case of *Ammann Photogrammetric Engineers, Inc.*, since the merger of title to the note in the hands of the son constitutes a disposition by him.

Another disadvantage of this plan involves a shift of taxable income from son to father as interest is paid on the note. In some cases, the father may wish to forgive interest on an annual basis. Such forgiveness constitutes an additional gift. If such forgiveness is made at the end of each year, after the interest has already accrued, the forgiveness might constitute realization of taxable income. Presumably, the forgiveness should take place each year before the interest accrues.

The annuity purchase variation will be workable if the stock involves a subchapter S company or if a partnership interest is purchased in the business, with sufficient cash flow to permit the son, as annuity obligor, to service the payments required to the father as the annuitant. The son has no interest or other deduction allowable from his annuity payments, but there will be no tax problem attending expiration of the annuity upon the father's death.

Recapitalizations: convertible preferred stock to freeze estate values

A recapitalization of a close corporation through which the older family members exchange voting common stock for preferred stock, and the small common stock interest owned by the younger generation becomes the entire common stock outstanding, is one of the most popular transactions for which private rulings are issued. An invariable problem in this area is the possibility that the fair market value of the preferred stock received by the older generation will be worth less than the value of the common stock surrendered, thus resulting in a gift to the younger family members. (See Rev. Rul. 74-269.) This is a factual problem for which no ruling will be issued.

In an attempt to enhance the value of the preferred stock and avoid this problem, taxpayers have provided the preferred stock with voting rights during the lifetime of the holder (IRS Letter Rulings 8027067 and 8009047); a dividend geared to the prime rate (IRS Letter Rulings 8006030, 7841045, and 7832043); a dividend geared to a percentage of earnings (IRS Letter Ruling 8027067); or interest on dividend arrearages (IRS Letter Ruling 7841071).

One of the more imaginative techniques employed to thwart the gift argument is the issuance of convertible preferred stock. Preferred stock convertible into common at a fixed ratio would fail to freeze the

estate since the preferred stock at the shareholder's death would be valued by reference to the increased equity value of the common stock into which the preferred stock is convertible. However, preferred stock convertible into a fixed dollar amount of common stock measured at the time of the recapitalization can result in an estate tax freeze. If such stock is convertible at any time, the older generation always has the right to receive common stock that has a value equal to the value of the stock given up by the older generation. Thus, the preferred stock is equal (at the time of the exchange) to the value of the stock given up and there is no gift. Presumably the preferred stock can then have a low, nonexistent or noncumulative dividend.

Such convertible preferred stock has been used in a number of recent letter rulings. (See IRS Letter Rulings 8028103, 8027021, 8021134, and 8017138.) These rulings suggest that convertible preferred stock is being widely used in estate freezes and that a number of practitioners believe it will avoid gift tax problems. The IRS will rule that the transaction qualifies as a recapitalization and that sec. 305 creates no problem at the time of the recapitalization, but it expresses no opinion as to the gift tax consequences and remains silent as to any future problems.

One such future problem may be sec. 305(b)(2), which provides that a stock distribution is treated as a dividend if the distribution has the result of the receipt of property by some shareholders and an increase in the proportionate interest of other shareholders. (See also sec. 305(b)(5).) Regs. sec. 1.305-3(e), example (7), deals with a case in which a corporation has both common and convertible preferred stock outstanding. The common stock pays no dividend but the preferred does. With each dividend on the preferred stock, the conversion ratio of preferred into common decreases. The example concludes that with each such dividend the holders of the common stock receive a constructive dividend since their proportionate interest increases.

Arguably, convertible preferred stock that is convertible into a constant dollar amount of common is essentially the same as a decreasing conversion ratio when the company grows in value. The corresponding payment of any cash dividends on the preferred stock completes the requirements for sec. 305(b)(2) and suggests future constructive dividends on the common stock.

In conclusion, the use of convertible preferred stock as an estate freezing mechanism has superficial appeal since it permits the payment of low or nonexistent dividends without gift tax problems. The technique is apparently in vogue. But the sec. 305(b)(2) issue arising subsequent to the recapitalization could be a problem.

"F" reorganization and net operating loss carryback

Assume that on July 31, 1980, *X* and *Y* merge into Z, with Z the surviving corporation. At the time of the reorganization, all three corporations (on the calendar year) were 100 percent owned by the same shareholder. All three corporations were in the same business both before and after the transaction. Income and (loss) for the three corporations before the reorganization and for the three divisions after the reorganization are as follows:

	X	*Y*	Z
1979	$300	$0	$150
Jan.–July 1980	50	100	100
Aug.–Dec. 1980	(100)	(300)	100

In addition to qualifying as an "A" and "D" reorganization, the merger of *X* and *Y* into Z also qualifies as an "F" reorganization (Rev. Ruls. 75-561 and 57-276). There are four possible approaches to the use of the divisional net operating losses (NOLs) of *X* and *Y*.

1. Under sec. 381(b)(1), the taxable year of the transferors (*X* and *Y*) does not end on the date of the reorganization. Thus, the combined loss for *X*, *Y*, and Z for all of 1980 ($50) can be a carryback to Z's 1979 income. (See regs. sec. 1.381(c)(1)-1(b).) However, in IRS Letter Rulings 7943009 (a technical advice memorandum) and 8047143 the IRS concluded that in a multiple "F" reorganization the taxable year of the transferor corporation ends on the date of the transfer even if the transferor and transferee have the same year end. Thus, preacquisition 1980 income cannot be combined with postacquisition losses in determining a carryback to Z's preacquisition income years.

2. In accordance with Rev. Rul. 75-561, if the $300 postacquisition loss of Z (made up of *X* and *Y* divisional loss and Z divisional income for August-December 1980) can be separately identified by division, it can be a carryback to each respective corporation providing such corporation had income in prior periods. Thus, the portion of the *X* division loss of $100 in the postacquisition period that is unabsorbed by Z's postacquisition income can be a carryback ($75) to *X*'s 1979 income of $300. Similarly, the portion of *Y*'s postacquisition loss of $300 that is unabsorbed by Z's postacquisition income ($225) can only be offset against $100 of *Y*'s preacquisition income, and $125 will be a carryover.

3. In accordance with regs. sec. 1.381(c)(1)-1(b), the postacquisition loss of Z ($300) can be a carryback to Z's 1979 income and can be used to the extent of $250 (Z's preacquisition income). Thus, treating the transaction as an "A" reorganization gives a better result than

treating the transaction as an "F". As can be seen, the rule of regs. secs. 1.381(c)-1(b) and 1.381(c)-1(b), example 1, is dependent on the identity of the acquiring corporation. All things being equal, the corporation with the largest preacquisition income in the previous three-year carryback period should be the acquiring corporation.

4. In IRS Letter Ruling 8025019 (a technical advice memorandum), the taxpayer, after using approach (2), above, and having a $125 unused NOL, attempted to carry back the $125 to Z's preacquisition income under approach (3), above. This was rejected.

Moral: You can pick approach (2) or you can pick approach (3), but you can't combine them. Since approach (1) is consistent with the language of the code, the courts may sustain it notwithstanding IRS Letter Ruling 7943009.

Step transaction doctrine: effect of post-reorganization dispositions on continuity-of-interest test

In addition to specific statutory requirements, a reorganization under sec. 368(a) must also satisfy the continuity-of-interest test, a judicially developed principle now incorporated in regs. sec. 1.368-(b). The purpose of this requirement is to limit the nonrecognition provisions accorded reorganizations to those situations in which the shareholders of the acquired corporation continue their investment in the ongoing enterprise. The extent of this continuing investment has never been satisfactorily established by the courts; however, for private ruling purposes, the IRS requires that the acquired corporation's shareholders have a continuing interest through stock ownership in the acquiring corporation, which, in the aggregate, is equal in value to at least 50 percent of the value of all the formerly outstanding stock of the acquired corporation. (See Rev. Proc. 77-37.)

The courts have also not satisfactorily resolved the issue of the effect on continuity of postreorganization dispositions by the acquired corporation's shareholders. For private letter ruling purposes, the IRS generally requires a representation that the acquired corporation's shareholders have no intention to sell or otherwise dispose of shares in the acquiring corporation that would reduce their holdings to a number of shares having, in the aggregate, a value at the time of the reorganization of less than 50 percent of the total value of the formerly outstanding stock of the acquired corporation.

The Tax Court recently considered the issue of the effect of post-reorganization dispositions on the continuity-of-interest requirement in *McDonald's of Zion, 432, Ill., Inc.* In *McDonald's*, the substantive

issue was whether to apply the step transaction doctrine to determine the existence or nonexistence of continuity. In this case, the shareholders of the acquired corporation disposed of almost all their shares of the stock of the acquiring corporation received in an otherwise tax-free merger within six months following the merger. The court found that the intention to sell existed at the time of the merger, although the acquired corporation's shareholders were not required or committed to sell their stock and the merger was not contingent on such sale.

In determining whether to apply the step transaction doctrine, the court employed the "mutual interdependence test" previously endorsed by the court in *American Bantam Car Co.* Under that test, two transactions will be joined together if they are so interdependent that the legal relations created by the first would have been fruitless without the second. Finding that the merger and the subsequent sale of the stock six months later upon the filing of a registration statement were independent steps, the court held that the acquisition was a valid tax-free reorganization because the requisite continuity was present. The fact that the shareholders intended to sell the stock they received and did sell the stock at the earliest possible moment did not obscure the discretionary nature of the sale. There was no requirement for the shareholders to sell the stock they received and the merger was not contingent on such sale.

Surprisingly, the IRS argued that the requisite continuity of shareholder interest existed in the *McDonald's* merger. It will be interesting to see whether the IRS will now modify its private ruling position regarding the continuity-of-interest requirement to reflect its own and the Tax Court's position in *McDonald's*. Note that in this case, the taxpayer (the acquiring corporation) argued that there was a taxable acquisition rather than a reorganization in order to claim a stepped-up basis for the acquired assets, rather than a carryover basis.

Reorganizations: indirect continuity of interest

The continuity-of-interest doctrine is invoked to distinguish genuine readjustments of corporate structures required by business exigencies from mere sales of property. Requisite to a tax-free corporate reorganization is a continuity of interest on the part of the transferor or its shareholders (regs. sec. 1.368-2(a)).

In defining "shareholder" for purposes of determining which party must hold the continuity-preserving stock interest, the service has recently focused on the "historic shareholder," that is, the party

whose long-established and pre-existing proprietary rights in the acquired corporation's stock legitimatizes it as the proper party to receive the consideration in the reorganization. When the historic shareholder disposes of its stock pursuant to a plan involving a corporate reorganization and a new and transitory shareholder receives stock of the acquired corporation, the service, for advance ruling purposes, has questioned the validity of the reorganization.

Assume Corporation *P* owns 100 percent of the stock of *X* and *Y* corporations, and *Y* owns 100 percent of the Z Corporation. Pursuant to one plan, *Y* distributes the Z stock to *P* (sec. 301 or sec. 355), and then *Z* merges into *X* for *X* stock, which goes to *P*, the current shareholder of Z. The service focuses on the historic shareholder (*Y*) and concludes that *Y*, and not *P*, must end up with *X* stock. *P* is a transitory shareholder of Z; that is, it received Z stock and immediately disposed of it in a purported sec. 354 exchange pursuant to the merger of Z into *X*. Since the transferor (Z) or its historic shareholder (*Y*) did not end up with *X* stock, continuity of interest is violated and the transaction does not qualify under sec. 368.

Assume the same fact pattern as that above except that *P* contributes the *X* stock to *Y*, and *X* then merges into Z for more Z stock, which ends up in the hands of *Y*, the new shareholder of *X*. Continuity of interest is still violated in that the historic shareholder of *X* (*P*) did not receive stock in the reorganization. If *P* did in fact receive Z stock and then transferred it to *Y*, the service would still conclude that continuity of interest is violated. However, if no Z stock is issued in the *X*-Z merger, the taxpayer can defeat the service's arguments on indirect continuity of interest by characterizing the entire transaction as a merger under sec. 368(a)(2)(D) of *X* into Z for *Y* stock, which should be given to *P*.

Editors' note: Since the form of the transaction is apparently important to the service, rather than the net result, the service's position appears questionable. Taxpayers, however, should be aware of this potential pitfall.

Continuity of interest in "cash-option" mergers—a proposal

Recently, the so-called "cash-option" merger has become a popular form of reorganization exchange. As the name implies, the shareholders of the target are usually given the option of receiving cash, stock, or both in exchange for their interests in the target. Typically, the cash portion is limited to 49 percent of the total consideration,

for conformity with the service's continuity-of-interest guidelines. These guidelines require the transfer of stock of the acquiring company (or its parent) with a value, as of the date of the exchange, equal to 50 percent of the value of the outstanding stock of the target. (See Rev. Proc. 77-37.)

In many such transactions, there is often a delay between approval of the agreement and consummation of the exchange. When the exchange ratio is fixed on the former date, it is possible that the value of the stock to be issued in the exchange will decline, because of the fluctuations of the stock market, by the time the parties complete the transaction. In such a case, additional stock must be issued so that the value of the stock component, as of the relevant date, continues to exceed 50 percent of the consideration.

It appears that the service has been inconsistent on the effect of stock market fluctuations and that acquiring companies should be permitted to rely on values existing on the date of the agreement for continuity-of-interest purposes. This inconsistency is illustrated by Rev. Rul. 75-468, dealing with a case in which preferred stock was issued in an "A" reorganization. On the date the agreement was approved, the preferred stock, for purposes of sec. 305(b)(4), carried a redemption premium of 5 percent. Later, on the date of consummation, the market price of the other corporation's stock had declined to a level that resulted in a redemption premium for the preferred stock that exceeded 10 percent. (See regs. sec. 1.305-5(b)(2).) Although the issue date is the relevant date for purposes of sec. 305, the service conceded that the redemption premium existing on the agreement date is controlling and that increases in redemption premiums due to market fluctuations would be ignored.

The rationale of the ruling, which is based on the principle that an unreasonable redemption premium was not intended, has much to commend it. The service should apply this approach when testing for continuity of interest and should allow date-of-agreement values to be used in satisfying the 50 percent advance ruling requirement.

Tax-free status of mergers with mutual funds no longer permitted

The Internal Revenue Service has moved to prevent the tax-free reorganization of certain companies: specifically, companies with liquid assets that recently have sold their operating assets for mutual funds, including mutual funds whose assets consist entirely or mostly of tax-free municipal bonds. The IRS, in so doing, has announced a reversal of a position it took in an earlier private letter ruling (IRS

Letter Ruling 7829045, the Dreyfus ruling), although since the Dreyfus ruling was issued the IRS has refused (without comment) to issue favorable rulings in this area. The recent IRS action casts doubt on the tax-free nature of several other types of acquisition transactions in which one or both parties are undergoing business changes.

The means chosen by the IRS in its attempt to block these tax-free mergers into mutual funds is an attempted redefinition of the "continuity-of-business enterprise" doctrine as it applies to tax-free reorganizations. On December 28, 1979, the IRS issued a notice of proposed rulemaking, adding a new paragraph (d) to regs. sec. 1.368-1, which states its new views on continuity of a business enterprise. Under prop. regs. sec. 1.368-1(d) there is an absence of continuity of business unless at least one of two tests is met: (1) the transferee corporation continues to conduct the transferor corporation's "historic business" or (2) the transferee continues to use a significant portion of the transferor corporation's "historic business assets" in its operations.

At the same time, the IRS issued two revenue rulings (Rev. Ruls. 79-433 and 79-434) and a revenue procedure (Rev. Proc. 79-68) on this subject. Rev. Proc. 79-68 states that favorable rulings will be issued only if one of these tests is met prior to final action being taken on the proposed regulation. The IRS says in Rev. Rul. 79-434 that it intends to apply the principle of the proposed regulation retroactively as well, although in the revenue procedure the IRS also says (not totally consistently) that it will not issue unfavorable rulings on proposed reorganizations that do not meet the standard of the proposed regulations. In effect, the service announced that it intends to adopt its new, very restrictive view of the continuity-of-business-enterprise doctrine unless it is convinced otherwise in the process of considering its proposed regulations.

Editors' note: The service adopted the proposed regulations, substantially unchanged, on December 29, 1980, to apply to acquisitions occurring after *February 1, 1981.*

"B" reorganizations: avoiding the "solely for voting stock" requirement

In IRS Letter Ruling 7849012, the service set up the framework for finessing the "solely for voting stock" requirement in a "B" reorganization, and permitted the payment of boot by the acquiring corporation by recognizing the separate existence of an intermediary step.

In the ruling, Parent, desirous of acquiring all of the stock of Tar-

get Corporation, had purchased 22 percent of Target's stock for cash. Target, an insurance company, could not transfer assets in a straight merger (sec. 368(a)(1)(A)) or a triangular merger (sec. 368(a)(2)(D)) because a transfer of Target's assets would require relicensing and reapplication with the state insurance authority, an expensive and time-consuming process.

Due to the short time-period between the prior cash purchase and the filing of the ruling (three months), Parent felt that the service would consider the cash purchase as part of any subsequent reorganization, thus precluding a "B," "C," and "E" reorganization. That fear was justified in light of a representation required to be made by Parent that the cash purchase counted adversely toward continuity of interest.

Parent's plan, upon which a favorable reorganization ruling was issued, was that the shareholders of Target (whose stock was traded in the over-the-counter market) would approve a plan to transfer all of their shares to Sub, an existing, wholly owned subsidiary of Target engaged in a data processing service, in exchange for Sub stock. As a result of this step, Target and Sub would be reversed, i.e., the shareholders of Target would own all of the stock of Sub, and Sub would own all of the stock of Target (Target's existing ownership in Sub being eliminated). Shortly after this was consummated and pursuant to a separate meeting and vote, Sub was merged into a newly created corporation of Parent (Newco) in exchange for Parent's stock. The service ruled that the first step was a good sec. 351 exchange and that the second was a reorganization under sec. 368(a)(2)(D).

The result is extremely favorable since the service treated the two steps as separate and concluded that the Target shareholders were in control of Sub immediately after the first step, even though as part of a general plan, it was intended that shortly thereafter Sub be merged out of existence into Newco. Since the cash purchase was actually a part of the overall transaction, it is seemingly incongruous to separate the transfer of Target stock to Sub from the subsequent merger with Newco. Moreover, the entire transaction could easily have been viewed by the service as a "B" reorganization that did not qualify since cash was used in the transaction. Thus, Target stock could have been viewed as being acquired for Parent's stock and cash.

The liberality of the ruling position was perhaps portended by Rev. Rul. 75-406, in which the spin-off of a subsidiary was treated as separate from the acquisition of that subsidiary in a reorganization by reason of the fact that a separate shareholder vote in a widely held

company was enough to separate the steps. (Cf. Rev. Ruls. 76-108 and 70-522.) One wonders, in light of the service's abhorrence of transitory corporations, whether the mere creation of a holding company as a prelude to the merger of that holding company into a new corporation would be given credence under sec. 368(a)(2)(D), as opposed to the more restrictive "B" requirement, in light of this private ruling. It is suggested that the same result would not have occurred if Target had been closely held so that the separate shareholder meeting would have had no significance and the transactions could be clearly deemed to be all part of one plan from the inception (i.e., the cash purchase).

Editors' note: Care must be taken in any event to avoid the result in the ITT-Hartford *line of cases. (See* Heverly *and* Chapman.*)*

Boot remains impermissible consideration in a "B" reorganization—scope of acquisition uncertain

The first and third circuits recently reaffirmed the long-standing principle that no consideration other than voting stock may be exchanged in the acquisition of stock in a "B" reorganization. (See *E. S. Chapman* and *A. S. Heverly.*) *Chapman* and *Heverly* reversed and remanded for further trial decisions of the Tax Court and the District Court of Delaware (*C. E. G. Reeves* and *Pierson* respectively), holding that other consideration is allowable in a "B" reorganization if control (80 percent) of the target corporation is obtained solely for voting stock. (*Reeves* still remains on appeal to the fourth and ninth circuits as well.)

The trial court decisions assumed, for purposes of a summary judgment motion, that cash purchases of stock over an 18-month period preceding a stock-for-stock "B" reorganization were constituent elements of the acquisition; but, according to the trial courts' analysis, these purchases did not defeat tax-free characterization of the acquisition so long as control was obtained for solely voting stock in a separate transaction. The first and third circuits held that there was no "B" reorganization if the purchase and exchange transactions were related. Still to be decided on remand, however, is what legal standards are applicable in making this determination.

The first circuit in *Chapman* does suggest some standards that may be appropriate. For example, the standard may be to include only

those transactions that are included in the formal plan of reorganization adopted by the two corporations. This alternative, advanced by the taxpayers in *Chapman*, offers taxpayers a simple and certain approach in planning—perhaps too certain—since it grants taxpayers considerable leeway in including or excluding certain transactions.

Another approach, advanced by the commissioner, would include all transactions sharing a single acquisitive purpose, with separation only being possible by a complete and thoroughgoing division in time and purpose. This approach favors the commissioner by requiring that taxpayers establish the separateness of cash and stock acquisition, but it is complicated by the need to define the boundaries of such nebulous terms as time and purpose. Note, however, that creeping control involving purchases is clearly allowable in a "B" reorganization. (See *Chapman*.)

Finally, as perhaps a more equitable approach, the *Chapman* court thought that the focus might be on "the mutual knowledge and intent of the corporate parties." With such an approach, "one party could not suffer adverse tax consequences from unilateral activities of the other of which the former had no notice."

New ground rules for liquidation-reincorporations

Until *Telephone Answering Service Co., Inc.*, in an unpublished opinion, the IRS was hampered in its efforts to maintain the sanctity of the code's liquidation provisions and to thwart liquidation-reincorporations because taxpayers could plan their transactions to avoid compliance with the reorganization sections.

Although a liquidation requires a termination of the corporation's business activities, or, alternatively, a dissociation therefrom by the corporation's shareholders, the courts were willing to tax purported liquidation transactions in accordance with their form *unless* the IRS could fit the transaction into one or more of the reorganization definitions of the code.

In *Telephone Answering Service Co.* (*TASCO*), involving sec. 337, the court declined to label the transaction; instead, it merely held that it did not qualify as a complete liquidation. In *TASCO*, a corporation received an offer to sell one of its subsidiaries. Immediately prior to the sale, it dropped down its operating business, consisting of only 15 percent of its total assets, to a new corporation, effected the sale, and distributed the cash therefrom and its remaining assets (including stock in the new subsidiary) to its shareholders. Since less than substantially all of the corporation's assets (here, only

15 percent) had been reincorporated, classification under sec. 368(a)(1)(D) was unavailable. (See sec. 354(b).) However, under the theory that substantial asset and shareholder continuity was inconsistent with the concept of a liquidation, the court departed from its customary position and held for the IRS under what might be termed an "alter-ego approach."

Predictably, this theory has been seized upon by the service and employed in IRS Letter Ruling 7836002 to prevent an attempted sec. 334(b)(2) liquidation. In the ruling, a corporation purchased the stock of another and caused the target corporation to be liquidated. As part of the plan, a portion of the target's assets, consisting of investment realty, was reincorporated. Had the IRS been restricted in its analysis to characterizing the transaction as reorganization in order to avoid liquidation treatment, it is clear that no reorganization would have resulted.

- Under so-called historical shareholder principles, the control requirements of "D" were violated, since the acquiring corporation's transitory ownership of the target did not count toward satisfaction of continuity of interest (See Rev. Rul. 78-130, *Kass* and *Yoc Heating Corp.*)
- The reincorporation of solely investment assets does not qualify as a transfer of substantially all the properties for purposes of sec. 354(b). (Cf. Rev. Rul. 70-240.)

Thus, under the pre-*TASCO* state of the law, the transaction would have been viewed as a liquidation, and the acquiring corporation would have succeeded to a sec. 334(b)(2) basis with respect to both the retained and reincorporated assets formerly held by the target. In the ruling, however, the service did not even test the transaction as a reorganization. Instead, it held under *TASCO* principles that the new corporation to which the realty was transferred was merely the alter-ego of the target. Under this continuing entity approach, the service disregarded both the liquidation and reincorporation steps and tested the transaction simply as though a continuing corporation had distributed a portion of its assets to its parent. Under this view, the parent was charged with a dividend, and, under sec. 301(d), both the retained as well as the reincorporated assets were ineligible for basis adjustments. (Cf. Rev. Ruls. 60-50 and 76-429.)

Thus, it is clear that the IRS victory in *TASCO* has completely altered the ground rules in the liquidation-reincorporation area. Since the IRS no longer operates in a straitjacket that requires demonstrating the existence of a reorganization, taxpayers hoping to qualify for the benefits of a liquidation will be required to retain the distributed assets outside of corporate solution.

Reincorporations: 15 percent of assets held to meet "substantially all" requirement

In order for a transaction to qualify as a nondivisive "D" reorganization, sec. 354(b)(1)(A) requires, *inter alia,* that the transferee corporation acquire substantially all of the assets of the transferor. To meet this requirement for advance ruling purposes, the IRS requires at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets to be transferred. (See Rev. Proc. 77-37.) However, in order to prevent corporate bailouts, the courts have applied a more liberal interpretation of the "substantially all" requirement in liquidation-reincorporation cases where the transferor retains primarily nonoperating liquid assets that are subsequently distributed to the shareholders in a purported liquidation. For example, in *James Armour, Inc.*, the court held that the transfer of all of a corporation's *operating* assets (about 51 percent of the corporation's total assets) met the substantially all requirement. Consistent with this reasoning, the fifth circuit has recently decided that the actual percentage of assets transferred is irrelevant in determining whether a transfer will meet this test, so long as all the assets necessary to operate the business are acquired by the transferee.

In *J. E. Smothers,* a corporation sold about 15 percent of its total assets, consisting primarily of rental property and a noncompetitive covenant (which were not essential to running the business), to another controlled corporation in exchange for cash as part of a purported sec. 337 liquidation. After the sale, the corporation promptly distributed its remaining assets (primarily cash and receivables) to its shareholders in a liquidating distribution. Recognizing the transaction as the familiar liquidation-reincorporation, the court recharacterized the transaction according to its true nature—a reorganization resulting in ordinary income (boot) rather than a liquidation resulting in capital gain.

The court interpreted the substantially all requirement as encompassing "all the assets, and only the assets, necessary to operate the corporate business. . . ." More important, however, the court reasoned that the extent to which tangible assets were transferred in this case was irrelevant. The business was wholly a service enterprise, and none of the tangible assets transferred were necessary to operate the business. But the transferee corporation rehired all three of the transferor's employees immediately after the liquidation and continued to serve the same customers. Thus, the most important assets—which were nonbalance sheet intangibles—were acquired, i.e., the corporation's reputation, sales staff, and managerial service, and the

assets distributed were those unnecessary to the operation of the business. The court said that "exclusion of assets not shown on a balance sheet . . . from the 'substantially all assets' assessment would offer an unjustified windfall to the owners of service businesses conducted in corporate form."

Thus, it is possible that the transfer of the assets of a service business can meet the substantially all requirement, even if only a relatively small percentage of the balance-sheet assets of the business is transferred.

"C" reorganizations: stripping away assets and selling the shell

A corporate charter or license to do business in a regulated industry can be very valuable even if the corporation owning the charter or license has no other assets. Generally, the charter or license is an integral part of the stock and cannot be segregated and sold as a separate asset.

IRS Letter Ruling 7950057 permitted a life insurance company to reorganize its operations and, at the same time, sell the corporate shell to an unrelated purchaser who wants to conduct a life insurance business in states where the shell is licensed.

The use of a nonliquidating "C" reorganization is the only tax-free vehicle that preserves the integrity of the corporate entity and permits its disposal to third parties after the assets have been taken out. In an "A" merger, the acquired corporation disappears; in a "B" reorganization, substantial assets must remain in the acquired corporation. A "D" reorganization (brother-sister acquisition) requires that the acquired corporation dissolve (sec. 354(b)(1)(B)). The IRS has privately ruled that the acquired corporation in an "F" reorganization must dissolve. Finally, taxpayers attempting to distribute all the assets of a subsidiary to its parent and sell the subsidiary stock have failed to convince the IRS to rule on the feasibility of such a plan, even though the subsidiary can remain in existence under sec. 332 (regs. sec. 1.332-2(c)).

In the case addressed by the letter ruling, *P* owned 100 percent of both *X* and *Y*, and *Y* owned 100 percent of *S*; *X* and *S* were life insurance companies, and *Y* was a holding company. *S* transferred substantially all its assets to *X* in exchange for stock commensurate with the value of the assets transferred. At this point, *P* owned 70 percent of *X* and 100 percent of *Y*, and *Y* owned 100 percent of *S*. *S*'s only asset was 30 percent of the *X* stock. Pursuant to the reorganization and sec. 354, *S* then distributed the 30 percent stock

interest in *X* to *Y* in exchange for *Y*'s surrender to *S* of 96 percent of its *S* stock (based on the value of the assets surrendered) in *S*. *S* now had no assets other than cash. *Y* then sold the balance of its *S* stock for $500,000 in excess of the capitalization of *S*. Rulings were obtained that the transaction qualified as a "C" reorganization notwithstanding the fact that the subsequent sale of the *S* stock to a third party was part of the plan.

The transaction would have fit nicely as a "C" reorganization if *S* and *X* were unrelated. Since *S* and *X* were affiliated, however, it was crucial that the transfer of assets from *S* to *X* should not result in a "D" reorganization. If the transaction were a "C" reorganization and also a "D" reorganization, this plan would not work because the "D" provisions would be controlling, and the IRS requires the acquired company in a "D" reorganization to liquidate. (See Rev. Rul. 74-545.) Note that it is the fact that *S* was a second tier subsidiary that permits the use of this transaction as a "C" reorganization; *Y* could not transfer substantially all its assets to *X* and hope to qualify the transaction as a "C" reorganization.

Intercompany transfers following reorganization

In regard to transactions among members of a controlled group of corporations that fall within the scope of sec. 381 (i.e., reorganizations and certain liquidations), the service has maintained the position that the transferee may not, after the initial transaction, again transfer a substantial portion of the assets of the transferor to another member of the group. Previously, the unpublished position was that a maximum of 30 percent of the fair market value of the assets received by the transferee in any such transaction could be retransferred to another member of the group by sale or by dividend.

This issue arose in connection with a recent as-yet-unpublished private ruling. There, an existing corporation (*X*) operated one business directly and two others through wholly owned subsidiaries (*Y* and *Z*). *X* wanted to form a holding company to conduct all of its operations. This could have been accomplished directly by a transfer of *X*'s operating assets to a newly formed subsidiary, but this was found to be inadvisable for certain business reasons. As a consequence, the following transaction was undertaken: *X* created a new subsidiary (*H*), which, in turn, formed another new corporation (Newco). Newco was then merged into *X* in exchange for *H*'s stock, which was distributed to the existing shareholders of *X*. At the same time, *H*'s stock in Newco was exchanged for *X*'s stock. As a result, *H* became the parent holding company owning the stock of *X*. *X* then declared

a dividend to *H* of its stock in *Y* and *Z* so that *H* became the holding company for each of the operating businesses. The value of the stock of *Y* and *Z* exceeded 40 percent of the total value of *X*'s assets; nevertheless, the service approved the dividend distribution.

In the course of obtaining the ruling, it became clear that the generally understood 30 percent limitation has been extended to at least 50 percent and may exceed that amount, depending on the circumstances involved. The limitation would apparently be exceeded, however, if substantially all of the assets (70 percent of gross and 90 percent of net fair market value) were retransferred. In that case, the particular transaction might be recast from a dividend to an asset acquisition pursuant to the authority of Rev. Rul. 76-123.

Basis of sub stock to parent in a triangular merger

In the case of an acquisition pursuant to a triangular merger qualifying under sec. 368(a)(2)(D), it has been the ruling position of the national office of the IRS that if the surviving corporation (Sub) is a preexisting subsidiary, the basis of the stock of Sub held by its parent (Parent) will be increased by the adjusted basis of the assets of the target company (Target) received in the merger and reduced by the amount of liabilities of Target assumed by Sub. (See, for example, IRS Letter Rulings 7917053, 7852068, 7742033, and 7839002, the last ruling being a technical advice memorandum dealing with a triangular "C" reorganization.) In effect, Parent increases its existing basis in its Sub by the net assets of Target.

This net asset basis increase in Sub's stock is made whether or not the consideration used in the merger is solely stock or includes up to 50 percent cash "boot," the maximum allowable for advance ruling purposes. (See Rev. Proc. 77-37.) Therefore, although up to 50 percent of the consideration in a triangular merger can be cash, no step-up in basis is received by the Parent in its acquiring Sub when Sub pays the cash consideration.

In IRS Letter Ruling 7852058, Parent purchased 4.8 percent of Target's stock just prior to the merger of Target into a newly formed Sub of Parent in a reorganization qualifying under sec. 368(a)(2)(D). The ruling held that Parent will have a basis in its Sub stock equal to Parent's basis in the recently purchased 4.8 percent of Target stock, increased by 95.2 percent of the basis of Target assets received by Sub and reduced by 95.2 percent of the liabilities of Target assumed by Sub.

In IRS Letter Ruling 7905018, it was Sub, rather than Parent, that made a cash purchase of up to 45 percent of the Target stock just

prior to the merger of Target into Sub in a reorganization qualifying under sec. 368(a)(2)(D). In this situation, the ruling held that Parent is only entitled to a basis increase in its Sub equal to the net assets of Target. (The cash purchase by Sub is disregarded for the purpose of determining Parent's basis in the stock of Sub.)

Therefore, it would appear that if the cash purchase price for up to 50 percent of the Target stock is greater than the corresponding portion of Target's net asset value, a basis advantage can be achieved by having Parent make the cash purchase. If the underlying net asset value of Target is greater than the cash purchase price of its stock, Sub should make the cash purchase so that the entire net asset value of Target will be used in determining Parent's basis in its Sub stock.

SECTION 381

Reorganizations: planning for possibility of later losses

The tax consequences attending corporate reorganizations extend well beyond the question of avoiding recognition of gain on an exchange of stock or assets. Unless the transaction qualifies as an "F" reorganization, sec. 381(b)(3) provides that the corporation acquiring property is not entitled to carry back a postacquisition net operating loss (NOL) or net capital loss to a taxable year of the transferor corporation.

One of the important considerations in a reorganization is to limit the impact of sec. 381(b)(3) so that postacquisition NOLs may be carried back and yield current refunds, rather than be carried over and perhaps never utilized. For example, in a triangular statutory merger under sec. 368(a)(2)(D), the acquired corporation merges directly into the controlled subsidiary, and stock of the parent is given as consideration. Postacquisition NOLs could not be carried back to a taxable year of the acquired (target) corporation in a sec. 368(a)(2)(D) reorganization as a result of sec. 381(b)(3). (See *Bercy Industries, Inc.*) If, however, the transaction had been structured as a reverse triangular merger under sec. 368(a)(2)(E), it would have been possible to carry back subsequent NOLs to a taxable year of the target corporation since it is that corporation that survives the merger. (Technically, in a sec. 368(a)(2)(E) reorganization, it is the controlled subsidiary (typically a newly formed shell) that is the transferor corporation since it merges into the target corporation.)

Similarly, even where a two-party (rather than a triangular) reorganization is contemplated, the carryback problem must be consid-

ered. Generally, the corporation with the greater premerger income should be the surviving corporation so as to minimize the impact of the sec. 381(b)(3) restrictions.

SECTION 385

Shortcut through the debt-equity maze: a guide to the sec. 385 regs.

The following chart analysis is intended to serve as a road map through the recently issued final regulations under sec. 385 (T.D. 7747, 12/29/80). The principal purpose of the regulations is to establish objective criteria for determining whether certain interests in corporations are to be characterized as stock or debt. A secondary purpose, but one with perhaps wider impact, is to treat excessive consideration paid for such an interest as a contribution to capital and inadequate consideration as a corporate distribution.

The regulations are prospective and apply to interests in corporations created after December 31, 1981, unless such interests were created pursuant to written contracts which were binding on, or a plan of bankruptcy filed before, December 29, 1980. All abbreviated references in the diagram and accompanying explanation are to subsections of regs. sec. 1.385.

Rules of characterization

	Events creating preferred stock status [4(c)]	
Type of instrument	Instrument held by shareholder	Instrument held by independent creditor [6(b)]
Straight debt [3(f)]	Proportionality and excessive debt [6(f)] Proportionality and issued for property if interest is not reasonable and there is no original issue discount or amortizable bond premium [6(d)] Proportionality and payable on demand, or failure to pay principal, if interest is not reasonable [6(l)] Proportionality and failure to pay interest [6(k)] Proportionality and substantial change in terms results in treatment as an instrument issued for property [6(j)]	Any straight debt or hybrid instrument (except hybrid with predominant equity features) held by an independent creditor will be treated as indebtedness [4(a)]

Rules of characterization (continued)

Type of instrument	Events creating preferred stock status [4(c)]: Instrument held by shareholder	Instrument held by independent creditor [6(b)]
Hybrid [3(e)]	Proportionality [6(c)]	
	Predominant equity features [5(a)]	Predominant equity features [5(a)]
Unwritten loan [7]	Any unwritten loan if excessive debt exists or if there is failure to pay reasonable interest [7]	Not subject to recharacterization under regulations; presumably indebtedness [7(a)(1)(i)]
Guaranteed loan [9]	Any guaranteed loan if, under case law, it is deemed to be made to the shareholder [9]	
Preferred stock [10]	Preferred stock providing fixed payments in nature of principal or interest is treated as an instrument and thus subject to recharacterization [10]	
Locked interests [8]	Test each interest separately for possible recharacterization [8]	

Rules of consideration

	Stock	Debt
Excessive consideration [3(a)(1)]	Consideration paid *minus* FMV of instrument = contribution to capital [3(a)(1)]	
	Face *minus* FMV of instrument = possible redemption premium creating deemed taxable dividend [4(c)(2), ex. 4; secs.305(c), 305(b)(4); regs. sec. 1.305-5(b)]	Face *minus* FMV of instrument = original issue discount [3(a)(3), ex. 1, sec. 1232]
Inadequate consideration [3(a)(2)]	FMV of instrument *minus* consideration paid = sec. 305 preferred stock dividend (presumably sec. 306 stock) [3(a)(2)(ii); 3(a)(3), ex. 6]	FMV of instrument *minus* consideration paid = sec. 301 distribution [3(a)(2)(i)]
	FMV of instrument *minus* face = nontaxable stock premium to corporation sec. 1032	FMV of instrument *minus* face = amortizable bond premium [3(a)(3) ex. 5, sec. 171, regs. sec. 1.61-12(c)(2)]

Definitions and explanations

Debt-to-equity. Ratio of liabilities (excluding trade accounts payable, accrued operating expenses and taxes) to stockholders' equity (adjusted basis of assets minus bad debt reserves plus any net operating loss for the year less liabilities

(including trade accounts payable, accrued operating expenses and taxes)). For cash basis corporation, adjusted basis of trade accounts receivable deemed equal to face, less a reserve for uncollectibles. In determining assets and liabilities, the characterization of any interest by sec. 385 as stock or debt is disregarded, except that preferred stock is considered a liability if it is treated as debt under sec. 385 (6(g).)

Excessive debt. All of the instrument's terms and conditions and corporation's financial structure would not be satisfactory to a lending institution making ordinary commercial loans. Safe harbor: No excessive debt if "outside" debt-to-equity (see definition above) at end of year in which instrument is issued does not exceed 10:1 and "inside" debt-to-equity (same as above but excluding liabilities to independent creditors (except in computing stockholder's equity)) does not exceed 3:1. (6(f).)

Failure to pay interest. Corporation fails to pay any part of interest due and payable during year within 90 days after year end and holder fails to exercise the ordinary diligence of independent creditor. Equity status retroactive to later of first day of year in which failure occurs or first day on which proportionality rules apply. (6(k).)

Fair market value. In general, FMV of instrument is price at which it would change hands between willing buyer and seller, neither under any compulsion and both with reasonable knowledge; FMV may also be determined by using present value and standard bond tables; noncommercial term may be disregarded if its principal purpose is to increase or decrease FMV of instrument. Safe harbors: FMV of straight debt instrument deemed equal to face if stated annual interest is reasonable and consideration paid (issue price) equals face; FMV of instrument registered with SEC and sold to public for cash is issue price. (3(b).)

Fixed payment. Interest or principal payments definitely ascertainable by amount and date and right to receive payments cannot be impaired without holder's consent. Illusory contingencies (no likelihood of affecting right to payment) are ignored. (5(d)(2), (3), (4), (5), (6), (7).)

Guaranteed loan. A guarantee either directly or indirectly, if under case law the loan is treated as made to the shareholder, is treated as capital contribution by the shareholder. All payment of principal and interest treated as sec. 301 distributions to shareholder who gets deduction for interest paid to creditor. (9.)

Hybrid instrument. One that is convertible into stock or provides for any contingent (i.e., not fixed) payment to the holder (other than call premium). (3(e).)

Independent creditor. Facts and circumstances test. Safe harbor: A person is considered an independent creditor with respect to a class of instruments if (1) stock owned by the corporation would not be attributed to him and (2) his holdings of stock and instruments are not substantially proportionate. Sec. 318 applies, but attribution to and from corporations triggered by 5 percent not 50 percent and, in determining 5 percent ownership of corporation, stock constructively owned by unrelated person through options is ignored. (6(b).)

Instrument. Any bond, note, debenture or similar written obligation. (3(c).)

Issued for property. Debt-for-property rule does not apply to new instrument issued in exchange for equal or greater principal amount of debt if both an

independent creditor holding old debt and issuing corporation, each exercising ordinary diligence, would have agreed to the exchange. (6(d)(3).)

Locked interests. Two or more distinct interests in corporation (e.g., bond and nondetachable warrant) are treated as separate even though title cannot be transferred separately. Provides alternative to use of hybrid instrument and avoids hybrid recharacterization tests. (8.)

Payable on demand. Either by terms of instrument or upon failure to pay principal within 90 days of due date if holder fails to exercise the ordinary diligence of independent creditor. Equity status retroactive to first day of year in which reasonable interest not paid. Does not apply to demand instrument retired in six months if outstanding principal amount of all such instruments plus balance of all unwritten obligations does not exceed $25,000. (6(l).)

Predominant equity feature. FMV of instrument on issue date without equity features (i.e., right to convert into stock and right to payments which are not fixed, other than call premium) is less than 50 percent of actual FMV of instrument. Substitute 45 percent, if issuer and holder reasonably believe FMV of instrument without equity features is not less than 50 percent of actual FMV of instrument. (5(a), (b), (c).)

Preferred stock status. If an instrument is characterized as stock under sec. 385, it is treated as preferred stock for all code purposes and is considered to have same terms as the instrument has under local law; each class of instruments characterized as stock is treated as separate class of stock. Payments of "interest" are treated as sec. 301 distributions and payments of "principal" are treated as distributions in redemption of stock. If instrument changes from debt to stock under rules of 6(j) (change in terms), 6(k) (failure to pay interest) or 6(l) (payable on demand), then it is treated as if exchanged for preferred stock in a deemed recapitalization under sec. 368(a)(1)(E). (4(c).)

Proportionality. Exists if holdings of stock and class of instruments are substantially proportionate. Use facts and circumstances test to determine proportionality, including sec. 318 attribution (except options are ignored if unreasonable to expect their exercise). No proportionality can exist (1) if stock and instruments widely held and instruments are separately traded and readily marketable or (2) with respect to instrument held by independent creditor. (6(a).)

Reasonable interest. In general, arm's-length rate paid to independent creditors. Safe harbor: Interest deemed reasonable if (1) between any of prime rate, 12 percent (code sec. 6621 rate), and average yield on outstanding marketable obligations of U.S. of comparable maturity, (2) debt-to-equity no more than 1:1 and (3) debt is recourse. (6(e).)

Straight debt. Any instrument other than a hybrid. (3(f).)

Substantial change in terms. A change in the terms of a debt instrument after the effective date of the regulations which postpones maturity date or could materially affect its FMV. Such change causes instrument to be treated as if newly issued in exchange for property and subject to recharacterization as stock. Excessive debt recharacterization rule does not apply to instruments issued in exchange for equal or greater principal amount of indebtedness; see also exception to application of debt-for-property rule. (6(j).)

Unwritten loan. Any loan of cash other than by an independent creditor which is not evidenced by an instrument within 6 months after loan is made. Does

not apply to loans not exceeding $25,000 which are repaid within 6 months. Even if there is no excessive debt, reasonable interest must be paid on loan within 90 days of year end or loan is treated as equity retroactively to later of first day of year in which reasonable interest not paid or the date of the loan. If loan is treated as contribution to capital, all payments of principal and interest are treated as sec. 301 distributions. (7.)

Deferred compensation

SECTION 401

Corporate fringe benefit timetable

An insurance carrier recently made available the following list of corporate fringe benefits, arranged in the life cycle of a closely held corporation.

Phase 1, survival and growth

- Blanket travel accident coverage—noncontributory.
- Basic group life hospital/major medical plan—employee pays for dependents.
- Business loan insurance for endorsers.
- Term insurance on key men.
- Stockholder/officer guaranteed disability income insurance.
- Stock retirement or buy-sell agreement.
- Cash bonus plan.
- Stock option plan (if publicly held).

Phase 2, stability and expansion

- Increased group life (multiple-of-earnings basis).
- Increased participation in hospital/major medical premiums.
- Short-term disability income program.
- Guaranteed long-term disability for executives and key people with no offsets (50/50 participation).
- Medical reimbursement for family medical, dental, drug bills.
- Income continuation to the families of executives and key people in the event of premature death (non-tax qualified).
- Profit-sharing plan for all employees.
- "Downside" value of stock-purchase buy-sell agreement insured with permanent insurance.
- Increased key man insurance.
- Split-dollar stockholder personal life insurance.
- Advanced estate planning for stockholders and key employees.

- Annual physical for stockholders.
- Salary savings for all employees—thrift plan.
- Employee benefit communications program.
- Disability buy-out insurance.
- Stock options, stock purchase, incentive (phantom) stock plans.
- Advisory board—annual business report and corporate review.
- Substitute creditor agreement for business loans.
- Stockholder/officer sec. 79 group life.

Phase 3, maturity

- Pension plan integrated with social security.
- Deferred compensation plan for key people.
- Split-dollar nonstockholder personal life insurance.
- Group permanent life insurance for executives.
- Sec. 303 stock retirement for key stockholders.
- Advanced estate planning for executives and all key people.
- Dental insurance.
- Annual physical for executives and key people.
- Retired life reserves insurance for executives and key people.

Phase 4, transfer of management and control

- Gifts of stock to family.
- Buy-sell agreement with key employees.
- Sale or gifts of stock to family employees.
- Recapitalization and reorganization.
- ESOP—employee stock ownership plan.
- Family capital corporation (personal holding company).
- Merger.
- Acquisition.
- Retirement.
- Lifetime sale.
- Private annuity.
- Charitable gifts of stock.
- Gifts of appreciated stock to college, community, etc.

Pensions: planning after *Garland*

Many tax planners were surprised by the Tax Court's decision in *L. M. Garland.* In that case, a professional corporation, which was a 50 percent partner in a medical partnership, adopted a pension plan for its one corporate employee (a physician). The plan did not cover the employees of the partnership nor those of the other 50 percent

corporate partner. It was held that the plan qualified under sec. 401 because sec. 414(b) and (c) are the exclusive means for determining whether employees of affiliated entities must be aggregated for purposes of applying the antidiscrimination rules; under sec. 414(b) and (c), a partner's interest in a partnership must exceed 50 percent before it will be deemed to control the partnership in order to come within the single employer rule of those subsections.

The *Garland* decision is appealable to the fifth circuit, and the government will probably appeal it. Legislation has also been proposed to nullify the holding. Nonetheless, many tax practitioners are planning to establish *Garland*-type corporate partners where the situation warrants.

Note, however, that there are some important differences between using a professional corporation to conduct an entire professional practice and the mere introduction of a corporate partner into a professional partnership. One important difference exists in those jurisdictions that impose a tax upon unincorporated entities. In these places, it is possible that income earned by a professional partnership will be taxed once at the partnership level and will then be subject to franchise tax again at the corporate partner level. This is true in New York City, where the city's unincorporated business tax is applied to professional partnerships along with other commercial partnerships. A 4 percent tax is applied to partnership earnings after allowing certain exemptions. It is the city's position that professional corporate partners will be required to pay general corporate income tax on the alternative basis, which, in part, adds back executive compensation. This is so even if all profits are distributed as salary to the shareholder.

Another important distinction between a *Garland* arrangement and the usual professional incorporation is the added recordkeeping and tax returns to be filed. Each additional entity obviously requires additional payroll tax returns and income tax returns, as well. ERISA filings also increase.

Insertion of a partnership intermediary, on the other hand, has some potential advantages besides the pension opportunity. Adoption of a fiscal year can cause a substantial deferral of taxation in the first year, thereby providing a permanent tax benefit (until liquidation). However, IRS approval may be required. (See Rev. Proc. 72-51, regs. sec. 1.706-1(b), and the instructions to Form 1128.)

Editors' note: In late 1980 Congress added sec. 414(m) to the code and effectively overruled the Garland *decision for plan years beginning after November 30, 1980.*

Pensions, etc.: IRS rules on affiliated service groups

In *Kiddie* and in *Garland,* the Tax Court temporarily paved the way for professional and other corporations to form partnerships with other corporations or individuals in order to avoid ERISA's nondiscrimination requirements with respect to coverage, contributions, and benefits. The "Kiddie-Garland" arrangement permitted professional corporations and members of the prohibited group therein to reclassify corporate employees as employees of the partnership; the claim was then made that the partnership was the entity which exercised control over their employment so as to eliminate them from the corporation's benefit coverage.

In 1980, Congress enacted sec. 414(m). This new section provides that all employees of an affiliated service group must be treated as employees of a single employer in determining whether a plan is qualifed under sec. 401. Classification as an affiliated service group is dependent upon a finding that one or more members of the group constitutes a service organization, which is an organization that is involved principally in the performance of services.

The service in Rev. Rul. 81-105 posits three situations dealing with the existence of an affiliated service group. The first deals with a law partnership consisting of three corporate and 10 individual partners that employed various professional and clerical employees. Only the partnership and two of the corporate partners maintained qualifed plans; also, the partnership plan covered some but not all employees of the partnership. The service viewed this arrangement as an affiliated service group so that all employees of the partnership and the partners must be included in determining whether plan coverage is nondiscriminatory.

The second example deals with a corporation which provided secretarial services, most of which were performed for its two professional corporation shareholders. Each shareholder maintained a qualified plan for its sole employee, a doctor. Here again the service found an affiliated service group, with the result that the employees of the secretarial corporation must be considered in determining the continued qualification of the plans of the shareholders.

The final example considers the situation whereby two professional corporations each owns one-half of a lock repair shop. The PCs utilize its services on a casual basis. The service contends that this arrangement does not constitute an affiliated service group inasmuch as the scrutinized services performed by the repair shop are not integrated with the business of the professional corporations, and are not a significant portion of its business.

The ruling indicates that the service will scrutinize professional arrangements in partnership form and that, absent disparate lines of service businesses, the IRS will attempt to disqualify plans which do not cover all partnership and shareholder employees.

Mandatory salary reduction plan permits deferral of income

The federal income tax consequences of so-called "salary reduction plans" were uncertain for several years. In 1972, the treasury issued proposed regulations that would have, in effect, precluded salary reduction arrangements from reducing compensation in return for contributions to qualified plans, by treating such reductions as employee contributions. Congress responded by prohibiting the issuance of salary reduction regulations until it had the opportunity to resolve the problem legislatively. The eventual legislative solution was sec. 401(k), enacted as part of the Revenue Act of 1978. It permits employers to establish a cash or deferred arrangement as part of a qualified profit-sharing or stock bonus plan. Under such an arrangement, covered employees may elect to have the employer make a payment as a contribution to a trust under the plan, or directly to the employee in cash. If the participation and nondiscrimination standards of sec. 401(k)(3) are satisfied, the employer contribution to the plan under a cash or deferred salary reduction arrangement will not be includible in the gross income of the participant until the taxable year in which the amounts are distributed or otherwise made available under the plan.

IRS Letter Ruling 8110037 provides an example of how a salary reduction arrangement can be used successfully even when it is mandatory and geared to highly compensated employees through an integration formula, and therefore fails to satisfy sec. 401(k). In this ruling, an employer, to avoid cash flow problems, funded its plan as follows: it made an annual plan contribution equal to 7 percent of each participant's annual compensation in excess of the social security wage base of $25,900. In turn, the annual compensation of employees entitled to an allocation under this plan was reduced by an amount equal to the annual contribution made on their behalf. The plan provided that all such amounts were deemed to be employer contributions.

Finding that the employee had no election as to whether his salary could be reduced to allow for contributions to be made to the plan, the IRS still held that no portion of the employer's contribution to the plan would be includible in the gross income of the participant in the year such contributions were made, but only in the taxable

year of the participant in which such amounts were distributed or made available under the plan. Furthermore, the contributions made to the plan by the employer would not be considered wages for purposes of FICA and FUTA and for federal income tax withholding purposes. The holding assumes that the plan was qualified under sec. 401(a).

This ruling illustrates that tax planning opportunities are still available for highly paid executives through salary reduction arrangements. Such arrangements would permit executives to finance their own retirement benefits on a tax-deferred basis without any additional cost to their employers.

Pensions, etc.: IRS restates rules on employee contributions

The IRS recently issued a revenue ruling which restates its position with respect to prohibited discrimination resulting from *mandatory* employee contributions under a qualifed retirement plan. While the new ruling retains the general pre-ERISA rules, it specifically departs from the former IRS position that, generally, prohibited discrimination would not result if the rate of mandatory contributions does not exceed 6 percent of compensation. In another recent revenue ruling, the service indicated that the long-standing limit on *voluntary* employee contributions of 10 percent of aggregate compensation remains in effect. The rulings have greatest application to qualified thrift savings plans.

Mandatory contributions. Rev. Rul. 80-307 provides that the level of mandatory employee contributions to a qualified plan must not result in prohibited discrimination either with respect to coverage or with respect to contributions or benefits. The ruling states that when mandatory employee contributions are burdensome, some of the lower paid employees may not participate, which may result in discriminatory coverage. The ruling also says that where the plan provides for optional rates of employee contributions, and employer contributions or the benefits are geared to employee contributions in such a way that a higher rate of employee contributions will result in larger benefits from employer contributions, discrimination may result if employer-derived benefits favor those who are highly compensated. Mandatory contributions result in discrimination in operation if they deprive lower paid employees of benefits at least as high in proportion to compensation as are provided for higher paid employees, after taking into account differentials permitted under the requirements for integration with social security benefits.

These general rules have long been the basic IRS position in this area. Rev. Rul. 80-307 is significant not because of its restatement of these rules, but because it specifically retreats from a statement in a prior revenue ruling (Rev. Rul. 72-58) that discrimination would, generally, not result if the rate of mandatory employee contributions did not exceed 6 percent of compensation. Thus, the general rules on permissible mandatory employee contributions do not describe a particular level of acceptable contributions, but sanction only a level which is in practice not discriminatory in operation. There has been a tendency, in some quarters, to regard the 6 percent figure of prior rulings as a safe harbor. With Rev. Rul. 80-307 serving notice that no such safe harbor exists, IRS challenges may be expected to certain plans which relied on the prior ruling.

Voluntary contributions. The shift in IRS position in the area of mandatory employee contributions has not affected the limit on voluntary employee contributions. Rev. Rul. 80-350 provides that the 10 percent limit on voluntary contributions remains in effect. Specifically, the ruling provides that voluntary contributions are allowed in any year so long as the total of such contributions for all years does not exceed 10 percent of the aggregate compensation received for all years since the employee has been a participant in the plan.

SECTION 402

Rollovers of lump-sum distributions by highly compensated employees

In order to avoid prohibited discrimination in a pension plan, regs. sec. 1.401-4(c)(2) provides that employer contributions used to fund the benefit for the 25 highest paid employees at the time of either the plan's inception or an increase in benefits must be restricted in accordance with the limitations set forth in regs. sec. 1.401-4(c)(2)(iii), if the full current costs of the plan have not been met within 10 years after either the plan's inception or an increase in benefits.

The IRS approved a method by which an affected employee could accommodate these restrictions. Rev. Rul. 61-10 held that a lump-sum distribution to a highly compensated employee would be entitled to capital gains treatment if an agreement were made between the employee and the plan's trustee to guarantee the repayment of the restricted portion of the distribution should the plan terminate within the first 10 years of its existence, or if the full current costs of the

plan were not met at any time during that period. In the ruling, the guarantee was effected by the employee's placing in escrow property having a fair market value of 125 percent of the amount repayable if the plan had terminated on the date of distribution; the employee was also to add property to the escrow account if the fair market value of the account fell below 110 percent of the restricted amount. Although the employee had the right to receive any income from the deposited property, the escrow agent could not redeliver the property to the employee without receiving certification from the plan trustee that the employee was no longer under any obligation to repay the distributed amounts. The service concluded that such an agreement adequately secured the obligation to repay and prevented any potential prohibited discrimination.

IRS Letter Ruling 8019078 discussed a situation similar to that in Rev. Rul. 61-10. Several employees planned to roll over to an IRA a restricted lump-sum distribution. They agreed to place property in escrow equal to 125 percent of the amount of the restricted distribution. The amounts in escrow would be released as the restrictions lapsed. None of the property rolled over to an IRA was to be pledged as security for the restricted portion of the distribution. The service concluded that, on the basis of Rev. Rul. 61-10, the entire distribution qualified as a lump-sum distribution, was not includible in gross income, and would be treated as a rollover distribution.

On the other hand, in IRS Letter Ruling 8019103, the employee intended to meet the requirements of Rev. Rul. 61-10 by investing property rolled over into his IRA equal to 125 percent of the restricted amount in certificates of deposit, and to assign them to the trustees of the plan. In this case, the service found that sec. 72(m)(4)(A) would be violated. That section provides that any interest in an IRA which is assigned or pledged by an owner-employee shall be treated as having been received by the employee; under sec. 72(m)(6), an owner-employee includes a person for whose benefit an IRA is maintained. Accordingly, the amount pledged would be included in the individual's gross income.

It is thus important in this context that property placed in escrow be separate and distinct from that deposited in the employee's IRA.

Tax-free rollovers from Keogh plans to SEP-IRA

Owner-employees may avoid the penalty tax on premature distributions from a Keogh plan, and continue to make annual deductible contributions equal to the Keogh maximum, by rolling over the distribution into an SEP-IRA upon termination of the Keogh plan.

A distribution from a Keogh plan to an owner-employee (sole proprietor or more than 10 percent partner) who is under age 59½ and not disabled is a premature distribution, subject to a 10 percent tax imposed by sec. 72(m)(5). Furthermore, receipt of such a distribution precludes an individual from benefiting as an owner-employee from contributions to a qualified Keogh plan for five taxable years after the year of distribution (sec. 401(d)(5)(C)). (Previously, in the case of plan terminations, it was necessary to continue the related trust and freeze the accounts of owner-employees to avoid the penalties.)

After the rollover provisions were expanded to allow rollovers for plan termination distributions that did not otherwise qualify as lump-sum distributions (see sec. 402(a)(5)), Rev. Rul. 78-404 provided that such a premature distribution could be rolled over into an IRA. Since the distribution is not taxable due to the rollover, the 10 percent tax under sec. 72(m)(5) is not imposed. In addition, contributions deductible under sec. 219 may be made to the IRA account without the imposition of the five-year penalty period. (Since the IRA is qualified under sec. 408 rather than sec. 401, the prohibition under sec. 401(d)(5)(C) doesn't apply.) The disadvantage of this arrangement is that only $1,500 can be contributed each year.

The reasoning in Rev. Rul. 78-404 would appear to be equally applicable to a rollover into a simplified employee pension, or SEP-IRA, established under sec. 408(k). This was recently confirmed in IRS Letter Ruling 8120112, in which the service ruled that the distribution is tax-free when rolled over, no sec. 72 tax is imposed, and the owner-employee may contribute up to $7,500 per year, to the SEP-IRA.

The factual situation described in this ruling pointed out that the Keogh participants wished to have greater control over the investments made with funds contributed in their behalf. But whatever reason an owner-employee may have for being disenchanted with a Keogh plan, the availability of the rollover to an SEP-IRA offers an alternative under which deductible contributions can be continued without interruption. Common law employees would also have to be covered by the SEP-IRA plan as well.

Tax-free lump-sum distribution

An interesting and unexpected tax benefit may result from the receipt of multiple lump-sum distributions. An individual who receives a lump-sum distribution may elect to have the distribution taxed under the special 10-year averaging rules of sec. 402(e).

If an individual receiving a lump-sum distribution in the current year has also received another lump-sum distribution during the six-taxable-year period ending with the last day of the current taxable year, a special aggregation rule comes into play. (See sec. 402(e)(2).) This special aggregation rule applies only to lump-sum distributions for which the taxpayer has elected to have the distributions taxed under the special 10-year averaging rules. In situations involving multiple lump-sum distributions, the tax on the current distribution under the 10-year averaging method is calculated by adding the earlier distributions to the current distribution. The general effect of the aggregation rule is to cause the current lump-sum distribution to be taxed in a higher tax bracket. However, even though this is the apparent result, it is not always the actual result.

Example. In 1978 the taxpayer received a lump-sum distribution of $49,000. Under the special 10-year averaging method, the tax on this distribution was $7,920. In 1980 the taxpayer receives another lump-sum distribution of $2,000. In order to calculate the tax under the 10-year averaging method on the $2,000 distribution, the two distributions are aggregated, and a tax is calculated on the total. In this situation, the tax on the aggregate distributions is $7,920. Thus, no tax is due on the $2,000 distribution received in 1980. The reason for this unexpected result is the change in the tax rates between 1978 and 1980: the widening of the tax brackets, the reduction of the tax rates, the increase in the zero bracket amount, and the increase in the personal exemption.

The law requires that the tax on the aggregate distributions be reduced, *but not below zero*, by the tax on the distributions from the earlier year. Thus, in the example, the second distribution would be tax-free.

Ten-year averaging: distributions from one of two plans rolled over

Many employees are covered by more than one retirement plan of a single employer. The tax consequences of an employee's disposition of the accrued benefits from multiple plans are not always well defined.

Suppose, for example, that an employee intends to continue working after retirement and wants to retain some of his accrued benefits in a tax-deferred retirement plan. Assume that the employee is entitled to benefits under his employer's pension plan and profit-sharing plan. He decides to take a lump-sum distribution from both plans but to transfer the pension plan distribution to an individual retirement account. Since the employee has elected a lump-sum

settlement option for both plans, it would appear that the pension plan distribution would escape current taxation under the rollover provisions of sec. 402(a)(5)(A) and that the profit-sharing plan distribution would be eligible for capital gains and 10-year averaging treatment under sec. 402(a)(2) and (e). The IRS, however, has held to the contrary in a recent private letter ruling.

In IRS Letter Ruling 7928017, the service held that in the above case the distribution from the pension plan would be eligible for tax-free treatment as a qualified rollover but that the profit-sharing plan distribution would be eligible only for capital gains treatment (on the portion attributable to participation in the plan before January 1, 1974). The post-1973 portion would not be eligible for 10-year averaging. The service explained that the provisions of sec. 402(e)(4)(B) provide that a recipient of a lump-sum distribution cannot use 10-year averaging treatment unless he combines into a single distribution all amounts received in the employee's taxable year that might be eligible for 10-year averaging tax treatment. Since the taxpayer rolled over one plan distribution, the provisions of sec. 402(e) were not available to him. However, the service noted that the provisions of sec. 402(a)(2) (relating to capital gain treatment for the pre-1974 portion) are applicable without regard to whether a distribution qualifies as a lump-sum distribution under sec. 402(e)(4)(B).

According to the letter ruling, 10-year averaging treatment was denied because of the failure to aggregate the lump-sum distributions under sec. 402(e)(4)(B). That provision, however, requires only that distributions be aggregated when they are received within one taxable year of the recipient. A taxpayer may be able to avoid the result in IRS Letter Ruling 7928017 by postponing the receipt of his distribution from one of the plans until a succeeding taxable year.

Private ruling vs. proposed reg. on lump-sum distribution from "frozen" plan

A recipient of a lump-sum distribution who was a participant in a qualified plan prior to January 1, 1974, may recognize a portion of the distribution as capital gain. (See sec. 402(a)(2).) Although the code states that the capital gain portion is the reciprocal of the ordinary income portion, prop. regs. sec. 1.402(e)-2 confines its discussion to the ordinary income portion. The proposed regulation provides that the ordinary income portion is determined by multiplying the total taxable amount by a fraction whose numerator is the number of calendar years of active participation after December 31, 1973, and whose denominator is the total number of calendar years of active

participation. The proposed regulation further states that the years of active participation end with the earliest of—

- The month in which the employee receives a lump-sum distribution;
- The month in which the employee separates from service;
- The month in which the employee dies; or,
- In the case of an employee who receives a lump-sum distribution on account of disability, the month in which he becomes disabled.

Thus, the proposed regulation seems to consider participants in a "frozen" plan (i.e., a plan for which contributions have ceased) as active participants for purposes of computing the ordinary income portion of a current lump-sum distribution.

IRS Letter Ruling 7846013 contradicts prop. regs. sec. 1.402(e)-2 as it relates to computing the ordinary income portion of a current lump-sum distribution from a "frozen" plan.

The two interpretations can be compared by the following example.

A is an employee of *X* Corporation. On January 1, 1969, *X* adopted a qualified pension plan in which *A* was an active participant. On December 31, 1973, *X* froze its pension plan. On December 31, 1978, *A* retired and received a $10,000 distribution from the *X* pension plan. *A*'s capital gain would be $5,000 if computed under prop. regs. sec. 1.402(e)-2, and $10,000 if computed under IRS Letter Ruling 7846013, determined as follows:

	Total distribution		Ordinary Income		Capital gain
Prop. regs.	$10,000	−	($10,000 × 5/10)	=	$ 5,000
Letter ruling	$10,000	−	($10,000 × 0/10)	=	$10,000

Although the two items are inconsistent, the proposed regulation probably never considered the "frozen" plan participant and thus it is felt that at least with respect to "frozen" plans the better position is that of the letter ruling.

Class-year thrift plan distributions

In a number of recent private rulings (e.g., IRS Letter Rulings 8028043 and 8035099), the IRS has adopted a very liberal position regarding the computation of income realized by an employee who makes in-service withdrawals from a class-year qualified thrift plan. Under these plans, the employee typically makes nondeductible contributions to the plan which the employer matches pursuant to the plan's formula. After a specified period of years, such plans typically allow the employee an opportunity to withdraw the current

value of both employee and employer contributions attributable to a particular prior year (a class year).

Contrary to the prior practices of many taxpayers, and its own past ruling policy, the IRS has now concluded that although benefits are grouped into class years for purposes of the withdrawal option, these plans constituted a single program of interrelated benefits within the meaning of regs. sec. 1.72-2(a)(3). As a result, the service ruled employee contributions for *all* class years up to the date of distribution (to the extent not previously offset against prior distributions) should be offset against the total currently distributed amount.

Practitioners should consider the effect of this IRS position on participants in such plans, particularly those who in prior years excluded only employee contributions for the withdrawn class year—*as many employees were instructed to do by their employers.* If withdrawals occurred only in open years, taxpayers may wish to file amended returns. If withdrawals also occurred during closed years, practitioners should consider the desirability of continuing the method used to determine income in prior years since this arguably may have established an accounting method for employee contributions. Alternatively, it could be argued that refunds may be obtained for open years with the mitigation provisions of secs. 1311–1314 affording some future relief for closed years to avoid duplication of tax. Unfortunately, none of the IRS's rulings to date provide guidance on the effect of prior-year reporting on the single class-year basis.

Distributees of disqualified plans not necessarily beneficiaries of non-exempt trusts

Sec. 402(a) covers "Taxability of Beneficiary of Exempt Trusts" and generally provides beneficial tax treatment for distributions from an exempt employees' trust. Sec. 402(b), on the other hand, is entitled "Taxability of Beneficiary of Non-Exempt Trusts" and generally taxes distributions to a beneficiary as ordinary income in the year received. When an exempt trust is disqualified and is subsequently terminated, the IRS has taken the position that termination distributions are from a non-exempt trust and, therefore, taxable under sec. 402(b).

In a Tax Court opinion last year, *C. B. Woodson*, on appeal to the fifth circuit, the court held that assets attributable to contributions to the profit-sharing plan while it was qualified should retain their qualified nature. For example, in *Woodson*, each distribution from the profit-sharing trust was held to be composed of two parts: (1) a proportionate share of the assets contributed and value accumulated during the period of the plan's qualification and (2) a proportionate

share of the assets contributed and value accumulated from the date of revocation of the determination letter until the plan was terminated. The first part was held taxable under sec. 402(a) and the second part under sec. 402(b). As the court stated: "We refuse to take an all-or-nothing approach. We have found no Congressional mandate requiring such an approach. Absent such a mandate we refuse to adopt a rule of law that would cause such inequities." In accord: *J. F. Sturdevant.*

Although this was the first decision of its kind by the Tax Court, it is in line with discussion in a second circuit opinion in *H. D. Greenwald.*

Ownership by profit-sharing trust of ordinary policy insuring participant's life

The issuance of IRS Letter Ruling 7844032 should remind the tax adviser of the income and estate tax benefits flowing from ownership by a profit-sharing trust, or other sec. 401 trust, of an ordinary policy insuring the participant's life, specifically where such ownership is treated as an investment allocated to the participant's individual account in the trust. The ruling explains, citing Rev. Rul. 73-336, that the purchase for value rule of sec. 101(a)(2) does not apply where there has been a purchase and sale of an insurance policy between two employee plan trusts, inasmuch as there is no change in the underlying beneficial interest of the participant in both trusts.

Rev. Rul. 74-76 was also cited for the proposition that the participant can transfer the policy directly to the trust for his account as a voluntary employee contribution. Presumably, rulings were sought by taxpayers in all of these cases in order to avoid an assertion that the purchase for value rule would require taxation of the insurance proceeds, in excess of the policy purchase price and subsequent premium payments, upon distribution of the proceeds to the participant's designated beneficiary.

The Labor and Treasury Departments have issued prohibited transaction exemption 77-7, which is a broad class exemption permitting a qualifying plan participant, or his sponsoring employer, to transfer a policy insuring the participant's life to the trust. Another class-prohibited-transaction exemption, 77-8, permits a sale by the trust of a life insurance policy or annuity contract to the plan participant or his employer. The second ruling does refer to an assumption that the trust would otherwise have surrendered the contract or policy if the sale could not be accomplished.

The insurance proceeds received by the participant's designated

beneficiary after his death are exempt from federal estate tax under sec. 2039(c)(1), as interpreted in Rev. Rul. 67-371 and Rev. Rul. 73-404, so long as the plan prohibits use of trust assets to satisfy obligations of the deceased participant's estate.

The "PS-58" value (of the life insurance protection), computed under tables now published in Rev. Rul. 55-747 and Rev. Rul. 66-110, is reportable as current taxable income by the participant, as provided in regs. sec. 1.72-16(b). The protection-value factor taken from these tables is applied to the life insurance "coverage," which is the excess of the policy face amount over the cash surrender value of the policy owned by the trust.

When the insurance policy premiums are charged to the participant's account, the participant ordinarily designates the policy beneficiary. Upon death of the participant, the payment of the policy proceeds is excluded from the beneficiary's income, under the provisions of regs. sec. 1.72-16(c), to the extent such proceeds exceed the cash surrender value at the date of death. The portion of the proceeds equal to such value is treated as a distribution from the qualified trust to the beneficiary. In computing the gain on such distribution, the beneficiary can subtract the "PS-58" costs previously reported as income by the participant.

Example (1) under subparagraph (c)(3) of this regulation states that this portion may be eligible for the $5,000 exclusion under sec. 101(b). This exclusion is available even though the participant's (and beneficiary's) rights are nonforfeitable, by virtue of the exemption provided in sec. 101(b)(2)(B)(i).

SECTION 403

Income recognition on policy loans prior to annuity starting date

Because of present interest rate levels, insurance policy loans, which generally bear relatively low interest rates, are an attractive means of borrowing. However, taxpayers planning to borrow on the loan value of sec. 403(b) annuity contracts should be advised of the IRS position that such amounts may be taxable when received.

In Rev. Rul. 81-126, the IRS restated its position that a policy loan made to an employee before the annuity starting date under an annuity contract purchased by an employer is includible in the gross income of the employee for the taxable year received to the extent that the loan proceeds exceed the employee's cost basis in the policy.

In announcing that it will not follow the contrary decision of the Tax Court in *R. W. Minnis*, the IRS concluded that such loans do not create a debtor-creditor relationship and are, in substance, a return of the consideration paid for the contract. As such, the loan is deemed to be an amount received under the annuity contract and is taxable under the rules of sec. 72.

In this ruling, the employee entered into a sec. 403(b) annuity purchase program through a salary reduction agreement under which the employer agreed to purchase an annuity contract. Under the contract, the employee could receive distributions from the insurance company to the extent of the loan value of the contract. The insurance company had no discretion to refuse the loan and was required to make the loan in accordance with the terms of the contract. There was no time limit for repayment, and the amounts never had to be repaid. The loan balance outstanding would reduce the total amount that the insurance company was ultimately obligated to pay under the contract.

The employee contended that the receipt of the loan was not taxable because the transaction was substantially similar to any conventional loan arrangement. However, the IRS found that the advance made to the employee was never a debt, but merely served to reduce the amount the insurer was ultimately obligated to pay under the contract. Under sec. 72, any amount received by an employee under the terms of an annuity contract that represents, in whole or in part, a return of the consideration paid for the contract, is includible in gross income to the extent the amount received, together with all previous payments received under the contract which are excludible from gross income, exceeds the employee's consideration paid for the contract. (See regs. sec. 1.72-11(b)(1).) Since the consideration paid by the employer for the contract was fully excluded from the employee's gross income, the entire amount received as a loan was fully taxable to the employee.

In the *Minnis* case, the Tax Court held, under similar circumstances, that a policy loan was not "an amount received under the contract" within the meaning of sec. 72(e)(1)(B), and that there was no statutory basis for distinguishing policy loans against employee annuity contracts qualified under sec. 403(b) from any other insurance policy loans for purposes of sec. 72(e)(1)(B). The court in *Minnis* found that the loan transaction was not a sham and that the taxpayer had borrowed the money from the insurance company rather than from a bank because of the lower interest rate. Also, the taxpayer in *Minnis* repaid the loan in question within a relatively short period of time.

The court relied in part on the legislative history of sec. 264, which

disallows under certain limited circumstances an interest deduction for indebtedness incurred to carry life insurance policies, endowment contracts, or annuity contracts. This legislative history explicitly acknowledges that policy loans are debts for purposes of the interest deduction.

SECTION 404

Contributions to qualified plans after close of taxable year

The Court of Claims in *Raybestos Manhattan, Inc.*, denied an accrual-basis taxpayer a deduction for contributions to a pension plan made after year end but prior to filing the tax return. The taxable years involved were 1968 and 1969. The denial was due to lack of any evidence in the company accounts or records that the additional contributions were made "on account of" the taxable years in question. The court commented that the same requirement was applicable to a cash-basis taxpayer; even a cash-basis taxpayer to whom sec. 404(a)(6) applies would have to show that his grace period cash payment was on account of a specific tax year, and not the subsequent one.

The court said that some proof must exist that the taxpayer intended, either at the time the payment was made or prior to the end of the year for which the payment was made, that the payment be on account of the taxable year for which the deduction was sought. Examples of such proof cited by the court were: corporate resolutions, actuarial statements, corporate records, provision of the plan, and communications to the trustee.

Rev. Rul. 76-28 contains the most recently expressed position of the IRS with regard to the on-account-of requirement. This ruling provides that

> whether a taxpayer is on the cash or accrual method of accounting, and whether or not the conditions for accrual otherwise generally required of accrual-basis taxpayers have been met, a payment made after the close of an employer's taxable year . . . shall be considered to be on account of the preceding taxable year if (a) the payment is treated by the plan in the same manner that the plan would treat a payment actually received on the last day of such preceding year of the employer, and (b) either of the following conditions is satisfied:
>
> 1. The employer designates the payment in writing to the plan administrator or trustee as a payment on account of the employer's preceding taxable year; or

2. The employer claims such payment as a deduction on his tax return for such preceding taxable year.

A literal reading of this ruling suggests that no action need be taken before year end by an accrual or cash-basis taxpayer as long as the deduction is taken in the tax return and the plan treats the payment as if received on the last day of the preceding year. Since this ruling represents a departure from the service's long-standing position that an accrual is required and since no regulations exist on this point, the prudent approach is still to accrue the liability prior to year end and, particularly in light of *Raybestos*, to take other appropriate corporate action to demonstrate that the payment is on account of the taxable year for which the deduction is claimed.

Funding non-ESOP pension contribution with employee stock

An Employee Stock Ownership Plan (ESOP) may seem appealing in today's economy because it can provide an employer with a significant tax deduction without any payment of cash. An ESOP, however, is not suitable for all corporations because of its additional administrative requirements and the resultant dilution of the current shareholders' control by distribution and voting pass through requirements. There is an alternative that provides many of the benefits of an ESOP, but few of the detriments: contributing shares of stock of the corporation to its existing pension plan.

There is significant latitude within the Employee Retirement Income Security Act of 1974 (ERISA) for such contributions of employer stock. By way of limitation, ERISA sec. 407(a)(2) provides that a plan may not acquire any employer stock, if immediately after the acquisition the total fair market value of all employer stock owned by the plan is greater than 10 percent of the fair market value of all the assets of the plan. If the contributed shares increase in value subsequent to the contribution so that the 10 percent ceiling is exceeded, there is no ERISA violation. (See ERISA sec. 407(a)(3)(B).) If the opposite occurs and the contributed shares decrease in value, or the balance of the plan's assets increase in value, then additional shares can be contributed to the plan, as long as the 10 percent ceiling is not exceeded. These examples are supported by labor regs. sec. 2550.407(a)-3(b)(2).

In addition to these limited exceptions to the 10 percent rule, ERISA sec. 407(b)(1) states that the limit shall not apply at all to an "eligible individual account plan." That type of plan is defined by

ERISA sec. 407(d)(3) as a profit-sharing, stock bonus, thrift, or savings plan, ESOP, or certain money purchase pension plans, but only if the plan provides explicitly for investment in qualifying employer securities, etc.

Contributions to exempt trusts are deductible under sec. 404 only when paid. There is no requirement, however, that the payment be made in cash. Contributions in property are acceptable, and a deduction is allowable for the fair market value of the property contributed, measured as of the date the contribution is made. (See *Colorado National Bank of Denver.*) Corporate stock is property. Therefore, a corporation may contribute its own stock to an employer plan and obtain a deduction. Obviously, before a contribution in stock is made, the plan and the agreement of trust must be reviewed to determine if stock ownership in the corporation is permitted.

Contribution of stock to an existing plan does not, of course, have all of the benefits of setting up an ESOP. An ESOP is still a better vehicle for promoting employee ownership of the company, and an ESOP can be leveraged to provide a cash infusion into company capital. An ESOP also has the advantage over regular plans (other than the "eligible individual account plan") of avoiding the 10 percent limitation of ERISA sec. 407(a)(2) on investment in employer securities. Contributions of stock to an ESOP, as to any qualified plan, can be made after year end and, under sec. 404(a)(6), be deducted, but the ESOP itself must have been established prior to year end. Contributions to an existing plan, however, can be made after year end without a cash outlay and deducted even if no pre-year-end planning was done. Also, the contribution of stock to an existing plan can improve the company's balance sheet by reducing the pension liability account and increasing equity accounts, which, of course, improves the company's debt-equity ratios. The effect of these improvements necessarily depends on the size of the stock contribution.

When companies are anxious about meeting growing retirement plan obligations and keeping their financial position as strong as possible in a difficult economy, a contribution of employer stock to the plan may help achieve both objectives.

Pension payment planning may produce permanent tax benefits this year

Rev. Rul. 76-28, applying sec. 404(a)(6), permits both cash- and accrual-basis taxpayers to relate current-year payments to a qualified pension plan back to the preceding year solely for deduction purposes,

as long as the maximum deductible amount for the preceding year is not exceeded, and provided such payments are made before the extended due date of the prior-year return. Often, normal periodic payments made during the current year can be related back for tax deduction purposes. The nonaccrual of such amounts for financial reporting purposes is not a relevant consideration, and the timing of the pension payment for deduction purposes is independent of the timing rules for minimum funding purposes. (Cf. Rev. Rul. 77-82.) Although pension plans are the most likely candidates for planning in this area, profit-sharing plans may also offer some of the same planning possibilities.

Although the tactic of relating back may be used solely to accelerate tax deductions and thereby maximize cash flow benefits, the corporate tax rate changes effected by the Revenue Act of 1978 can produce permanent tax savings for calendar year 1978 and fiscal year 1979 corporations by relating deductions back to years when the tax rate exceeded 46 percent.

Editors' note: This tactic is useable any time that there is a change of the top rate between years.

SECTION 408

Revoking rollover of lump-sum distribution

Recent IRS Letter Rulings 7944097, 7945043, and 7951061 underscore the necessity of careful planning when a lump-sum distribution is received from a qualified plan. In both of the first two rulings, the taxpayer rolled over a lump-sum distribution to an IRA but, after filing a tax return for the year of the rollover, determined that 10-year averaging treatment under sec. 402(e) would produce better tax consequences.

Although the IRS ruled that the taxpayers could file amended returns for the years of receipt and elect 10-year averaging, the resulting double tax consequences are so severe as to create a virtual bar to revoking a rollover: The IRS ruled that the amounts distributed from the IRA are subject to ordinary income tax under sec. 408(d)(1) for the year the rollover is revoked even though such amounts are also separately subjected to a 10-year averaging tax. In addition, the

taxpayer could be liable for the 6 percent sec. 4973 excise tax on excess contributions and the 10 percent sec. 408(f)(1) penalty tax on premature distributions.

It appears that this painful result can be avoided if the rollover is revoked *before* the taxpayer's tax return is filed for the year the rollover contribution is made. (See IRS Letter Ruling 7951061.) In addition, the last sentence in sec. 4973(b) provides that amounts described in sec. 408(d)(4) are treated as not having been contributed to the plan (and thus the 6 percent excise tax would not apply). Finally, the 10 percent penalty tax of sec. 408(f)(1) only applies to amounts included in income and, therefore, at worst, should only apply to any earnings distributed in accordance with sec. 408(d)(4)(C).

ERISA-prohibited transaction exemption: some DOL guidelines

As a result of enactment of the Employee Retirement Income Security Act of 1974 (ERISA), the types of transactions that could be entered into by fiduciaries were severely restricted. Although ERISA provides a statutory exemption from the prohibited transaction rules in section 408(e) of the act, no regulations have as yet been issued. The fiduciary can also request an exemption from the prohibited transaction rules under section 408(a) of the act. An exemption under section 408(a) can only be granted if the exemption request is "administratively feasible, is in the interests of the plan and of its participants and beneficiaries, and is protective of the rights of participants and beneficiaries of such plan."

In a prohibited transaction exemption request the Department of Labor pointed out the following:

1. The equity investment in any real property that is to be acquired by a qualified plan cannot exceed, in any given year, 25 percent of the total plan assets. Equity investment in the property is measured by the original equity investment plus any additional prepayments of principal on loans of the property. The treatment to be accorded normal amortization of mortgage principal is not clear at this time.
2. Periodic revaluations of the property will be required.
3. The plan must maintain a high degree of liquidity in order to satisfy the demands of any participants who may leave.
4. Until regulations are issued, the department will not rule on whether leasing parcels of real property to the employer will qualify under section 408(e).

SECTION 409A

Tax credit ESOP advantages

Some employers may have been deterred from adopting a TRASOP plan, renamed, under the 1978 Revenue Act, as a "Tax Credit Employee Stock Ownership Plan," by the misconception that full voting rights must be passed through to the employee participants, and by concerns that the company's closely held stock might fall into unfriendly hands after being distributed to a former participant. The codification and refinement of the TRASOP rules in sec. 409A, formerly found only in the 1975 Tax Reduction Act as amended, should dispel these concerns.

If the stock is closely held or, more broadly, is not required to be registered under the 1934 Securities and Exchange Act (fewer than 500 stockholders or less than $1,000,000 company assets), the participants need have no voting rights except on questions which, under the pertinent corporation code or corporate articles, must be decided by more than a majority vote of outstanding common stock. These questions ordinarily are confined to sale, merger, or liquidation of the corporation. Under the Delaware Corporation Code and in certain other states, where the state law and company charter permit simple majority voting on these questions, the TRASOP participants need have no voting rights whatever.

In addition, a TRASOP trustee may distribute cash in lieu of stock. If the stock is not readily tradable on an established market (note the difference in definition from that used for voting rights), stock distributed to a former participant must be subject to an employee put option which, if exercised by the distributee, will require the employer to repurchase the stock. Other advantages under the revised TRASOP rules include the availability of a first refusal option by the employer or the TRASOP trustee where the stock distributed is closely held, and the ability to make current distributions from the TRASOP to participants for dividends received on the stock while held in the plan.

Furthermore, the employer now has the choice, under sec. 48(n)(4), to deduct an amount equal to investment credit recapture, or to reduce the contribution otherwise required for the recapture year or future year of pledged cash or stock value equal to that year's investment credit. Together with other inducements, such as recoupment of administration expenses, it would appear that most employers should find TRASOPs advantageous, even though traditional ESOP plans are otherwise unsuitable for them.

SECTION 412

Pensions: minimum funding when due date falls on Saturday, etc.

Sec. 404(a)(6) provides that a taxpayer is deemed to have made a payment to a qualified plan on the last day of the preceding taxable year if the payment is for the taxable year and is made not later than the time prescribed by law for filing the return for the taxable year (including extensions). Sec. 7503 provides that if this date falls on a Saturday, Sunday, or legal holiday the payment may be made on the next succeeding day that is not a Saturday, Sunday, or legal holiday and still be considered timely.

Sec. 412(c)(10) provides that for minimum funding purposes any contributions for a plan year made by an employer after the last day of the plan year, but not later than 2½ months after that day, will be deemed to have been made on the last day. The IRS, under authorization provided by that section, has extended this 2½-month period for an additional six months so that payment can be made for minimum-funding purposes at any time within 8½ months after the last day of the plan years for which the payment is made (temp. regs. sec. 11.412(c)-12). The grace period provided by sec. 7503 does not appear to apply to this extension for minimum-funding purposes. (See Rev. Rul. 72-541 and regs. sec. 301.7503-1(a).)

SECTION 415

1981 dollar limitations on contributions and benefits for qualified plans

The IRS recently announced the new dollar limitations on contributions and benefits for 1981: IR 81-16. These new limitations reflect the latest adjustment made for the annual increase in the cost of living, pursuant to sec. 415(d).

The limitation on an individual's annual retirement benefit from a qualified defined benefit plan is now the lesser of $124,500 or 100 percent of compensation averaged over the individual's high three years. The limitation with respect to the maximum "annual addition" to an individual's account under a qualified defined contribution plan is now the lesser of $41,500 or 25 percent of compensation.

In general, the "annual addition" for the purpose of determining this limitation is the sum of employer contributions, certain employee

contributions, and forfeitures credited to the participant's accounts under profit-sharing plans, stock bonus plans, money purchase pension plans, thrift (savings) plans, target benefit plans, and, in general, employee contribution accounts within defined benefit plans.

Final regulations issued by the IRS late in 1980 permit plan provisions which effect an automatic adjustment to benefits in accordance with the annual limitations so long as the wording precludes the possibility that the limitation imposed by sec. 415 will be exceeded. In addition, the operation of the plan provision cannot be at the discretion of the employer. (See regs. secs. 1.415-5(c)(1) and 1.415-6(d)(2).)

Defined contributions plans: allocating dollar limitations

Sec. 415(c)(1) limits any one participant's allocation of his employer's contribution and other additions to a defined contribution plan to 25 percent of his compensation, not to exceed $41,500 for 1981.

The recently promulgated regulations under sec. 415(c), dealing with limitations on such annual additions, fail to give definitive guidance on how to apportion the dollar limitation (prescribed by sec. 415(c)(1)(A)) where a highly compensated participant is covered by a money purchase pension plan with a mandated annual contribution and a discretionary profit-sharing plan. The IRS's position on appropriate alternatives would be helpful, considering the prevalence of the following situation:

> An employer maintains a qualified money purchase pension plan with a mandated 10% contribution rate and a discretionary profit-sharing plan to which it ordinarily contributes 15% of compensation. The Sec. 415(c)(1)(A) dollar limitation applies, and will continue to apply, to one or more key employees. For plan years through 1980, the money purchase pension plan has been fully funded at the 10% level, and the entire impact of the Sec. 415(c)(1)(A) limitation has been borne by the profit-sharing plan.

The following alternatives appear to warrant consideration:

> (1) Continue giving the money purchase pension plan priority on the strength of:
>
> —Regs. Sec. 1.401-1(b)(1)(i), which defines such a plan as one in which ". . . contributions are fixed . . .;" and
>
> —Sec. 412, which provides for minimum funding standards.
>
> (2) Apportion the Sec. 415(c)(1)(A) limitation on the basis of both plans' contribution rates, i.e., 10/25 to the pension plan and 15/25 to the profit-sharing plan.
>
> (3) Allow affected participants to determine their own allocations.

(4) Permit allocation to be governed by specific and consistent language in each plan document, as implied in Regs. Sec. 1.415-1(d)(1).

Consequently, the IRS's position should be made known to the public, through such vehicles as the following:

- Revenue ruling. This problem seems to be so common that the IRS should state its position in a published ruling for the benefit of all taxpayers. For example, regs. sec. 1.415-1(d)(2) describes two defined contribution plans (profit sharing or stock bonus), presumably *both* discretionary. Do the regulations' coverage of two plans, each having discretionary funding, suggest that where an employer maintains two plans, and only one has required contributions, a priority automatically exists that requires the plan with the mandated rate to be funded first (as suggested in alternative (1) above)?
- Private letter ruling. While this may be acceptable to the concerned employer who seeks it, it fails to address the public's need to rely on the IRS's position.
- New determination letter. While this might be expected to force the issue, it presupposes that each employer resubmitting his plans for approval (as will be required under these new sec. 415 regulations), or the IRS employee plans specialist reviewing the resubmission documents, will have recognized the issue. The weakness of this approach is that, if the employer is not aware of any IRS predisposition in allocating the sec. 415(c)(1)(A) limitation, a second amendment may be likely to perfect the plan under sec. 415(c). This is not efficient tax administration. (IRS Notice 81-2 allows transition time periods for plan amendments to comply with the sec. 415 regulations.)

Obviously, IRS guidance, published as soon as possible, will do much to eliminate confusion and obviate further approval requests under these regulations.

Accounting periods and methods of accounting

SECTION 442

Does loss in a preceding year preclude automatic change of corporation's accounting period?

Pursuant to regs. sec. 1.442-1(c), a corporation is entitled to an automatic change of its taxable year without the consent of the commissioner provided certain criteria are satisfied. One requirement is that taxable income for the short period resulting from the proposed change is, on an annualized basis, at least equal to 80 percent of the taxable income for the immediately preceding taxable year (regs. sec. 1.442-1(c)(2)(iii)). It is unclear whether an NOL in the immediately preceding year would preclude the taxpayer from satisfying this requirement and would necessitate seeking service approval for the proposed change of period and, therefore, satisfaction of the business-purpose or natural-business-year test.

This issue is properly within the jurisdiction of the appropriate district director's office. Thus, if a timely filed statement for an automatic change were to be filed with the district director and then rejected because of a loss in the prior year, it would not be deemed a timely request. (Cf. regs. sec. 1.442-1(b) with (c).) Regs. sec. 1.442-1(c)(3) is not helpful because it deals only with audit changes that result in a failure to satisfy the 80 percent test. Thus, in those circumstances, it is advisable to file a request for change in accounting period with the national office in the first instance so that if the automatic change is disapproved, the taxpayer has already filed a timely ruling request. This question will not arise where there is taxable income in the prior year that is eliminated by an NOL deduction. (See Rev. Rul. 65-163.)

Automatic change of fiscal year—is filing Form 7004 an irrevocable election to change?

A corporate taxpayer is considering a change in its fiscal year end. The corporation is eligible for an automatic change but would like to keep its options open as long as possible. A Form 7004 (application for extension of time to file a return) is due, and the question is raised of whether or not the filing of this form constitutes an irrevocable election to change its year end or whether the taxpayer can still decide to remain on the old year end.

Regs. sec. 1.442-1(c)(1) provides that corporations may change an annual accounting period without prior approval if certain conditions are met and "if the corporation files a statement with the district director with whom the returns of the corporation are filed at or before the time (including extension) for filing the return for the short period required by such change." It is not uncommon for a corporation to request permission (as opposed to making the automatic election) to effect such a change and then later to conclude that the change was not desirable. In such a case, the corporation is not bound by its request to make the change and can remain on the old year end by merely notifying the national office of its change of mind. (Note that permission to change is at the discretion of the national office, whereas automatic changes are handled through the local district.)

In discussion of this matter with the national office, it was pointed out that permission to change will not be granted unless all conditions imposed by the IRS are met. Failure to meet any condition—including the filing of a short-period return with the local district—invalidates the request and leaves the taxpayer on his old year end. Similarly, it was argued, the automatic change is, in reality, the granting of permission from the IRS without the involvement of the national office.

It should, therefore, be possible to invalidate the permission by failing to file a short-period return. It is recognized that Rev. Rul. 57-589 can be interpreted as holding a Form 7004 to be the equivalent of a return, but a nonautomatic permission to change fiscal year would fail in the absence of a Form 1120, and it seems that the same should be true of an automatic change.

IRS reaction is that, in such a situation, the taxpayer would have to deal with the district director but that, if the district director were to contact the national office for technical advice, he would probably be told that the taxpayer had not fulfilled all of the conditions for an automatic change and that it probably should be allowed to remain on the old year end. That is, the Form 7004 should not be deemed an irrevocable decision.

SECTION 446

Deferral of income from credit card fees

Under the Depository Institutions Deregulation and Monetary Control Act of 1980, thrift institutions were granted the authority to issue credit cards. Following the lead of commercial banks, many savings and loan associations have begun to charge the users of their credit cards an annual fee for the privilege of available credit on an as-needed basis. Typically, these annual fees range from $10 to $25 and are received shortly after the credit card is issued.

This kind of income generally must be included in gross income in the taxable year in which it is received. Rev. Proc. 71-21, however, apparently allows *accrual-basis* associations to defer the credit card annual fee in part. Such associations can defer the fee—payments (or amounts due and payable)—received in one year for services to be performed by the end of the next taxable year.

The amount that is earned in a taxable year from the performance of services may be reported on a straight line ratable basis. However, the amount included in taxable income may not be less than the amount included in income for financial statement purposes. For example, assume that a calendar year, accrual-basis association starts up its credit card operations, issuing 10,000 credit cards on October 1, 1981, and that an annual service fee of $20 is charged for each credit card issued. The association is allowed to report only $50,000 of the credit card fees in taxable income for 1981 provided that no more than $50,000 is reported as income for financial statement purposes. The balance of the fees is reportable in 1982.

Adopting this method of recognizing income may constitute a change in accounting method, subject to accounting method change provisions. However, if associations are charging this credit card fee for the first time, adopting the deferral method is not considered a *change* in method and, therefore, a change in accounting method request does not need to be filed.

Different accounting methods for tax and financial reporting

In IRS Letter Ruling 8028005, a computer consulting service corporation was permitted to use the cash method of accounting for reporting income, although its financial statements used the accrual method. However, the corporation's permanent books and records

must reflect a proper reconciliation between the two methods, according to the IRS.

The examining agent contended that the accrual method reflected taxable income more clearly than the cash method, that the difference was significant, and that the taxpayer must, according to sec. 446(a), use the same method of accounting for reporting taxable income as it used for its records. The taxpayer argued that its practice is common among taxpayers required to publish financial statements on the accrual method.

The national office cited *Carver* as sustaining the service's authority to require a taxpayer to change the tax method to that used in financial accounting in order to clearly reflect income. However, the national office also referred to Rev. Ruls. 68-35 and 68-83, which suggest that such authority is discretionary. Those rulings allowed banks to remain on the cash method for tax purposes even though they were required to use the accrual method for financial accounting purposes if a reconciliation was readily available. Accordingly, even though financial statements are prepared on an accrual method, the cash method should be available for tax purposes provided there is a reconciliation of both methods.

SECTION 451

Acceleration of income by sale of future rights

A cash-basis taxpayer can sell his right to future income and realize income immediately upon receipt of the sales proceeds. This technique is useful to a taxpayer who wants to fully utilize certain deductions or credits that would otherwise be lost. Support for this technique is found in *Est. of Stranahan*, where the court allowed a taxpayer to accelerate income by selling future dividends (for adequate consideration) in order to offset a large interest deduction. Thus, a tax-motivated sale can result in immediate acceleration of income.

The above decision is distinguishable from others where the IRS successfully challenged arrangements to create income that operated to the taxpayer's benefit. In *Stranahan*, the sale of future undeclared dividends constituted a sale and not a loan because the transfer was for adequate consideration and because there was a risk that the dividends would not be received by the purchaser who was compelled to look to a third person (the corporation that issued the stock) for payment.

On the other hand, sale of future income may be treated as a loan (not a sale) where there is no risk because the seller obligates himself to produce the income for the benefit of the purchaser. For example, a purported sale of future rents (*J. A. Martin*), a purported sale of future manufacturing revenue (*Hydrometals, Inc.*), and a purported sale of future pipeline revenues (*Mapco, Inc.*) were all ineffective to accelerate reporting of income.

An accrual-basis taxpayer can also accelerate income if the conditions in *Stranahan*, above, are met; i.e., (1) sale is for adequate consideration and (2) seller does not guarantee the income.

SECTION 453

Transfer of installment note to Clifford trust

After a taxpayer effects a sale and elects installment reporting under sec. 453, it is ordinarily too late to shift the incidence of taxation on the transaction to another party, such as a low-bracket child or other relative. However, by transferring the installment obligation to a Clifford trust satisfying secs. 671-678, it may be possible to shift the taxation of the *interest income* on the installment note away from the seller. As the trustee collects principal on the note, the capital gain reportable under the installment-reporting provisions would be taxable to the grantor in the taxable year in which realized by the trust (Rev. Rul. 58-242). This may cause a cash-flow problem since the grantor would have to pay the capital gains tax currently, while the Clifford trust rules require the grantor to maintain a "hands off" policy with respect to the trust for at least ten years. However, over the term of the trust, the interest income from the installment obligation should be taxable to the trust or the beneficiary.

The success of this device depends on the transfer of the installment note to the Clifford trust not being a disposition under sec. 453(d). The tax consequence of a disposition is to accelerate the deferred gain into the year of the transfer of the installment note. Since the transfer of the installment obligation to a trust is not a sale or exchange, the measure of the gain on disposition would be the excess of the note's fair market value over its basis. (See sec. 453(d)(1)(B).)

A transfer of an installment note to a trust will be considered a disposition under sec. 453(d) unless the grantor is considered the owner under the Clifford trust rules of the portion of the trust consisting of the deferred profit included in the installment obligation. (See Rev. Ruls. 67-70 and 74-613 but cf. *A. W. Legg*, holding that

the grantors transferred their interest in the installment note, which resulted in a disposition.)

The IRS has issued a ruling in which the transfer of an installment note to a ten-year trust was considered to be a disposition. However, a significant fact in that ruling was that the entire amount of each installment and interest payment on the note was currently distributed to the beneficiary. (See Rev. Rul. 67-167.) Subsequent to that ruling, a district court issued a decision dealing with the transfer of an installment note to a ten-year trust in which the grantor retained the deferred profit on the installment payments. Under the trust instrument, interest income was distributable to the beneficiaries; but principal payments, including deferred-profit receipts, were to be retained and reinvested by the trustee and then returned to the grantor at the end of the trust term. The district court held that this constituted a disposition of the installment note in the year of the transfer. (See *Springer*.) However, it appears that this decision may be erroneous and that the transfer of an installment note to a ten-year trust with similar terms should not constitute a disposition of the installment note under sec. 453(d). (See Ginsburg, "Taxing the Sale for Future Payment," 30 *Tax Law Review*, 469, 540. See also Rev. Rul. 64-302 (not involving sec. 453).)

It is understood that the IRS national office is studying the issues involved in transfers of installment notes to Clifford trusts. The IRS has been unwilling to issue private rulings on such transfers until it completes its study.

It appears that a seller-grantor should be able to transfer an installment note to a Clifford trust without the transfer being considered a disposition under sec. 453(d). The trust instrument would have to provide that the principal payments of the installment note, including deferred-profit receipts, are to be retained and reinvested by the trustee, and returned to the grantor at the end of the trust term. However, in view of the *Springer* decision and the IRS study of the question, taxpayers cannot be certain that such transfers will not be characterized as dispositions. Practitioners should watch for further developments, since such transfers can be very useful planning devices.

Installment Sales Act restricts only spouses for installment sales of depreciable property

Just prior to reporting the Installment Sales Revision Act of 1980 (P.L. 96-471), the Senate Finance Committee added an amendment to the bill in an attempt to deter certain deferred payment sales of

depreciable property. The amendment is aimed at transactions designed to give a related purchaser a stepped-up basis for depreciation prior to the time the gain would be reported by the seller on the installment basis.

New sec. 453(g) effectively places a cash-basis taxpayer on the accrual basis for sales of *depreciable* property between certain closely related parties. All payments on the sale are deemed to be received by the seller in the year of disposition. To define related parties, Congress referred to sec. 1239; however, the attribution rules of that section were considered too broad. The resulting amendment to sec. 1239 may present planning opportunities which were not available before because "related parties" in terms of individuals now will be limited to spouses. (See sec. 1239(b).)

Consider, as one example, the opportunity created by new sec. 1239 for a trust-leaseback arrangement. Assume *T* and his wife own almost all of the stock in a closely held corporation with some small amount (less than 10 percent) held by minor children. A building used in the corporate business is owned by an irrevocable trust for the benefit of the children. The corporation currently leases the building from the trust. The trust now proposes to sell the building to the corporation on the installment method, which would enable the corporation to obtain the depreciation write-off on a stepped-up basis, while the trust reports its income as installments are received.

Prior to enactment of P.L. 96-471, the sale would have been governed by sec. 1239. (See prior sec. 1239(c).) The stock owned by taxpayer and his spouse would be attributed to the children under sec. 318(a)(1) and from the children to the trust under sec. 318(a)(3). Thus, the sale would be to a 100 percent owned entity and all payments received by the seller (trust) would be ordinary income under sec. 1239. This was the price paid for a stepped-up basis and installment reporting of the gain.

The amendment to sec. 1239 removed family attribution except as between an individual and the individual's spouse, however. In the instant case, the parent's stock is not attributed to the children and thereafter to the trust. As a result, the sale falls outside the new related party definition of P.L. 96-471. The seller (trust) is entitled to elect installment reporting for the gain and the buyer (corporation) is entitled immediately to a stepped-up basis for depreciation. Moreover, the seller's gain is capital gain.

Note that such a sale remains subject to the new two-year disposition rule for related parties. (See sec. 453(e).) For purposes of the two-year rule, attribution is under sec. 318, not sec. 1239. Thus, if the corporation disposed of the property within two years after the

first sale, under terms more favorable than the first sale, acceleration of the gain would take place. The two-year rule should have no effect in most cases, however, because the usual objective is to obtain greater depreciation deductions, not to resell.

SECTION 454

Series E bond election on decedent's final return

There are a few after-death planning techniques that may ameliorate what might otherwise be a distorted final income tax return of a decedent because of either unusually low income or unusually small deductions. One of these techniques is to increase income through a Series E bond election.

The Series E savings bonds are issued at a discount; the interest income is usually reportable when the bonds are redeemed. A cash-basis taxpayer would, at redemption, ordinarily report as interest income the difference between the proceeds of redemption and the original cost of the bond (75 percent of face value). Sec. 454(a), however, permits a cash-basis taxpayer to report as income in any one year the total increase in value of his Series E bonds to date—the difference between their redemption values at the year end and their cost. The annual increase in redemption value is thereafter reportable as income by the taxpayer. Most individuals do not take advantage of this election to report annually the increment in value of these bonds. They may not do so on the theory that one should defer the reporting of taxable income as long as possible, or perhaps because they anticipate being in lower tax brackets when the bonds are redeemed.

Many an executor has found Series E bonds among the decedent's assets. The decedent usually has never made a sec. 454(a) election. In such a case, if desirable, the executor has an excellent opportunity to accelerate income into the decedent's final return.

For example, a decedent who had never made a sec. 454(a) election dies owning Series E bonds having untaxed appreciation of $5,000. If the income otherwise reportable on his final return is insignificant or substantially less than the income that will be reported on the fiduciary income tax returns filed after death, the executor is able to achieve overall income tax savings by electing sec. 454(a) treatment on the decedent's final return. (See Rev. Rul. 68-145.) The $5,000 appreciation will be taxed at the decedent's lower tax rates; thereafter, until the bonds are redeemed, the estate will report only the annual increase in the redemption value of the Series E bonds.

However, before making the election, the executor should weigh the effect of losing the sec. 691(c) deduction for the federal and state death taxes—described in sec. 691(c)(2)(A)—attributable to income in respect of a decedent.

Series E bonds reaching final maturity

Pursuant to 31 CFR sec. 316.8(a)(2), Series E United States savings bonds with issue dates from May 1, 1941, through April 1, 1952, reach final maturity 40 years from their respective issue dates. According to the U.S. Treasury, the maturity date of these Series E bonds will not be further extended. Thus, the owners of such bonds can take one of two forms of action—redeem the Series E bonds for cash or exchange them for Series HH bonds.

Redemption. The taxpayer who chooses to redeem his Series E bond(s) must include the excess of the redemption value over the adjusted basis of the bond in gross income for the taxable year of final maturity. (See sec. 454(c).) For example, an E bond with an original face value of $500, bought for $375 in May, 1941, will have a redemption value of about $1,800 at final maturity in May, 1981. If no election was made to report interest annually, all of the $1,425 in accrued interest will have to be reported as interest income for 1981. If under sec. 454(a) the taxpayer had previously elected to treat the increase in redemption value as income received each year, the increase in value previously reported is not treated as interest income upon redemption. Note that no interest will be paid for periods after final maturity.

Exchange. The alternative is to exchange a Series E bond at its current redemption value for a Series HH bond. The current redemption value of the bonds submitted in exchange in any one transaction must be $500 or more. Under 31 CFR sec. 352.7(a), the Series E bond is eligible for exchange until one year after its final maturity date.

Series HH bonds are issued at face amount in denominations of $500. If the current redemption value of the Series E bond(s) submitted in exchange is an even multiple of $500, Series HH bonds must be requested in that exact amount. If the total current redemption value is not an even multiple of $500, the taxpayer has two options. He may either furnish the cash necessary to obtain Series HH bonds at the next highest $500 multiple or receive payment of the difference between the total current redemption value and the next lower $500 multiple. For instance, if the total current redemption

value of the Series E bonds is $4,253.33, the taxpayer may receive $4,000 in Series HH bonds and the amount of the difference, $253.33, or he may pay the difference, $246.67, and obtain $4,500 in Series HH bonds.

The exchange is generally tax-free pursuant to sec. 1037(a). Thus, the taxpayer who exchanges his Series E bonds for Series HH bonds, and who has not been reporting the interest on his Series E bonds annually, may continue to defer reporting the interest on the bonds exchanged until the Series HH bonds reach final maturity, are redeemed, or are otherwise disposed of, whichever is first. Under 31 CFR sec. 352.7(g)(3), however, the taxpayer who receives any difference paid on exchange ($253.33 in the above example) must treat this amount as income for the year in which it is received, up to the amount of the total interest on the bonds exchanged.

Holding Series E bonds after final extended maturity date

Uncertainties still exist as to the timing of the maturity gain upon a Series E bond which runs past the final extended date, 40 years from the month of issue. Possibilities include a tax-free exchange for a Series HH bond or, absent such an exchange, ordinary income for the increment of redemption value over original cost, either upon the expiration of the last extension (as a constructive receipt of income) or deferred increment until actual redemption.

The Department of Treasury fiscal service adopted regulations effective January 1, 1980, under the Second Liberty Bond Act, which were published in February in IRB 1980-5. Part 351 explains the treatment for newly issued Series EE bonds, and states that the owner may defer federal income tax reporting for the increase in redemption value of the bond until the year of final maturity, redemption, or other disposition, whichever is earlier. The regulation also states that the increment in value is interest income. Ordinarily, interest characterization should invoke the constructive receipt rules. Furthermore, there is no indication that the treatment of the Series EE bonds differs from the Series E bonds; the reference to the earlier of maturity or redemption for tax reporting also suggests the constructive receipt concept.

Part 352, on the other hand, which deals with the offer of Series HH bonds, explains that the holder of a Series E bond or Series EE bond may exchange either bond, tax deferred, for Series HH bonds. No mention is made of inability to achieve the tax-deferred exchange for a Series E bond that has run past the final extended maturity

date. The tax-deferred increment transferred from the Series E or Series EE bond into the Series HH bond is reportable under part 352 on the earlier of maturity, redemption, or other disposition. It may be noteworthy in this regard that IRS Letter Ruling 8028022 (April 15, 1980), which confirms that no increment or income is taxable to a profit-sharing plan participant upon distribution in kind to him of Series E or Series EE bonds, does not address the question of when the increment will be taxable to the distributee participant.

It appears that further guidance is needed from the treasury on the income tax status of a Series E bond owner who continues to hold the bond after the final extended maturity date.

SECTION 461

Expense accrual for the self-insured corporation

There is an increasing tendency toward the adoption of self-insurance plans by corporations for accident claims, especially in the area of workmen's compensation. Whether the accrual-basis corporation will be allowed a deduction for amounts estimated to be due in future years for injuries occurring in the current year will depend on the corporation's degree of accuracy in determining the estimate.

In order to establish a deductible expense under the accrual method of accounting, the taxpayer must prove both—

- the fact of liability, and
- that the amount thereof can be determined with reasonable accuracy (regs. sec. 1.461-1(a)(2)).

The ninth circuit held in *Crescent Wharf & Warehouse Co.* that the fact of injury to an employee in an uncontested workmen's compensation case is sufficient to establish the self-insured employer's liability. In reversing the Tax Court, the court of appeals held that this was true even though medical services are rendered or disability occurs at a future time. The taxpayer-employer in that case had a self-insurance workmen's compensation program that was administered by a third party. An initial accrual was established in the month of an employee's injury. Liability was not dependent upon fault or the absence thereof, and denial of liability was extremely rare. Under applicable state law, the employer was required to provide medical treatment, disability payments, and death benefits. It was the plan administrator's practice to review the status of outstanding claims at least once every 90 days.

The taxpayer accordingly arrived at an accrued-expense amount

for workmen's compensation consisting of the following three elements:

1. Actual disbursements in respect to injuries occurring in the current year;
2. Additional amounts estimated by the administrator to be due in subsequent years for injuries occurring in the current year; and
3. Adjustments for updated estimates relating to injuries occurring in prior years.

Further adjustments were made to eliminate excess claims paid by the company's liability carrier. Also eliminated were any accruals that applied to contested claims.

Although the court held for the taxpayer on the issue of liability, it refused to rule on the issue of whether the amount of liability could be "determined with reasonable accuracy." The Tax Court had not reached that question, so the court of appeals remanded the case for a determination of that issue. The court of appeals did instruct the Tax Court as follows:

> This amount can be estimated by experts in the injury cases. The amount of weekly disability payments is known, the doctors have experience in estimating medical costs and length of disability and permanent injury, if any.

In the most significant development since *Crescent Wharf*, the court in *Wien Consolidated Airlines, Inc.*, allowed a deduction for estimated payments due to the minor children of employees killed in the course of their employment. The court sustained the reasonableness of the company's estimate based on evidence presented as to the life expectancy of the minor children over the period (minority) that the company was required to make payments under applicable state law. The court denied a similar deduction for payments due the widows of these employees because the taxpayer failed to present any evidence on the probability of remarriage, a contingency to payment under the same law. The commissioner has recently announced nonacquiescence in *Wien*.

In the most recent case involving an accrual for accident claims, *Steere Tank Lines, Inc.*, the court disallowed a deduction for amounts paid into a "contract premium account" with an insurance company. The balance in the account was applied to accident claims against the taxpayer. Payments into the account were based on a percentage of gross sales, rather than on an assessment of outstanding injury claims. Although the case was primarily decided on a lack of riskshifting, the court found as a conclusion of law that "Steere's payment into the premium contract has no demonstrable relationship to Steere's claims experience or expectations."

Corporations that do accrue amounts for liability on current claims

should do so based on actuarially sound estimates maintained by experts in the injury field. In no case should they accrue amounts for claims that are contested. The corporation should be aware that the service has not adopted the *Crescent Wharf* rationale, as evidenced by its nonacquiescence in *Wien.*

Editors' note: The Tax Court has recently upheld the two part test for deductibility in Southern Pacific Transportation Co. *(accruals for payroll taxes on future year's vacation pay not deductible).*

SECTION 471

Inventories: ten-year spread of adjustment on untimely change to full-absorption method

After the transition period allowed by regs. sec. 1.471-11(e) (full-absorption method) has passed, a ten-year spread of the adjustment is no longer available. As was pointed out, this could cause a hardship to a taxpayer that has an incorrect overall method of accounting or an inventory method that is incorrect with respect to more than overhead.

Question: Is there any relief for a taxpayer, engaged in manufacturing, who never considered inventory in determining taxable income and who now desires to change to a correct accounting method that would require the recognition of inventory? Inventory in this case consists of raw materials, work in process, and finished goods.

Based upon an informal inquiry, we have been advised by the IRS that in a case such as this, the service will permit the amount of the raw material inventory at the beginning of the year of change to be taken into income over ten years. However, the entire amount of the work in process and finished goods inventory, including in both cases the material content, would have to be taken into income in the year of change. While the IRS is willing to exercise its discretion and allow some relief so far as raw material inventory is concerned, it feels that taxpayers were given ample opportunity to change to full absorption and if they did not do so they will have to suffer the consequences. We were also advised that if a manufacturer using the cash method requests a change to the accrual method, the service will permit such taxpayer to deduct in the year of change those accrued expenses at the beginning of the year of change that related to items that went into overhead and were included in the inventory at the beginning of the year of change.

Inventories: five-year adjustment period now available on change to full-absorption method

Rev. Proc. 80-51 makes major changes in the procedures for changes in accounting method. One interesting point under the new procedures is that a taxpayer who now changes to the full-absorption method of inventory costing, as required by regs. sec. 1.471-11(a), will be allowed a maximum five-year spread period for the purpose of taking any resulting income or deduction adjustments into account. In order to qualify for this new adjustment period, taxpayers must satisfy the following requirements:

- Applications must be made on Form 3115.
- Forms 3115 must be filed in accordance with Rev. Proc. 75-40.
- Applications must be filed on or after December 1, 1980.
- Taxpayers must not have been contacted by the IRS in any manner for any year in which the taxpayer was not on full absorption.

This revenue procedure provides that an early application (i.e., qualifying application filed within six months prior to the beginning of the year of change) will be considered, as well as those filed within 180 days after the beginning of the year of change.

Remember that unless taxpayers file their applications before being contacted in any manner by the IRS, they will not be able to avail themselves of the new procedure and thus will receive no spread on any adjustment.

Inventories: living with *Thor Power Tool*

In January 1979, the Supreme Court decided *Thor Power Tool Company*, in which approximately 44,000 inventory items, mostly spare parts, were determined by management to be excess inventory since they were held in excess of any reasonable foreseeable future demand. The taxpayer wrote this inventory down to its net realizable value, which, in most cases, was scrap value. Although Thor wrote down all its excess inventory at once, it did not immediately scrap the articles or sell them at reduced prices.

The Supreme Court held that sec. 471 establishes two distinct tests to which an inventory must conform. First, it must comply "as nearly as may be" with the "best accounting practice," a phrase that is synonymous with "generally accepted accounting principles." Second, it "must clearly reflect the income."

There was no dispute that the write-down conformed to GAAP. The only question was whether the IRS abused its discretion in

determining that the write-down did not satisfy the test's second prong in that it failed to clearly reflect Thor's income.

Although the IRS's discretion is not unlimited and may not be arbitrary, the Court sustained its exercise of discretion because the write-down was plainly inconsistent with the following requirements of regs. sec. 1.471-2(c) and 4: A taxpayer must value inventory for tax purposes at cost unless the market is lower. "Market" is defined as replacement cost, and the taxpayer is permitted to depart from replacement cost only if—

1. The merchandise is defective, or
2. The taxpayer, in the normal course of business, has actually offered merchandise for sale at prices lower than replacement cost.

Although Thor conceded that "an active market prevailed" on the inventory date, it "made no effort to determine the purchase or reproduction cost" of its "excess inventory." Thor thus failed to ascertain market in accord with the general rule of the regulations. In seeking to depart from replacement cost, Thor failed to bring itself within either of the above authorized exceptions.

The Supreme Court's decision is binding, of course, on all taxpayers in similar fact situations. Therefore, any write-down of excess stock or other market write-downs that do not conform to the regulations are not acceptable for tax purposes. However, if the taxpayer has consistently made such write-downs in prior years, it is probable that this constitutes a method of accounting. Under the regulations, the taxpayer may not change its method of accounting without the IRS's prior permission and the taxpayer is not under any obligation to seek such permission. Therefore, it appears that such write-downs can continue. On the other hand, this issue would have to be conceded if raised by the service upon examination (unless features can be found to distinguish the taxpayer's situation from that in *Thor*). In such event, the taxpayer would be entitled to request the appropriate spread of the transition adjustment under Rev. Procs. 70-27 and 75-18.

In the case of new businesses, if the facts conform to *Thor*, write-downs of excess stock may not be deducted for income tax purposes even if they are necessary for financial statement purposes. In such cases, it may be necessary to have a Schedule M adjustment in the tax return to reflect the deferred tax accounting.

Tax advisers should be alert for circumstances in both old and new businesses that are distinguishable from *Thor*, such as—

- Market is lower than cost, e.g., use of replacement cost (reg. sec. 1.471-4(a)).

- Defective merchandise (regs. sec. 1.471-2(c)).
- Sales below replacement cost, e.g., seasonal sales (regs. sec. 1.471-4(b)).

More on coping with *Thor*

The *Thor* decision, discussed in the preceding item, raises a number of issues which taxpayers must confront.

What is the best way to ensure that an inventory write-down will be acceptable to the IRS? Scrapping inventory in the year it is written down is the most certain way to secure the tax deduction. In fact, the Thor Company was unchallenged on a 1974 write-down of more than $2.5 million of inventory that the IRS believed had been scrapped. Obviously, evidence of scrapping should be retained even though an IRS physical audit of inventory to verify that scrapping has occurred is rather unlikely. Scrapped inventory must not be found in the taxpayer's possession in its original form.

What if scrapping is not desirable from a business point of view? To support a write-down of unscrapped inventory to below its current cost of production in the taxpayer's facilities, evidence must be shown of sales, made by the taxpayer or others, of each type of article in reasonable volume at a price that will justify the write-down. If sales cannot be shown, an offering price for each type of article, less the cost of disposition, may be used to support the write-down. The sale or offering period may not be more than 30 days after the inventory date. Continuing sales of the merchandise at original prices, as was Thor's practice, is not acceptable.

What if inventory has been written down in prior years contrary to Thor? See the item following immediately for a detailed discussion of this point.

What if management does not wish to request the IRS's permission to change accounting methods? A request to change accounting methods will permit the taxpayer to spread the addition to income for improperly written-down inventory over a ten-year period. Sale of the inventory will increase income as the sales are made. If upon audit the IRS forces a change to the correct method, it is possible that the income will be includible in the year of the change with no ten-year spread permitted. Filed tax returns clearly reflecting inventory write-downs contrary to *Thor* that are made after the date of this Supreme Court decision (January 16, 1979) may attract a negligence

penalty for both the taxpayer and the tax return preparer. In the future, inventory records will have to be maintained both on the tax-basis method of accounting required by *Thor* and the method of accounting required under GAAP.

Inventories: IRS seeks to implement *Thor*

The AICPA Federal Tax Division responded to inquiries concerning the effect of *Thor Power* on the preparation of returns containing inventory reserves. This response was that sec. 446(e) requires a taxpayer consistently using a *Thor*-type inventory reserve (i.e., an unsubstantiated formula-type write-down) to continue to use that method of accounting until it voluntarily applies for change or until the IRS initiates a change on audit. However, this result was changed by Rev. Rul. 80-60 and Rev. Proc. 80-5 (announced February 8, 1980, and published in I.R.B. 1980-10).

Rev. Rul. 80-60 states, "Taxpayers have an obligation to file returns prepared in accordance with appropriate laws and regulations; income tax return preparers are subject to a similar obligation in preparing returns. Therefore, if a taxpayer files a Federal income tax return not using the 'prescribed method' of inventory valuation the taxpayer will have filed a return not in accordance with the law. . . ." Accordingly, the ruling holds, "A taxpayer using a method of inventory valuation for 'excess' inventory that is not in accordance with the 'prescribed method' must change its method of accounting to such method for its first taxable year ending on or after December 25, 1979" (e.g., calendar year 1979).

Changes of accounting method require IRS consent. Generally, this consent must be requested within 180 days after the beginning of the taxable year for which the change is desired. Rev. Proc. 80-5 has granted advance consent to make the change required by Rev. Rul. 80-60.

An adjustment is required to prevent amounts of income from being duplicated or omitted when this change in method of accounting for inventory is made. Taxpayers are given the following choice in handling the adjustment, whether positive or negative: The change may be deemed to have been initiated by the taxpayer, or the change may be deemed to have *not* been initiated by the taxpayer.

Under the first choice, the adjustment is to be taken into account ratably over a period of taxable years equal to the number of taxable years during which the taxpayer used the impermissible method. This period may not exceed 10 years. When the entire adjustment is attributable to the taxable year immediately preceding the year of

change, the total adjustment will be taken into account in computing taxable income for the year of change. (The amount attributable to the preceding taxable year is the difference between the adjustment for the year of change and the adjustment that would have been required if the same change in accounting method had been made in the preceding year.)

When 67 percent or more of the net amount of an adjustment is attributable to the first, second, or third taxable year immediately preceding the year of change, the highest percent attributable to the first, second, or third taxable year will be taken into account ratably over a three-taxable-year period beginning with the year of change. An amount attributable to the first, second, or third taxable year is the difference between the adjustment for the year of change and the adjustment that would have been required if the same change in accounting method had been made at the beginning of the preceding first, second, or third taxable year. Any remaining balance will be taken into account ratably over an additional period equal to the remainder of the number of years the taxpayer has used the accounting method that is being changed. The total adjustment period cannot exceed 10 taxable years. This rule only applies if the taxpayer has used the method being changed for at least three taxable years.

If a taxpayer elects lifo during this spread period, the balance of the unamortized adjustment must be taken into account in full as an item of ordinary income in the year for which the election is made.

If at the end of any taxable year during the spread period the value of the taxpayer's year-end inventory is reduced by more than 33⅓ percent of the inventory valued at the beginning of the first taxable year ending on or after December 25, 1979, the balance of the unamortized adjustment must be taken into account in full as an item of ordinary income in the year of the inventory reduction. This rule does not apply if the reduction is attributable to a strike or involuntary conversion.

Under the second choice, the adjustment is modified by the pre-1954-Code-years adjustment (i.e., the 1954 freeze), if applicable. The remaining net adjustment is taken into account *completely* in the year of change unless there is a positive adjustment exceeding $3,000. In this event, for purposes of computing the tax for the year of change, the adjustment can be allocated ratably to the year of change and the two immediately preceding taxable years (if the incorrect method was used for these two prior years). Alternatively, the adjustment can be allocated to prior years under the prescribed method, with any remaining balance allocated to the year of change (if the incorrect method was used for the prior years and the prior

years' records substantiate taxable income under the prescribed method).

Rev. Proc. 80-5 contains two examples illustrating these new rules, as well as procedures to be followed in order to effect the required change.

These new rules do not apply if the use of a nonprescribed method of accounting for excess inventory has been raised by the IRS and is pending as an examination issue as of February 8, 1980. In that case the 10-taxable-year spread period under Rev. Proc. 70-27 is available, unless a shorter spread period applies under Rev. Proc. 75-18. Rev. Proc. 75-18 applies in any of the following situations:

- The taxpayer has been in existence for less than 10 taxable years.
- The incorrect method was used for less than 10 taxable years.
- An insubstantial portion of the adjustment relates to earlier years.

Some questions have arisen about whether the adjustments required by Rev. Rul. 80-60 and Rev. Proc. 80-5 can apply to closed years. These adjustments are governed by sec. 481. The courts have held that sec. 481 adjustments can affect closed years. (See *Graff Chevrolet Co.* and *W. S. Badcock Corp.*)

Note that Rev. Proc. 80-5 was amended by IR 80-48.

The *Thor* rulings and subnormal goods

In *Thor Power Tool Co.*, the Supreme Court sustained the IRS determination that the taxpayer's first-time use of a formula-type, unsubstantiated write-down of excess inventory was an unacceptable method of inventory valuation for tax accounting purposes. To implement its victory in *Thor*, the IRS published Rev. Proc. 80-5 and Rev. Rul. 80-60 in March 1980. Together, the rulings prohibit write-downs of excess inventory under a method not prescribed by the regulations and require taxpayers who have been taking such write-downs to change to a prescribed method for years ending after December 24, 1979.

Although the rulings clearly limit their application to write-downs of excess inventory, no definition of this key term is supplied by the IRS. The lower court decisions, however, make it clear that excess inventory and subnormal (or abnormal) goods in inventory are mutually exclusive categories. The Tax Court observed that excess inventory is excessive not because of its physical characteristics but because of management's view of future demand for it. Similarly, the seventh circuit stated that *Thor*-type excess inventory was not distinguishable from other units of normal inventory—they were

commingled and interchangeable. Both courts referred to subnormal goods (as defined by regs. sec. 1.471-2(c)) as "any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shopwear, changes of style, odd or broken lots or other similar causes."

Under regs. sec. 1.471-2(c) the general rule is that subnormal goods are valued at "bona fide selling prices" less direct cost of disposition. The regulation states, "Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date." This language offers no respite from the *Thor* rulings, since it essentially requires write-downs of subnormal goods to be substantiated in the same manner as dictated by *Thor*.

The regulation then provides an important exception for valuing raw materials or partly finished goods held for use or consumption: Such goods "shall be valued upon a reasonable basis, taking into consideration the usability and condition of the goods, but in no case shall such value be less than scrap value." Thus, unlike write-downs of excess inventory within the scope of *Thor*, write-downs of subnormal raw materials or work-in-process (partly finished goods) that are held for use or consumption need not be substantiated by sale at reduced prices or by scrapping soon after the inventory date.

The application of these rules for valuing subnormal inventory can lead to differing results, depending on the type of goods being written off.

Example. Corporation *A* manufactures drill bits used in a variety of specialized industrial processes. In 1978 the following subnormal items were written down to scrap value on the basis of reasonable estimates:

- *Finished goods*. Finished drill bits, manufactured in 1973, that are technologically inferior to bits made from other alloys currently available on the market.
- *Partly finished goods*. Partially finished bits and associated raw materials that were being manufactured to the unique specifications of a customer that went out of business. Due to the unusual design, there is no other market for the bits, and they cannot be reworked into another salable form at the present stage of manufacture.

The above items should be treated as subnormal goods rather than excess inventories. Accordingly, regs. sec. 1.471-2(c), rather than the *Thor* rulings, governs the proper write-down of these items, with the following consequences:

- *Finished goods*. The finished drill bits are deemed to be unsalable. However, the amount of the write-down must be supported by bona fide selling prices, i.e., an actual offering of goods within 30 days of the inventory date for 1978. Since *A* did not satisfy the substantiation requirement, the IRS may refuse

to recognize the write-down for tax purposes. Thus, for finished drill bits, the write-downs may be disputed by the IRS—but under the 30-day-offering rule for subnormal goods rather than the excess inventory rule. The difference is not without a distinction, since the requirements of the *Thor* rulings (including applying for change in accounting method) do not apply to the write-down of finished bits.

- *Partly finished goods.* Assuming that their scrap value was determined on a reasonable basis (taking into consideration their usability and condition), the write-down of the partially finished goods was proper. It is not necessary for such goods to be scrapped or subject to an offering for sale within the prescribed 30-day period. (The same result would be true for raw materials that are technologically outdated or physically imperfect.)

Thus, write-downs of subnormal raw materials and work-in-process to market or scrap value, on the basis of *reasonable estimates,* are still sustainable for tax purposes, despite the *Thor* rulings. Of course, the special rules applicable to the lifo method of inventory valuation must be observed. (See Rev. Proc. 76-28 and IR 80-48.)

The IRS itself is apparently unsure of how to define the scope of excess inventory. In IR 80-48, amending the earlier pronouncements, the IRS states that its application of *Thor* will be on a case-by-case basis rather than pursuant to an explicit definition of excess inventory.

Note also that the IRS has not previously attempted a significant distinction between excess inventory and other types of inventory in write-down situations. For example, in Rev. Proc. 76-28, concerning restoring write-downs to cost for goods affected by the lifo election, the IRS considered excess inventory to be in the same class as subnormal goods. IR 1655 confirms this point. If obsolete inventory is involved, the demarcation between what is excess and what is obsolete may become exceedingly blurred.

Finally, it must be emphasized that the questions of whether a write-down is made pursuant to a reasonable estimate and whether the item is subnormal are separate issues from that of the application of *Thor*. As always, this involves a facts and circumstances determination.

SECTION 472

Lifo—timely election without Form 970 information

For the taxable year in which lifo is adopted, regs. sec. 1.472-3(a) requires that a statement be attached to the income tax return either

on Form 970 or in such other manner as may be acceptable to the commissioner. Rev. Proc. 74-2 provides that a Form 970 need not necessarily be filed if the taxpayer includes *all* the information required by Form 970 on a timely filed income tax return for the year of adoption.

If these requirements are not met, is the election automatically invalid? Not necessarily so. Apparently Rev. Proc. 74-2 is meant to be an *example* of a lifo election that is considered valid, even though Form 970 is not attached to the taxpayer's return. At least that's the conclusion of the national office of the IRS in a technical advice memorandum based on the following facts:

- Taxpayer elected lifo on its return (indicated on schedule A and elsewhere on Form 1120) but did not attach Form 970 or the information required by Rev. Proc. 74-2.
- At the same time, taxpayer amended its return for the prior taxable year to restore previous years' market write-downs and to revalue the ending inventory on such return at cost, as required by sec. 472(d).
- It stated in all of its reports to shareholders and the SEC that lifo had been elected, and it subsequently filed an amended return for the year of election and attached a Form 970.

The national office concluded that the taxpayer had substantially complied with all the provisions incident to the adoption and use of the lifo method, and the record of the taxpayer's intent to elect lifo was "in such other manner as may be acceptable to the Commissioner."

Editors' note: In Rev. Ruls. 78-262 and 79-418, the service ruled that the failure to submit a Form 970 and the information required thereon results in an invalid election. See also Rev. Proc. 79-63, wherein the service sets forth the considerations pertinent to determining whether good cause exists for granting an extension of time to file Form 970 pursuant to reg. sec. 1.9100-1.

Lifo: proposed regs. on use of BLS indexes

Rev. Rul. 75-181 holds that only department stores meeting the requirements of Rev. Rul. 23 may use the Bureau of Labor Statistics (BLS) indexes in connection with the lifo inventory method. Rev. Rul. 23 holds that a retail establishment known in the trade as a "specialty store" may, without further proof, qualify as a "department store" for the purpose of using the BLS indexes if it has a reasonable number and variety of departments and if the goods carried in its

various departments are reasonably similar to those carried in corresponding departments by a typical department store in its general locality.

On January 16, 1981, the IRS proposed regulations that would allow taxpayers to compute a price index for valuing an inventory pool by using 80 percent of the percent change in selected consumer and producer price indexes published by the BLS. Product pools can be formed for any group of goods included in one of the 11 general categories of the CPI.

However, the IRS stated that it has not determined how to apply the 80 percent limit to the inflation rate for more than one taxable year and wants public comment on a solution. The 80 percent limit is to offset overestimates and underestimates of inventory price changes that are tied to the CPI or PPI.

The proposed regs. specify that indexes used for pools must closely resemble the type of goods contained in the pools set up by the taxpayer. The IRS wants suggestions on additional criteria for picking the appropriate BLS index, particularly for specific types of businesses.

Editors' note: Taxpayers should proceed with caution before employing price indexes, since the regulations will not be effective until specifically adopted. Further, a taxpayer already on lifo may not adopt the inventory price index computation method without requesting approval for a change in accounting method. This appears to be true even though Congress has directed the service to issue regulations permitting the use price indexes. (See new code sec. 472(f).)

Lifo: use of natural business-unit pool by wholesalers

Under regs. sec. 1.472-8(c), before a wholesaler, retailer, jobber, or distributor can adopt a natural business-unit pool or change from multiple pools to a single pool, the prior consent of the commissioner must be obtained.

We have been informally advised of a favorable private ruling that suggests greater receptiveness by the IRS national office to the use of a natural business-unit pool by wholesalers. The rationale of the ruling, which permitted a taxpayer engaged in the wholesale distribution of certain industrial supplies and equipment to combine several dollar-value pools into a single dollar-value pool, was that all the goods in the wholesaler's inventory were substantially similar

and directly related to one industry and one product line. This product-line concept of the natural business unit might be successfully utilized by various types of wholesalers and jobbers. The following factors may support the propriety of a natural business-unit pool for a wholesaler:

- All inventory items are similar and directly related as to source, origin, and manufacturing industry;
- There is no departmentalization of the purchasing function;
- Individual salesmen handle and sell all inventory items;
- All inventory items are similar and directly related as to potential purchasers;
- Potential purchasers use or sell all inventory items; and
- The ultimate consumers or users of the goods all use and consume the same products.

Editors' note: In Rev. Proc. 79-23, the service indicated that improper pooling will not warrant the termination of a lifo election. Further, sec. 237 of the Economic Recovery Act of 1981 (adding code sec. 474) permits small-business taxpayers to use one pool for purposes of sec. 472(b), applicable to taxable years beginning after December 31, 1981. Special transitional rules are provided for those taxpayers who are currently using multiple pools.

Dollar-value lifo: IRS criteria for change to link-chain method

In applying dollar-value lifo procedures, there are three possible methods of application. These three methods, discussed in regs. sec. 1.472-8(e)(1), are the double-extension method, the index method, and the link-chain method.

The main difference among these methods is the manner of computation of an index of changes in costs. Under both the double-extension and index methods, the index is derived by pricing inventory at both current and baseyear costs. The index method allows for use of a sampling technique in pricing that can reduce the mechanical burden of the process.

The link-chain method involves the use of a cumulative index. This technique eliminates the need to value inventory at baseyear costs. Instead, an annual index is derived by pricing inventory at beginning and end-of-year prices. These annual indexes are then multiplied cumulatively to arrive at the current-year index expressed in terms of base costs. This method can greatly simplify lifo computations. As a result, many taxpayers are attempting to change to the link-chain

method from one of the other two methods of computing the cost index.

In regs. sec. 1.472-8(e)(1) the IRS expresses a clear preference for the double-extension method. In cases where this method is impractical, the index method may be used. Only in cases where the taxpayer can demonstrate that both the double-extension and the index methods are impractical or unsuitable in view of the nature of the pool will the use of the link-chain method be approved, according to the regulation.

The IRS national office will apparently approve a change to the link-chain method only when there is an extreme fluctuation in the items constituting the inventory. In this regard, a formula has evidently been developed by the national office to measure the level of turnover of items in a lifo inventory pool during a five-year period. This formula involves computation of two ratios:

$$\text{Ratio \#1} = \frac{W}{X}$$

W—Number of inventory items deleted from the lifo inventory pool during the five-year period preceding the year for which the change is requested.

X—Total number of items in the lifo inventory pool at the beginning of the five-year period.

$$\text{Ratio \#2} = \frac{Y}{Z}$$

Y—Number of inventory items added to the lifo inventory pool during the five-year period.

Z—Total number of items in the lifo inventory pool at the end of the five-year period.

If during the five-year period preceding the taxable year for which a change to link-chain is requested, each of the ratios equals 90 percent or more, it is understood that the national office will approve the change. If each of the ratios is as low as 85 percent, a change to the link-chain method may be approved.

The test levels of the ratios used in the analysis by the IRS have been reduced from about 95 percent to 90 percent over the past few years. Whether or not this represents a trend on the part of the IRS toward less resistance to the link-chain method is not clear.

This discussion has focused on the criteria used by the IRS in approving requests for change to the link-chain method. Note that since an initial lifo election is subject to the approval of the IRS, these same criteria may be employed for that purpose; accordingly, taxpayers contemplating a change to lifo should retain adequate records regarding the turnover of inventory items.

Insilco affirmed—another bite out of lifo conformity

On April 17, 1981, the Second Circuit Court of Appeals affirmed the Tax Court decision in *Insilco Corp*. The Tax Court had held, contrary to Rev. Rul. 70-457, that it was not a violation of the lifo conformity requirement of sec. 472(e)(2) to issue consolidated financial statements reflecting the operating results of subsidiaries on a non-lifo method even though the subsidiaries used lifo for tax purposes.

Insilco and its three subsidiaries filed a consolidated federal income tax return. The taxable income of each subsidiary was computed based on the lifo method of inventory valuation, which each had properly elected in an earlier year. For financial statement purposes the subsidiaries reported to Insilco on a lifo basis; however, Insilco converted these reports to reflect inventories in a moving average (non-lifo) method. Insilco then issued financial reports to its shareholders, which reflected the combined operations of Insilco and its subsidiaries based on the moving average method of inventory valuation.

The IRS contended that the issuance of such consolidated financial statements by Insilco to its shareholders violated the lifo conformity requirement, thereby resulting in a termination of the lifo election of each subsidiary. The following factors formed the basis for the courts' decision in favor of the taxpayer:

- IRS regulations, which provide that the common parent is the sole agent for each subsidiary in all matters relating to the consolidated tax liability of the group, do not put the parent corporation in an agency capacity for purposes of applying the conformity requirement. Thus, Insilco's statements were not issued by the taxpayer subject to the conformity requirement (i.e., each subsidiary).
- The consolidated financial report was not issued to "shareholders, partners, or other proprietors, or beneficiaries" of the lifo subsidiaries. All reports issued by the subsidiaries to their sole shareholder (Insilco) were based on lifo. The court also rejected the argument that the shareholders of Insilco were indirectly shareholders of each wholly owned subsidiary, or that they were "other proprietors" within the meaning of the IRS regulations on conformity.
- The parent company was an active and operating entity whose inventory was valued using a non-lifo method. The court indicated that the result might have been different had the electing corporations established a holding company merely to circumvent the conformity requirement.

Perhaps the most significant ramification of the *Insilco* decision is that non-lifo companies whose subsidiaries have inventory now can have their subsidiaries change to lifo for tax purposes, while continuing to use a non-lifo method for financial reporting purposes. However, companies that are already using lifo for both book and tax purposes should be careful not to view the *Insilco* case as justification to switch back to fifo for financial reporting purposes, since this change could jeopardize the subsidiary's lifo election for tax purposes. Moreover, a switch to fifo for financial reporting purposes would be a change in accounting principles which requires the company and its independent accountant to agree as to preferability. Ordinarily this will not be so. Note also that companies wishing to restructure their corporate operations to increase the potential tax benefit, e.g., forming a new holding company (with operations) or transferring a portion of the parent's business activities with inventories to new operating subsidiaries, could be subject to IRS challenge. The Tax Court decision specifically noted that the "substance vs. form" or "sham" arguments may be employed successfully by the IRS to form-oriented restructurings.

The consequences of this decision are likely to evolve over time for several reasons. First, it is not clear whether the IRS will follow the *Insilco* case. Second, the court based its decisions on very specific facts and circumstances. Companies wishing to apply the principle of the *Insilco* case to somewhat different facts should recognize that they could be challenged by the IRS.

Editors' note: Recently adopted regs. sec. 1.472-2(e) does not resolve the problem.

Lifo: adoption by corporation formed under sec. 351 by fifo transferor

In IRS Letter Ruling 7839056, the service took a highly questionable position on the sec. 472(d) adjustment following a sec. 351 transfer. Sec. 472(d) provides that when a taxpayer elects lifo for a taxable year, the preceding year's ending inventory must be restated to cost so that any market write-downs are includible in income.

In the facts of the ruling, the transferor, an individual, used fifo, lower of cost or market. The individual transferred a business, including inventories, to a new corporation in a sec. 351 transfer. The transferee corporation elected lifo in its first year and did not propose to make any sec. 472(d) adjustment on the apparent grounds that its opening inventory was at transferor's basis, pursuant to sec.

362, and that it had no preceding closing inventory as described by sec. 472(d).

The ruling holds that the corporation must increase its opening inventory to the transferor's cost and report the restoration as income in the year it elects lifo. The stated grounds for the holding are that lifo is a cost method and that a failure to carry the inventory at cost would distort income. The ruling also indicated that under the authority of regs. sec. 1.472-4, the service would require the restoration as a condition of the election.

The ruling does not explain how a distortion of income can arise by using the transferor's basis as required by sec. 362, nor does it explain why sec. 472(d) has any application since the transferee corporation had no preceding closing inventory and thus had no write-downs to restore. For purposes of sec. 472(d), the transferor's cost would seem irrelevant to the transferee corporation electing lifo.

Editors' note: The service has confirmed this position in Rev. Rul. 79-127, involving the transfer of assets by a partnership.

Electing lifo with undervalued inventories

Taxpayers with undervalued inventories who are thinking about a switch to the lifo method should consider some planning that could result in a substantial deferral of taxes.

In making a lifo election, the code requires that beginning inventories for the year of change be valued at cost. (See sec. 472(d).) For taxpayers who have taken write-downs below cost, this is accomplished by filing an amended return for the year preceding the year of change. The resulting adjustment from restoring these write-downs is an item of income, and the full amount is subject to taxation upon filing the amended return. (See Rev. Proc. 76-6.)

The IRS's position is that the restoration required for making the lifo election relates not only to the lower of cost or market write-downs permitted under regs. sec. 1.471-4, but also any other write-downs below original cost. These include the regs. sec. 1.471-2(c) adjustments allowed for damaged, obsolete, etc., goods, as well as write-downs not permitted by the regulations. Therefore, a taxpayer with excess inventories (as in *Thor Power Tool*) must also restore the full amount written down.

As an alternative to this course of action, a taxpayer with undervalued inventories should consider first requesting an accounting method change from the IRS to "clean up" his inventories. If granted,

and if other conditions are met, the taxpayer should be able to spread at least a portion of the income resulting from the restoration adjustment over a period of up to 10 years, instead of recognizing it all in one year. (See Rev. Proc. 70-27.) A word of caution, however: the two steps (i.e., the accounting method change and the subsequent lifo election) cannot be part of an overall plan conceived for the sole purpose of getting a spread of the lifo cost restoration. The IRS has adopted a two-year rule as a guideline in enforcing this, which is one of the standard paragraphs in ruling letters granting taxpayers permission to change their methods of accounting for inventories. Essentially, it is the IRS's position that ordinarily the two steps will not be collapsed into one if the taxpayer waits to make his lifo election until after the year of the accounting method change and one year thereafter. For example, a calendar year taxpayer who had filed an application for change in accounting method for 1980 could make the lifo election for 1982.

Note: Taxpayers with excess inventories under Rev. Rul. 80-60 and Rev. Proc. 80-5 (*Thor Power Tool* write-downs) may not avail themselves of a lifo election at any time during the spread period they are using for this adjustment without recognizing as income the full unamortized balance of the adjustment.

Also, most taxpayers elect the lower-of-cost-or-market method, as permitted by the regulations, when cleaning up their inventories (they presumably were already on this method, albeit using a write-down procedure not in accordance with the regulations). Thus, the restoration from bringing this inventory from lower of cost or market up to cost would all be recognized at one time when lifo is elected. If the taxpayer requested cost valuation in the method change application, he would have to come up with a valid business reason for doing so and, in addition, would probably be suspected of having an integrated plan if lifo were adopted two years later.

Finally, in order to fully evaluate the benefits to be gained from this suggested two-step approach, the taxpayer should weigh the disadvantages of forgoing the lifo election for two years against the value of spreading the undervalued inventory adjustment. If the undervaluation is large enough, the latter could very well pay.

Editors' note: Sec. 236 of the Economic Recovery Tax Act of 1981 amends sec. 472(d) to provide that the adjustment shall be taken into income ratably over three taxable years beginning with the year lifo was adopted (effective for taxable years beginning after December 31, 1981).

A car is a car is a car? Lifo inventory pools for automobile dealers

In April 1978, the IRS national office issued two onerous technical advice memorandums, Letter Ruling 7827018 and Letter Ruling 7916001, concerning the establishment of lifo inventory-valuation pools for automobile dealers. In *Wendle Ford Sales, Inc.*, decided June 7, 1979, much of this onus has been removed.

The area of controversy centered around determination of lifo pools under the dollar-value method of inventory valuation. The service, in its technical advice memorandums, denied the taxpayer's contention that all cars are freely substitutable or fungible goods that can be categorized into one dollar-value pool. The service stated that automobiles are unique and that the buying public associated a certain quality or character with each particular—and therefore different—model of automobile.

In order to measure the lifo index accurately, the position of the service is that separate indices should be computed for each model of automobile. Thus, if any one dollar-value pool is used for each make of car (e.g., Ford vs. Mercury), then additional subcomputations must also be made for each model of car (e.g., compact vs. luxury). The subcomputations are then aggregated in order to ascertain the lifo value regarding each such make. The service maintains that "by stratifying and segregating the new car inventory in this manner, artificial liquidations and increments are minimized; the index computation is based on a rational principal of comparability; and the integrity of the lifo pool is maintained."

While this approach is reasonable in terms of establishing lifo pools, the service further ruled that in order to allow a comparison between the ending inventory and the baseyear inventory, the nature of the items included in the pools must be similar. Because of various technological improvements that have been added to new automobiles, such as catalytic converters, electronic ignition systems, etc., this cost, if identifiable, has to be removed from the factors used to determine the lifo index. If these amounts cannot be specifically determined, then the earlier inventory cost should be adjusted to include these improvements.

While agreeing with the taxpayer's position of establishing a single pool for new-car inventory consisting of five model-subpools (luxury, Fords, intermediates, subcompacts, and compacts), the Tax Court in *Wendle* severely restricted the service's position requiring technological improvements to be adjusted to the baseyear cost. The case rested upon the taxpayer's position that the term "item," as defined in regs. sec. 1.472-8(e)(2)(iii), refers only to a motor vehicle and not

to the individual components. Thus the real issue is whether, for example, a 1974 compact model is the same item as a 1975 compact model. The court agreed with the taxpayer's position although it limited its discussion to the specific facts of the case. The court would not say that a "car is a car regardless of the model and style changes that are made." It limited the overall application of the item issue to provide that when substantial changes have in fact occurred over a period of time, such as ten years, a proper adjustment to baseyear cost might then be applicable. The determination of when the improvements are substantial enough to warrant an adjustment to baseyear cost can only be made by examining the facts of each case.

It appears that while models of cars must be separated into various subpools, such as compact, subcompact, etc., technological improvements need not be segregated and added to cost unless substantial improvements have been made. While the courts have held the service at bay on this issue, it would appear that the definition of the term item remains at large. Even though this decision dealt only with automobiles, it should have far-ranging application to all dealers of products that experience frequent model changes and technological advances.

Editors' note: The service has acquiesced in Wendle *(1980-2 CB 2). Further, the Tax Court has recently held in two cases (*Fox Chevrolet, Inc. *and* Richardson Investments, Inc.*) that only two pools (one for automobiles, one for trucks) must be used by an automobile dealer.*

. . . cost-component method challenged by IRS

Last year, the IRS national office issued a technical advice memorandum (IRS Letter Ruling 7920008) dealing with the cost-component method of computing a dollar-value lifo price index. In the facts presented, the taxpayer used the link-chain method for determining its annual lifo index based on the cost elements of its inventory. A separate lifo price index was computed for the material, labor, and overhead cost components. The separate indexes were then aggregated into a single price index used to value lifo increments.

The IRS technical advice memorandum concluded that direct labor cost was not an *item* of inventory for purposes of computing lifo values, and, therefore, the cost-component method was inappropriate. It appears that the IRS's main objection to this method is that its treatment of productivity efficiencies could result in the allocation of less labor and overhead to base period inventories than was originally allocated when lifo was first adopted. A converse effect could take

place where productivity decreases exist. Denial of the use of the cost-component method by the IRS has caused concern among tax practitioners since many large companies use it.

A simplified example may illustrate the distinction between the cost-component method and traditional double extension lifo:

> Assume the base period inventory contained a single item whose only cost component was 100 hours of direct labor at $10 an hour, or $1,000. If in the subsequent year it took only 97 hours of direct labor (at say $11 an hour for a fifo cost of $1,067) to manufacture this item, the cost-component method would ascribe a lifo value of $970 to the base period cost (97 hours at $10) while traditional double extension would result in a continuing base year cost of $1,000.

Since the issuance of this private letter ruling, the service has been considering publication of its conclusions as a revenue ruling. Meanwhile, the service has received many adverse comments about its conclusions. The point of the comments has been that (1) many companies use this method and denial of its use would cause a significant effect on their cost accounting system; and (2) use of this method is supportable under the current lifo regulations.

At present, this controversy lingers on within the service and the Treasury Department, and its resolution is uncertain. In the meantime, companies currently using the cost-component method should continue using it since any change would constitute a change in accounting method that requires advance IRS approval. Companies contemplating the adoption of lifo should be advised that this question is still unresolved and that use of this method may eventually be denied.

SECTION 481

Negative adjustment deduction resulting in NOL in year of change

Several years ago, when ruling on changes in a method of accounting, the IRS imposed the condition that if there was a loss in the year of change, the taxpayer had to contact the service to determine how to handle the loss. Depending upon the circumstances, the service might require that the loss be carried forward, etc. About two or three years ago, the service stopped including that condition in its rulings. Recently, however, a taxpayer sought and obtained permission to change from the percentage-of-completion to the completed-contract method in connection with long-term contracts. There was

a negative adjustment involved. One of the conditions for granting the permission to change stated the following:

> To the extent that the ratable portion of the negative Section 481(a) adjustment to be taken into account in the year of change creates or increases an existing net operating loss for such year, such amount may not be carried back to earlier taxable years, but must be carried forward until absorbed over the appropriate number of taxable years specified in Section 172 of the Code.

It is our understanding that a similar provision is now being included in all change-in-accounting-method rulings involving a negative (deduction) adjustment.

Nonrecognition transaction accelerates sec. 481 adjustment

Most practitioners are aware that certain sections of the code (e.g., secs. 341(f), 617(d)(1), 1245(a), 1250(a), 1251(c), 1252(a), and 1254(a)) can override the various nonrecognition provisions of the code. The result is the recognition of taxable income by a taxpayer in a so-called "tax-free" transaction. In a recent ninth circuit case, *D. R. Shore,* a conflict with IRS procedures on changes in method of accounting yielded a similar result.

A taxpayer changing from the cash to the accrual method of accounting often realizes a net increase in income arising from the adjustments required by sec. 481(a). Pursuant to sec. 481(c) and Rev. Proc. 67-10, the taxpayer is permitted to take this net increase into income ratably over a 10-year period starting with the taxable year of change, and continuing for each of the nine succeeding taxable years. If the taxpayer ceases to engage in a trade or business, Rev. Proc. 70-16 requires the balance of the adjustment not yet reported to be taken into account immediately, unless sec. 381 applies to the transaction.

In *Shore,* a case of first impression, taxpayers operated their business as a proprietorship when they changed to the accrual method of accounting. The change resulted in a positive sec. 481 adjustment which taxpayers began reporting over the 10-year period. Two years later, the proprietorship was incorporated in a transaction qualifying under sec. 351. The individual taxpayer-shareholders continued to report the sec. 481 adjustment on their individual income tax returns for the years following incorporation.

The ninth circuit determined that a corporation and its shareholders are generally to be treated as separate taxable entities. Further, the court pointed out that the continuity required by Rev.

Proc. 70-16 is that of the entity rather than the enterprise. It also noted that while sec. 381 applies to a corporate reorganization under sec. 368, it does not apply to a corporate organization under sec. 351. Thus, the individual shareholders ceased doing business when the property was transferred to the corporation. As a result, taxpayers were required to accelerate the balance of the income adjustments not previously taken into account despite the language of sec. 351(a). The decision in *Shore* is consistent with a 1977 IRS ruling (Rev. Rul. 77-264).

SECTION 482

Sec. 482: letters of credit

Regarding a sec. 482 adjustment imputing income to a parent corporation for its guarantees of a foreign subsidiary's loans, the IRS position has been confirmed in a recent technical advice memorandum that treats the transaction as the rendering of services by the parent corporation measured by the parent's out-of-pocket costs, characterizes the adjustment as foreign source income of the parent, and computes the income at the exchange rate for the periods during which the costs were incurred.

A simpler approach might be for the parent to arrange for issuance of a bank letter of credit to guarantee the foreign subsidiary's defined obligations. The measure of imputed (also foreign source) income under sec. 482 then would be the fee charged by the bank to the parent corporation.

A letter of credit may also be a useful device where an installment seller wishes to have maximum security on his purchaser's obligation, but under Rev. Rul. 77-294 cannot take a purchaser's deposit in escrow in either the year of sale or a subsequent year.

Brother-sister corporations—court upholds one-sided adjustment

A "group of controlled taxpayers" as defined in sec. 482 should not feel secure that adjustments made by the IRS to the income of one member of the group will automatically result in correlative adjustments to the income of another member or members. In *OTM Corporation,* the court sanctioned a one-sided adjustment to the income of a member, holding that the government was not obliged to apply the principles of sec. 482, which would have required a correlative adjustment to the income of another member.

The facts were that OTM leased equipment from its sister corporation, TIERCO, at a rental higher than that which would have been charged had the lease been negotiated at arm's length between unrelated parties. Apparently as a result of negotiations, the taxpayer and the commissioner agreed that a portion of the rent was unreasonable and therefore subject to disallowance under sec. 162. The taxpayer argued, however, that it was improper for the commissioner to disallow a deduction of OTM without, at the same time, reducing the income of TIERCO correspondingly. The taxpayer's argument would have prevailed if the commissioner had been seeking to allocate or apportion income between related taxpayers under sec. 482. (See *Hearst Corp.*) The court agreed that the government had the choice of applying sec. 482, but the taxpayer could not compel it to do so. The court held that OTM's deduction could be denied solely on the basis of sec. 162, which does not require a correlative adjustment. The case serves as a reminder that the benefits of sec. 482 are available only to the commissioner; taxpayers have no right to demand that an appropriate allocation be made. (See regs. sec. 1.482-1(b)(3).)

Although unnecessary to its decision, the court makes a suggestion as to how OTM and TIERCO might have salvaged the situation. If TIERCO had filed a timely suit for refund of tax on the excessive rent included in its income, the court indicated that it might well have joined the two cases "in order to obtain complete adjudication." The validity of this suggestion is open to question. First, there is doubt whether TIERCO could have filed suit for refund until after the amount of the excessive rent became known and had been repaid to OTM. Secondly, even if TIERCO repaid the excessive rent, it would not necessarily be entitled to a deduction. Since the repayment would not be made pursuant to a binding obligation, it would represent a voluntary repayment, which, in similar situations, has been held not to give rise to a deduction. (See, e.g., *Ernest H. Berger*.)

Perhaps, OTM and TIERCO could have protected themselves by including in the case agreement a provision requiring TIERCO to repay to OTM the amount of rent found to be excessive by the IRS. Agreements binding corporate officers to repay to their corporation salaries found to be unreasonable by the IRS have been held to be effective in permitting the officers to deduct the repayments. (See, e.g., *Vincent E. Oswald*.)

Editors' note: But see Castle Ford, Inc., *wherein the Tax Court indicated that the existence of a repayment agreement implied preexisting knowledge of unreasonableness.*

Exempt organizations

SECTION 501

Request for extended advance ruling period by new charity

New sec. 501(c)(3) organizations are generally required by regs. sec. 1.508-1(a)(2) to apply for exemption within 15 months of their organization. The request is made on Form 1023 (Application for Recognition of Exemption). If the organization responds negatively to question 1, part IV of the form (Statement as to Private Foundation Status), it then must answer question 2(a), (b), or (c). If definitive ruling information is either not available or a definitive ruling is inapplicable, the organization must either request an advance ruling or an extended advance ruling.

Request for an advance ruling or an extended advance ruling will enable the organization to be treated as a public charity for the reliance period, as specified in regs. secs. 1.170A-9(e)(5)(iii) and 1.509(a)-3(e). Accordingly, sec. 170(b)(1)(A) will permit individual donors to deduct up to 50 percent of their contribution bases. During the advance ruling or extended advance ruling period, the organization must meet one of the tests specified in regs. sec. 1.170A-9(e)(1), (2), and (3) to substantiate that it is publicly supported and, therefore, is operating as a public charity. The advance ruling period is two taxable years (three if the organization has not been in existence for at least eight months during its first taxable year); the extended advance ruling period according to regs. secs. 1.170A-9(e)(5)(iv) and 1.509(a)-3(d)(4) is five taxable years (six if the organization's first taxable year is less than eight months). Request for an extended advance ruling period will require an extension of the statute of limitations on assessments.

The extended advance ruling period is generally more advantageous to newly created charitable organizations, since it permits the organization a longer period to qualify as a public charity without

jeopardizing the status of the organization or its contributions for the extended reliance period. Since it is relatively simple to request this extended period, newly created sec. 501(c)(3) organizations should consider this procedure whenever it is appropriate. According to Rev. Rul. 77-115, this request may not be made after Form 1023 has been filed.

Co-op hospital laundries taxable

In *HCSC-Laundry*, the U.S. Supreme Court held that a cooperative laundry established by 15 nonprofit hospitals could not qualify for tax exemption under sec. 501(c)(3) since laundry services are not one of the specifically listed activities authorized by sec. 501(e), and that that statutory provision exclusively controls the exemption for hospital cooperative services.

In the absence of a legislative change, the Supreme Court's decision prevents a group of exempt hospitals from obtaining tax exemption for a nonprofit cooperative laundry venture. However, a group of hospitals might consider operating their laundry as a subchapter T cooperative (secs. 1381 through 1388). Although the cooperative organization is taxable in form, it is entitled to a deduction for patronage dividends (1) paid on the basis of the quantity or value of business done with or for the patrons pursuant to an obligation that existed before the cooperative received the amount paid, and (2) determined by reference to its net earnings from patron business. (See secs. 1382(b) and 1388(a).) However, no such deduction is allowed for either amounts paid to patrons from nonpatron business or amounts derived from business with or for patrons who receive no dividends or smaller amounts than other patrons on substantially identical transactions.

Assuming that these statutory requirements are complied with, the taxable cooperative can completely eliminate all of its taxable income. Further, the dividends would be tax free to the patron exempt organizations.

In view of the Supreme Court's decision, the subchapter T alternative provides a practical solution for a group of exempt hospitals.

Supreme Court upholds "line of business" requirement in business league regulation

In *National Muffler Dealers Ass'n, Inc.*, the U.S. Supreme Court upheld the validity of the requirement in the regulations that an

organization must benefit one or more lines of business, not just a single brand or product, to qualify as a business league exempt from tax under sec. 501(c)(6). The case involved a national association of Midas Muffler franchisees. Despite language contained in the association's bylaws and the association's stated purpose of intending to promote the interests of individuals generally engaged in business as muffler dealers, the district court found—and the Supreme Court apparently agreed—that there was no evidence that the association conferred a benefit upon any group other than Midas Muffler franchisees, as distinguished from the muffler industry as a whole or muffler franchisees as a group.

Regs. sec. 1.501(c)(6)-1 defines a "business league" under sec. 501(c)(6) as an organization whose activities are directed to the improvement of business conditions of one or more lines of business, as distinguished from the performance of particular services for individual persons. The term "line of business" in the regulation has been interpreted to mean either an entire industry or all components of an industry within a geographic area. The IRS has consistently held that groups composed of businesses that market or deal in a single brand or type of product do not qualify as a business league. The basis for this position is that such groups benefit a particular product at the expense of others in the same industry.

The seventh circuit, in *Pepsi-Cola Bottlers' Ass'n*, held that an association composed solely of bottlers of a single brand of soft drink did qualify for exempt status under sec. 501(c)(6) on the basis that the line of business requirement contained in regs. sec. 1.501(c)(6)-1 unreasonably narrowed the language of the statute. The Supreme Court granted *certiorari* in *National Muffler* to resolve the conflict between the second circuit, which upheld the district court's denial of tax exemption to the National Muffler Dealers Association, and the seventh circuit.

The Supreme Court rejected each of the taxpayer's arguments and held that the current regulation is a valid and reasonable interpretation of the statute and falls well within the intent of Congress in enacting sec. 501(c)(6). The court refused to substitute its interpretation for the commissioner's since it found that the IRS interpretation was reasonable and within the proper administrative functions of the service as delegated by Congress.

As a result of this case, any businessmen who wish to join together to enjoy the benefits of common association (e.g., increased bargaining power, lower group rates on common expenses), but whose association is based upon a single product or brand that is not an entire industry or that does not encompass all the elements of an industry within a

single geographic area, must consider broadening its purposes and membership in order to meet the line of business requirement if it wishes to qualify for tax-exempt status. Often, however, such a step may be inconsistent with the reason for forming such an association in the first place.

An alternative to attempting to meet the line of business requirement under sec. 501(c)(6) might be to form a cooperative under subchapter T of the code. Although such a cooperative would not be exempt from taxation, it would be eligible for the special deduction for patronage dividends under sec. 1382. Hence, such an organization could become essentially tax-exempt by paying out as patronage dividends to its members any remaining income not expended during the year. Tax-exempt status under sec. 501(c)(6) is clearly the preferable choice (due to such factors as lower postal rates, lower administrative costs, etc.), but where such exemption is not feasible, a subchapter T cooperative should be considered as offering significant advantages over maintaining a normal taxable entity or not forming an organization at all.

SECTION 512

Hospital's referred specimen lab service income held related

Under the code, an exempt organization will have unrelated business income subject to tax if the income is derived from a regularly carried-on activity which is not substantially related to the performance of its exempt function. (See secs. 512 and 512(a).)

Caring for patients is ostensibly within the scope of a hospital's exempt functions, but prior to the issuance of a recent technical advice memorandum and some other unpublished rulings, the IRS had resisted extending the scope of relatedness to services for individuals who were not hospital patients.

However, in technical advice memorandum 8121098, the service concluded that income from referred specimen testing services for private physicians' patients could qualify as related where the facts and circumstances showed that these activities contributed importantly to the objective of serving the health of the community. The hospital involved in the technical advice memo was engaged in nonpatient Pap smear testing, and the nearest commercial laboratory was 70 miles away. (See also technical advice memoranda 8124006 and 8122013.) In 8124076, which also concluded that the referred

specimen service was related, the service noted that although substantial commercial laboratories were located in the hospital's metropolitan area, the hospital possessed testing instruments and highly sophisticated techniques not offered elsewhere. Thirty-five diagnostic procedures were not offered by proprietary laboratories in the area served by the hospital. Moreover, 56 percent of the lab services were offered for the benefit of persons residing outside of the hospital's metropolitan area.

These rulings are significant because they indicate a liberalization of the IRS position regarding the relatedness of services performed for nonpatients to the hospital's exempt function.

Social club's losses from nonprofit activities don't offset investment income

Exempt social clubs (sec. 501(c)(7)) are taxed on both their investment and nonmember income. Many clubs shelter a sizable amount of investment income with their losses on nonmember business. IRS examining officers traditionally have attacked this practice by reducing overhead expense allocated to nonmember business. Now, however, a more direct approach is being taken. Rev. Rul. 81-69 holds that nonmember losses will be denied in their entirety.

The ruling notes that under sec. 512(a)(3)(A) the unrelated business taxable income of an organization described in sec. 501(c)(7) means the gross income (excluding any exempt function income) less the deductions which are directly connected with the production of the gross income (excluding exempt function income). In this connection, sec. 162 permits the deduction of all ordinary and necessary expenses incurred in carrying on any trade or business. To the IRS, recurring losses connote an activity lacking a profit motivation. Such an activity does not constitute a trade or business for purposes of the deduction of expenses under sec. 162. For example, *Iowa State University of Science and Technology* follows the principle that an exempt organization (in this case a university exempt under sec. 501(c)(3)) may not offset net losses derived from a nonprofit activity (the operation of two noncommercial radio stations) against income derived from a for-profit unrelated business (a commercial television station). In Rev. Rul. 81-69, since the "club's sales of food and beverages to nonmembers are not profit motivated because its prices are insufficient to recover costs," the organization has consistently had, and will apparently continue to have, only losses from its sales to nonmembers. Such sales not being profit motivated, "the social club may not, in determining its unrelated business taxable income under sec. 512

. . . , deduct from its net investment income its losses from such sales to nonmembers."

There are several reasons why the ruling should not be upheld by the courts, and at least one reason why the service should hope it would be upheld. The former include the following:

- The nonmember business of an exempt social club is not a separate trade or business, almost by definition. Nonmember business in excess of 15 percent of gross revenues can deprive a club of its exempt status; and a separate activity that caters exclusively to the general public would probably cost a club its exempt status, even if nonmember business did not exceed the 15 percent limit. Moreover, in many clubs, even the entire food and beverage operation is not a separate trade or business; rather it is an integrated part of a sometimes much larger facility that constitutes the trade or business. Sec. 183 prohibits individuals and subchapter S corporations from offsetting losses from activities not engaged in for profit (hobby losses), but there is no similar statute applicable to the activities of regular corporations—nonprofit or otherwise. It is common for businesses to continue departments that lose money because they contribute to the whole. Under the rationale of Rev. Rul. 81-69, loss-leader operations might be disallowed in every instance.
- Sec. 512(a)(3)(A) does not state that nonmember business is a separate trade or business; it merely defines the taxable income of a club otherwise exempt under sec. 501(c)(7), i.e., nonexempt gross income less the expenses directly connected with producing it.
- In *Iowa State University*, the only case cited in the ruling, a central issue was whether the for-profit activity (a television station) was a trade or business separate from the two not-for-profit radio stations operated by the University. (If they were one trade or business, the radio station losses would have offset the television station profits.) In holding that the television station was a separate trade or business, the court considered it important that (1) the radio and TV activities had relatively few employees in common and (2) for a period of time they used entirely separate facilities. On the other hand, in a typical club's food and beverage operation, members and nonmembers use the same facilities and are served by the same employees.
- Sec. 277 was added to the code for the stated purpose of preventing the anomaly of nonexempt status being more advantageous than exempt status. It does this by providing that clubs which operate as nonexempt corporations can deduct member-

related expenses only to the extent of member-related gross income. Thus an argument against Rev. Rul. 81-69 is that, since it does not affect nonexempt clubs, it frustrates the congressional intent evidenced by sec. 277.

- The ruling contains an anomalous element by providing that it is undesirable to sustain losses on nonmember business, while the service contends in another forum (litigation on the question of whether nonmember business should cost a club its exempt status) that losses on nonmember business are a favorable factor for the club. (See *Pittsburgh Press Club.*)

In other areas it is generally in the service's interest to restrict the scope of the term trade or business rather than expand it to include activities. One of the more obvious examples is the partial liquidation area (sec. 346). The service may want to reconsider a ruling that will not pass muster in its intended area and yet be used against it in other areas.

SECTION 514

Cash collateral received by tax-exempt organization for securities loaned to brokers is not debt-financed property

The borrowing of funds by a tax-exempt organization for the purpose of investing in income-producing securities results in acquisition indebtedness, causing the income from the securities to be treated as unrelated debt-financed income under sec. 514 and to be subject to the unrelated business income tax of sec. 511.

A recent ruling illustrates how this type of transaction can be undertaken without causing the security income to be characterized as debt-financed income. In IRS Letter Ruling 8011100 a tax-exempt sec. 501(c)(3) organization loaned securities to brokers who needed the securities in their operations. The brokers were required to collateralize the loans fully with cash or other securities, and the organization was entitled to all interest earned on the loaned securities. Further, the organization was permitted to invest the cash collateral, retaining the resultant interest. It also had the right to terminate the loan and to recover the securities upon notice to the broker and remittance of the cash collateral and the broker's fees.

Sec. 512(b)(1) excludes from unrelated business income payments with respect to securities loans (as defined in sec. 512(a)(5)). Sec. 512(a)(5) defines such payments as amounts received in a transaction

entered into with a broker pursuant to an agreement meeting certain conditions contained in secs. 512(a)(5)(B) and 1058. These conditions were held to have been met in the transaction described above. In such a case, sec. 514(c)(8)(A) provides that the income received from the investment of the cash collateral is deemed to come from the loaned securities, not from the broker's cash collateral. Accordingly, such income is not treated as unrelated debt-financed income.

This IRS letter ruling in effect allows a tax-exempt organization to finance an investment activity with debt but to avoid unrelated-business taxable income by fully collateralizing the loan with securities owned by the organization.

"Neighborhood land" rule can relieve exempt organization of UBI tax

In general, unrelated debt-financed income of an exempt organization is taxable as unrelated business income. (See sec. 514). There is a little-known, little-used exception to this rule—the "neighborhood land" rule. (See sec. 514(b)(3).) There are only two published private letter rulings on this topic—IRS Letter Rulings 7850071 and 7744025.

If an exempt organization acquires real property for the principal purpose of using the property in the performance of its exempt purpose, and the use commences within 10 years of the time of acquisition, the property will not be treated as debt-financed property. In order to qualify for this exemption, the property must be in the neighborhood of other property that the organization owns and uses for exempt purposes, and the organization must not abandon its intent to use the land for exempt purposes within the 10-year period. Churches or associations or conventions of churches have an additional five years (i.e., a total of 15 years) to commence the exempt-purpose use of the property. (See sec. 514(b)(3)(E).)

The organization has five years to establish that the acquired land will be used for an exempt purpose within the 10-year period. If the exempt-purpose use cannot be established, the property will be treated as debt-financed property. The neighborhood-land rule will apply after the first five years of the 10-year period only if the organization receives a ruling from the IRS that demonstrates it is reasonably certain that the property will be put to the exempt-purpose use within the 10-year period.

If an exempt organization secures a ruling, it has the full 10 years (15 for a church) to put the property to the exempt-purpose use without paying UBI tax. If it does not devote the property to its exempt-purpose use, the IRS can assess the tax for the full 10 (or 15)

years despite the regular statute of limitations. If the organization cannot get a ruling because it cannot establish with reasonable certainty that the land will be put to the exempt use, but within the 10-year (or 15-year) period it actually uses the property for the exempt purpose, it can get a refund of the overpayment of taxes even though barred by limitations.

SECTION 528

Lower taxes on homeowner associations not always beneficial

The tax rate on nonexempt income for homeowner associations (including condominium management associations) claiming tax-exempt status has recently been lowered from 46 percent to 30 percent by P.L. 96-605 for years beginning after 1980. Although most of these associations are operated on a nonprofit basis, they are taxed on investment income and also on any income derived from transactions with nonmembers. (See sec. 528).

It is not necessarily a good idea, however, for a homeowner's association to choose tax-exempt status, especially if its taxable income is less than $100,000. Instead, it might be wiser to pay taxes under the regular corporate tax rate schedule, thus benefiting from the substantially lower rates for the first $50,000 of taxable income. (See sec. 11(b).) By contrast, if the association chooses tax-exempt status, it will pay a 30 percent tax on all of its nonexempt income, beginning with the first dollar. The following table shows the considerable difference:

	Income tax	
Nonexempt (taxable) income	Regular corporate rates	30% rate for tax-exempt associations
$ 25,000	$ 4,250	$ 7,500
50,000	9,250	15,000
75,000	16,750	22,000
100,000	26,750	30,000
120,000	35,950	36,000

Note that a homeowner's association may change its tax treatment from year to year by filing Form 1120-H for the years it wishes to be exempt and Form 1120 for years when it does not.

Corporations used to avoid income tax on shareholders

SECTION 542

PHCs: avoiding ineligible affiliated group status

In certain situations, the 60 percent gross income test of sec. 542(a)(1) for personal holding company purposes would be met if it were applied on a separate-company basis, thereby requiring a company to be taxed as a personal holding company (PHC). However, sec. 542(b)(1) allows a consolidated group to make the PHC income test based on the combined adjusted ordinary gross income of the consolidated group unless the group is determined to be an ineligible affiliated group. Sec. 542(b)(2) defines an ineligible affiliated group as one in which any member (a) derives 10 percent or more of its adjusted ordinary gross income for the year from sources outside the group, and (b) 80 percent of this income from outside the group is personal holding company income.

The above provision could trap an affiliated group of corporations, the parent of which is a typical U.S. holding company that owns operating subsidiaries and holds stock in nonaffiliated companies which are less than 50 percent owned. Typically, in such a situation, at least 60 percent of the adjusted ordinary gross income of the parent company would consist of PHC income, such as dividends, interest, etc. Thus, if the PHC test were made on the basis of the parent company alone, it clearly would be considered to be a PHC. For example, assume the parent had the following items of gross income in a given year:

Dividends from outside the affiliated group (Corp. *A*)	$5,000,000
Interest from outside the group	50,000
Interest from within the group	700,000
Total adjusted ordinary gross income	$5,750,000

In this example, 100 percent of the parent's income is PHC income.

The 10 percent/80 percent test is met and the group constitutes an ineligible affiliated group under sec. 542(b)(2). Accordingly, PHC status must be determined separately for each member.

If, however, the stock in Corporation *A* were transferred to an operating subsidiary of sufficient size to avoid the effect of sec. 542(b)(2), the group would not constitute an ineligible group and the PHC tests would be made on a consolidated basis. For example, assuming Corporation *X* is a member of the affiliated group with outside gross profit on sales of $20,000,000:

	Parent (without *A*)	*X* (with *A*)	Total
Adjusted ordinary gross income	$5,750,000	$20,000,000	$25,750,000
Dividend income from *A*	(5,000,000)	5,000,000	—
	$ 750,000	$25,000,000	$25,750,000

After the *A* stock is transferred to *X*, 10 percent of *X*'s income is from outside the group but the 80 percent test of sec. 542(b)(2)(B) is not met. The PHC test could therefore be made on a consolidated basis, and the consolidated group would not be a personal holding company despite the fact that the dividends from outside the group are greater than 10 percent of *X*'s adjusted ordinary gross income. Although the parent's gross income is all PHC income, less than 10 percent of its adjusted ordinary gross income is from outside the group, so the test need not be made on a separate-company basis.

Note that dividends from a member of the affiliated group can effectively shelter outside income for the 10 percent test since the affiliated company dividends are included in gross income for purposes of this test. (See examples 1 and 2 of regs. sec. 1.542-4(b)(4).) However, no sheltering is needed for dividends received from a more than 50 percent-owned, but less than 80 percent-owned, subsidiary that is not a PHC because they are not included in the parent's gross income of PHC income in determining whether 10 percent or more of its income is from sources outside the affiliated group. (See regs. sec. 1.542-4(d).)

Finally, note that dividend distributions from a member of an affiliated group (but not other income, e.g., royalties, interest, etc.) are not included in PHC income and undistributed PHC income under sec. 542 and 545 (IRS Letter Ruling 8025114). However, dividends from the 50-percent/80 percent-owned company are required to be included in the consolidated adjusted ordinary gross income and the consolidated PHC income of the group for the consolidated test.

. . . but planning to avoid consolidated status may be advantageous

Sec. 542(b)(1) provides the general rule that an affiliated group of corporations filing a consolidated federal income tax return must look to combined ordinary gross income for purposes of determining personal holding company status. There are times when this requirement will result in a group being classed as a personal holding company when only some, or even none, of the companies would be so classified on an individual basis. In those cases, it would obviously be beneficial if personal holding company tests could be applied separately.

Careful planning might provide such an opportunity. Sec. 542(b)(2) provides an important exception to the combined income rule so that if any member of an affiliated group of corporations (including the common parent) filing a consolidated return derived at least 10 percent of its adjusted ordinary gross income for the year from sources outside the group, and 80 percent of that income consisted of personal holding company income, the group must apply personal holding company tests on an individual basis. Note that for this test, sec. 542(b)(4) precludes the parent from including dividends received from another corporation in which it has a more than 50 percent voting ownership unless that other corporation is a personal holding company in that year.

To illustrate the planning opportunities, an example is provided. Corporations *P* and *S* have income sources which would normally constitute personal holding company income. Corporation *P* would have a taxable loss except for a large capital gain. Corporation *S* has large taxable income. If personal holding company tests are made on a combined basis, the group will be a personal holding company and a dividend will have to be paid out to the individual shareholders.

	Corp. *P*	Corp. *S*	Combined
Income (dividends, interest, rent)	$ 100,000	$200,000	$300,000
Capital gain	200,000	—	200,000
Total income	300,000	200,000	500,000
Less deductions	(200,000)	(90,000)	(290,000)
Taxable income	100,000	110,000	210,000
Less capital gain	(200,000)	—	(200,000)
Personal holding company income	$(100,000)	$110,000	$ 10,000

Assume, through planning, that *S* has managed to generate enough

outside source income to trigger the exception provided by sec. 542(b)(2). The result is as follows:

- *S*, considered alone, is a personal holding company. To avoid the 70 percent additional tax under sec. 541, a dividend must be paid out to its shareholders.

Taxable income	$110,000
Less applicable FIT	(31,350)
Required dividend	$ 78,650

- *P*, considered alone, has taxable income but, for personal holding company purposes, has realized a loss due to the elimination of the capital gain. No dividend payment to individual shareholders is needed.

Taxable income	$ 100,000
Less applicable FIT	(26,750)
Less capital gain (net of FIT)	(173,250)
Undistributed personal holding company income	$(100,000)
Required dividend	None

- *S* distributes the $78,650 dividend to *P*. *P* still is in a personal holding company loss position by $21,350 and is, therefore, not required to make a dividend payment to its individual shareholders. Furthemore, *P*, at the corporate level, incurs no additional tax liability since the full amount of the divídend qualifies for exclusion under sec. 243(a)(3).
- No tax has been incurred at either the corporate or individual level on the $78,650 dividend.

	Corp. *P*	Corp. *S*
Tax due—pre-dividend		
Taxable income	$100,000	$110,000
Tax	26,750	31,350
Tax due—post-divídend		
Taxable income	$100,000	$110,000
Add dividend	78,650	—
Taxable income before dividend exclusion	178,650	110,000
Dividend exclusion	(78,650)	—
Taxable income	100,000	110,000
Tax	$ 26,750	$ 31,350

Editors' note: Although the tax computations above are based upon rates established before the Economic Recovery Tax Act of 1981, the concept is not changed.

SECTION 543

Sec. 1248 gains as personal holding company income

The gain on the sale of stock of a foreign corporation will be treated as a dividend if sec. 1248 is applicable. A question then arises as to whether this sec. 1248 gain is personal holding company income.

Personal holding company income, as defined in sec. 543, includes amounts received as dividends but excludes gains from the sale of capital assets. (See sec. 543(b)(1)(A).) Sec. 1248(a) provides that the ". . . gain recognized on the sale or exchange of such [foreign corporation's] stock shall be included in the gross income . . . as a dividend." An argument could be made that although the sec. 1248 gain is treated as a dividend, the essential capital nature of the gain has not changed; so for purposes of sec. 543 the gain should be considered a capital gain and excluded from personal holding company income.

IRS Letter Ruling 8027059 and proposed regs. sec. 1.543-12(b), however, indicate that the IRS regards this as an erroneous conclusion. According to these two sources, sec. 1248 gains are included in the computation of ordinary gross income for personal holding company purposes.

Therefore, even though there may be a reasonable basis for excluding sec. 1248 gains from personal holding company income calculations, the practitioner should be aware that this position will undoubtedly be challenged by the service.

SECTION 551

FPHC may be preferable to CFC status

In computing undistributed foreign personal holding company (FPHC) income, sec. 556(b)(4) permits a one-year carryover of a net operating loss. For this and other reasons, a closely held domestic corporation owning a controlled foreign corporation (CFC) may want to plan to achieve FPHC status for the foreign subsidiary. If the stock ownership in the domestic corporation satisfies the FPHC stock-ownership requirement of sec. 552(a)(2) for a foreign corporation (more than 50 percent ownership by five or fewer U.S. citizens or residents), each wholly owned foreign subsidiary will also meet this test (sec. 554(a)(1)). The following example will illustrate the possible advantages of FPHC status in such circumstances.

Domestic Corporation *A* derives most of its income from operations and is owned by what would be defined as a U.S. group in sec. 552(a)(2) if *A* were a foreign corporation. *A* owns 100 percent of the outstanding stock of foreign Corporation *B*, also an operating company, incorporated in foreign country *X*. *B* in turn owns 25 percent of the outstanding stock of foreign Corporation *C*, incorporated in foreign country *Y*. All corporations use the calendar year. By application of the constructive-ownership rules of sec. 554, specifically sec. 554(a)(1), the U.S. group owns *B*. *B*, therefore, meets the stock-ownership requirements for being a FPHC and CFC [sec. 957(a)].

Assume that *B* wants to sell its 25 percent interest in *C* in 1979 at a price that will result in a $750,000 capital gain. The gain will be FPHC income (sec. 553(a)(2)) for purposes of the gross income requirement of sec. 552(a)(1) and the definition of foreign-base company income (sec. 954(a)(1)). Assume further that *B* had substantial accumulated earnings at December 31, 1978, but it had a $650,000 operating loss in 1978 and a $90,000 loss from operations is expected for 1979. The capital gain is assumed to be sufficient to satisfy the gross income requirement of sec. 552(a)(1), so that *B* becomes a FPHC.

If *B* were not an FPHC because *A* was a public company, then *B* would have $660,000 of net income ($750,000-$90,000) and $660,000 of subpart F income in 1979. This would be taxed to *A* for U.S. tax purposes without the benefit of the deemed-paid foreign tax credit because *X*, the foreign country in which *B* is organized and doing business, does not tax capital gains, and operations for both 1978 and 1979 reflect losses for tax purposes under *X*'s tax rules. Also, foreign country *Y* would not tax the gain on the sale of the shares of *C*.

However, since *B* is an FPHC, it has $10,000 of undistributed income that is taxed to *A* as a dividend under sec. 551(b). The $750,000 capital gain to be recognized in 1979 is reduced by both the $90,000 operating loss of 1979 (sec. 556(a)) and the $650,000 operating loss of 1978 that is carried over to 1979 (sec. 556(b)(4)). Therefore, classification as an FPHC operates to the taxpayer's advantage because the prior year's operating loss offsets the current year's capital gain. A corporation may be able to plan when the capital gain will be recognized so as to take advantage of this benefit.

The $660,000 subpart F income of *B* will not be taxed to *A* under subpart F because it was subject to tax under sec. 551(b) for its taxable year (sec. 951(d)). Sec. 951(d) also excludes all of the sec. 951(a) amounts from income, including an increase of a CFC's earnings invested in U.S. property. Thus, there may be other advantages to FPHC status in addition to the one-year NOL carryover.

However, since the FPHC income is imputed to the domestic parent as a dividend (see regs. sec. 1.543-1(b)(1) and prop. regs. sec.

1.543-4(b)), which is personal holding company income under sec. 543(a)(1), each situation would have to be carefully analyzed to determine whether the FPHC status of the foreign corporation might cause its domestic parent to become a personal holding company. This problem is not present if the capital gain is taxed to the domestic parent under the subpart F rules, because capital gains per se are not PHC income and capital gains retain their character under the subpart F rules for purposes of testing the domestic parent as a PHC (regs. sec. 1.951-1(c)).

SECTION 563

Presto! One dividend distribution, two deductions

The proper timing of a dividend distribution can result in a double benefit to a corporation when the corporation is vulnerable with respect to the accumulated earnings tax in one year and becomes a personal holding company or a subchapter S corporation in the next year.

Under sec. 563(a), a corporation's distribution on or before the 15th day of the third month after the close of its taxable year will be treated as having been paid during such taxable year for purposes of determining the sec. 561 dividends-paid deduction for accumulated earnings tax purposes. If, in the subsequent year, the corporation becomes a personal holding company (which can happen, for example, when the corporation sells its business in the preceding year), the distribution used in determining the dividends-paid deduction for purposes of the accumulated earnings tax will also be allowed in determining the sec. 561 dividends-paid deduction in computing undistributed personal holding company income.

> *Example.* Based on a "Bardahl" formula computation, *X* Corporation determines that it has accumulated excess earnings subject to tax under sec. 531 for 1974 of $150,000. On or before March 15, 1975, *X* pays a dividend of $150,000, thereby avoiding the accumulated earnings tax penalty. In 1975, *X* becomes a personal holding company because of a sale of its business at the beginning of the year. In computing its undistributed personal holding company income for 1975, it can again take the $150,000 dividend payment into account since it was not a personal holding company in 1974.

The double-deduction treatment would also apply if *X* became a subchapter S corporation in 1975, instead of a personal holding company. Even though the dividend distribution was made within 75 days after the end of 1974, it will also be treated as a deduction

in computing X's undistributed taxable income under sec. 1373(c) for 1975, assuming the requisite amount of current E&P. This double-deduction allowance in both situations has received the blessing of the IRS in Rev. Rul. 72-152.

Editors' note: The taxpayer should be cautioned that the dividends-paid deduction of sec. 563 shall not exceed 20 percent of the dividends paid for the taxable year.

SECTION 565

PHCs: consent dividends to avoid tainted rental income

Rental income constitutes personal holding company (PHC) income unless (1) the adjusted income from rents is 50 percent or more of the corporation's adjusted ordinary gross income (AOGI) *and* (2) dividends paid for the year equal or exceed the amount, if any, by which its nonrent personal holding company income for the year exceeds 10 percent of its ordinary gross income (OGI) (sec. 543(a)(2)). Thus, under the general rules, a corporation that meets the stock ownership test of sec. 542(a)(2) and has the following items of income and expense is a PHC.

Ordinary gross income	
Rents	$430,155
Interest	52,155
Dividends	800
Other	9,134
OGI	$492,204
Less adjustments to rental income	
Depreciation on rental buildings	$ 99,301
Interest on rental buildings	126,532
Real estate taxes on rental buildings	35,490
	261,323
Adjusted ordinary gross income (AOGI) and assumed taxable income	$230,881

"Rent" test of sec. 543(a)(2)

1) Sec. 543(a)(2)(A)

Adjusted income from rents

$$\frac{(430{,}155 - 261{,}323)}{\text{AOGI}} = \frac{168{,}832}{230{,}881} = 73.125\%$$

2) Sec. 543(a)(2)(B)		
Dividends actually paid during year		$1,000
Nonrent PHC income		
Interest	$52,115	
Dividends	800	
	52,915	
10% of OGI (492,204)	49,220	
	3,695	(3,695)
Excess dividends		—
Personal holding company income		
Adjusted income from rents		$168,832
Interest		52,115
Dividends		800
AOGI	$\frac{221,747}{230,881}$ =	96.044% (over 60%)

Even though rents constitute 50 percent or more of AOGI under sec. 543(a)(2)(A), rents are considered PHC income because the additional sec. 543(a)(2)(B) test is not met. Since more than 60 percent of the company's AOGI is PHC income, the company is considered a PHC subject to the sec. 541 penalty tax of 70 percent on its undistributed personal holding company income (UPHCI). If federal income taxes of $87,881 are applicable, the UPHCI is $142,000 ($230,881 − $87,881 − $1,000), and the penalty tax is $99,400.

An alert practitioner should realize, however, that all is not lost at this point because some post-year-end planning can cure the PHC taint on the rent income and thereby remove the taxpayer from the scope of the PHC tax. Sec. 543(a)(2)(B) defines "dividends paid" to include not only the dividends *actually* paid during the year (sec. 562) but also dividends *considered* as paid on the last day of the taxable year under sec. 563(c) (limited to 20 percent of dividends actually paid during the year by sec. 563(b)(2)), and consent dividends for the taxable year as determined under sec. 565. In the example, an actual distribution within 2½ months after the taxable year under sec. 563(c) will be limited to $200 (20 percent of $1,000) by sec. 563(b)(2). The resulting total dividend of $1,200 would still not allow the company to meet the sec. 543(a)(2)(B) test.

Consent dividends. Will a consent dividend help? A consent dividend is a hypothetical distribution to a shareholder who consents to treat the amount as a dividend that was distributed on the last day of the corporation's taxable year, even though the amount is not actually distributed by the corporation. The dividend is considered to be paid in money to the shareholder and immediately returned to the corporation as a contribution to its capital on the last day of the year. The consent must be filed with the corporation's return.

With the availability of the consent dividend, the next question

becomes how much of a consent dividend should be elected. Should the full amount of UPHCI be distributed? The answer lies in sec. 543(a)(2)(B). Under that section, it is only necessary to consent to enough dividends to avoid the categorization of rents as PHC income. Again referring to the preceding example, assume that the shareholders consent to $3,000 of dividends. The computation under sec. 543(a)(2)(B) is as follows:

Dividends actually paid during year		$1,000
Consent dividends		3,000
		4,000
Nonrent PHC income		
Interest	$52,115	
Dividends	800	
	52,915	
10% of OGI	49,220	
	3,695	3,695
Excess dividends		$ 305

Since the dividends paid for the year exceed the amount by which nonrent PHC income exceeds 10 percent of ordinary gross income, *and* the 50 percent-or-more test of sec. 543(a)(2)(A) is met, rents are no longer categorized as PHC income. The PHC test is then made as follows:

Personal holding company income		
Adjusted income from rents	—	
Interest	$ 52,115	
Dividends	800	
	52,915	= 22.919%
AOGI	$230,881	

Therefore, in the example, the corporation has not only removed rents from the PHC taint but also has effectively removed itself from the PHC taint altogether, since 60 percent of the corporation's AOGI is no longer PHC income. By consenting to only $3,000 of consent dividends, the shareholders have saved $99,400 in corporate penalty taxes in exchange for a nominal income tax cost to themselves of not over $2,100. It obviously follows that in considering the amount of consent dividends it is possible to look for an amount much less than the full amount of undistributed personal holding company income.

SECTION 593

Thrift institution's loss-carryback may result in recomputation of bad debt deduction

The addition to the reserve for losses on qualifying real property loans is, according to sec. 593(b)(1)(B), an amount that may not exceed

the largest that can be determined under the percentage-of-taxable-income method, the percentage-of-loans method, or the experience method. Regs. sec. 1.593-6A(a)(1) provides that the use of a particular method for a tax year is not a binding election for that year or subsequent years. Regs. sec. 1.593-6A(b)(5)(vi) further provides that taxable income, for purposes of computing the deduction for the addition to the bad debt reserve under the percentage-of-taxable-income method in sec. 593(b)(2), is computed by taking into account NOL carrybacks from a taxable year beginning after 1978.

A bad debt reserve addition computed under either the percentage-of-loans method or the experience method is unaffected by an NOL carryback. Consequently, a greater addition to the bad debt reserve may result from using either of these two methods in a year in which an NOL carryback has reduced taxable income for purposes of sec. 593(b)(2). Although it is not clear, regs. sec. 1.593-6A(a)(1) appears to support the theory that a taxpayer may change its method of calculating its bad debt reserve addition in a year otherwise barred by the statute of limitations if an NOL carryback causes a reduction of taxable income for purposes of sec. 593(b)(2) for that year.

Natural resources

SECTION 613

Percentage depletion: IRS approves alternative method of calculating constructive income from mining

In the recent IRS Letter Ruling 8107007, the service took a step it had refused in the past: it approved a taxpayer's request to use an alternative method for calculating constructive gross income from mining as the starting point for the taxpayer's calculation of his deduction for percentage depletion.

The deduction for percentage depletion is calculated in two steps: first, gross income from mining is determined and multiplied by the percentage specified in the code for the mineral; second, taxable income (net) from mining is calculated, and 50 percent of this amount serves as a limitation on the percentage depletion deduction. (See sec. 613.) A higher gross income from mining is usually to the taxpayer's advantage.

If a taxpayer sells his mineral before applying a process characterized in the code as a nonmining process, the gross income from mining will simply be the sales proceeds. Whenever the mineral is sold after the application of a nonmining process, however, the sales proceeds will reflect not only mining income, but nonmining income as well. In such cases the regs. prescribe two methods to determine the portion of total sales proceeds that represents the gross income from the mining process. First, the taxpayer must use the representative market or field price if one is ascertainable. (See regs. sec. 1.613-4(c).) The objective is, if possible, to derive a price which represents the approximate amount at which the taxpayer could have sold his mineral before applying nonmining processes. If no such price is ascertainable, use of the proportionate profits method is ordinarily required. (See regs. sec. 1.613-4(d).) A proportionate profits fraction is calculated by dividing mining costs by total costs and is multiplied

by gross sales to find the portion of sales price resulting from mining costs. This portion is then the constructive gross income from mining. (See *Portland Cement Co. of Utah.*)

Use of the proportionate profits method when a representative market or field price cannot be determined is not an *absolute* requirement. An alternative method may be used if the taxpayer establishes to the satisfaction of the IRS that the alternative method is more appropriate under the taxpayer's particular circumstances than the proportionate profits method. (See regs. sec. 1.613-4(d)(1)(ii).) Until IRS Letter Ruling 8107007, the satisfaction of the service had apparently never been obtained. The fact that an alternative method has finally been approved is significant, but of even greater importance is the service's rationale for approving the method. An understanding will be instructive to taxpayers wanting to use an alternative method.

The first question is, what did the taxpayer establish? The taxpayer showed that the proportionate profits method failed to clearly reflect the gross income from mining of an integrated miner-smelter selling finished products the mining operations of which are more profitable than its nonmining activities. This results from the underlying premise of the method that all costs, mining or nonmining, contribute ratably to profits in the finished product. In the taxpayer's situation, mining costs contributed proportionately more. The taxpayer also showed the alternative method more clearly reflected constructive gross income from mining.

The second question is, how did the taxpayer prove it? First, the taxpayer calculated constructive gross income from mining under both the proportionate profits method and its alternative method. Using each amount, it calculated the resulting return on investment and profit-cost ratio. Second, the taxpayer established the returns on investment and profit-cost ratios of a number of nonintegrated miners and nonintegrated smelters. A comparison of the results under the proportionate profits and alternative methods with the demonstrated industry norms convinced the IRS that the taxpayer's method more clearly reflected gross income from mining.

The final question is: what is the taxpayer's alternative method? Conceptually, it seeks to base gross income from mining on a return on investment in mining activities consistent with industry norms. First, a standard return on investment in mining and smelting activities is determined based upon the industry average over a five-year period. Second, if the combined calculated returns on investments are less than the profits (i.e., a particularly profitable year), the remainder is divided equally between the mining and smelting activities. Third, if the profits are less than the combined calculated

returns on investment they are allocated in proportion to those returns. Once the proper amount of profit has been isolated as mining profit, it is added to the mining costs to reach gross income from mining.

The letter ruling is valuable for a number of reasons. It shows that the service will approve an alternative method. In addition, it describes the rationale for the approval. Finally, it shows that a method can be established as more appropriate by using data available within the particular industry.

Depletion: effect of termination provision in contract on economic interest

When coal reserves are leased to a mining entity, the lessor may find it desirable to provide that the contract or lease is terminable at will or upon short notice (e.g., 30 days). In that case, the lessee will often have all the attributes of the owner of an economic interest for depletion purposes, with the possible exception of the termination provision. The effect of a termination provision on an otherwise valid conveyance of an economic interest has been the source of a continuing conflict between the Court of Claims on one hand and the IRS and Tax Court on the other hand.

The Court of Claims in two recent decisions, *Thornberry Constr. Co.* and *Swank*, followed the position previously taken in *Bakertown Coal Co.* to the effect that a taxpayer may possess an economic interest where the contract or lease conveying such interest is subject to termination at will or upon short notice. It has been the IRS position, as set forth in Rev. Rul. 77-341 and Rev. Rul. 74-506, that a taxpayer will not be treated as possessing an economic interest where the contract or lease is so terminable, and that a taxpayer must have sufficient time to extract a substantial portion of the reserves in place that are covered by the contract or lease.

In summary, the IRS position regarding this matter is clear and is supported by Tax Court decisions, e.g., *Whitmer*. The Court of Claims decisions, including *Bakertown*, *Thornberry*, and *Swank*, are consistent in their inconsistency on this issue, and still hold that a taxpayer may have an economic interest where the contract is terminable at will or upon short notice. In effect, the Court of Claims has treated terminability as just one factor—not to be viewed in isolation—in determining who has the economic interest. In that light, the question is who had the right to the proceeds of the minerals already extracted, not who will have future rights. Obviously, because of the importance of the issue, i.e., the percentage depletion

deduction, it will probably continue slowly toward resolution through the courts.

Editors' note: The Supreme Court has affirmed the Court of Claims in the Swank *case.*

SECTION 613A

Change in percentage depletion rate: keep track of production dates

Beginning in 1981, independent producers and royalty owners face a reduction in the percentage depletion rate for oil and natural gas. The depletion rate applicable to the maximum depletion quantity has remained at 22 percent since January 1, 1975. It will be reduced to 15 percent over a four-year period, and the first phase of the reduction—from 22 percent to 20 percent—applies to production during the calendar year 1981. (See sec. 613A(c)(5).)

The scheduled rate reductions have raised the question of the appropriate depletion rate to be used by cash-basis taxpayers and certain accrual-basis taxpayers for income recognized in one calendar year, but attributable to oil or gas produced in the prior year. For example, a royalty owner may receive payments from the producer in calendar year 1981 that relate to production in October, November, and December, 1980. Are those payments subject to depletion at the 22 percent rate?

The clear language of sec. 613A(c)(5) and the recent position taken by the IRS in Rev. Rul. 81-168 support the conclusion that the applicable depletion rate is determined by the year in which the oil or gas is *actually produced* rather than the year in which the gross income attributable to the production is recognized.

In Rev. Rul. 81-168, a cash-basis, calendar-year taxpayer received income in 1975 from oil and gas produced in 1974. Sec. 613A had become effective on January 1, 1975, and is applicable to taxable years ending after December 31, 1974. Under sec. 613A, the allowance for percentage depletion is limited to specified quantities of oil and gas. The service held that the taxpayer was entitled to percentage depletion without regard to the quantity limitations of sec. 613A(c). The ruling relies on regs. sec. 1.613A-1, which provides that sec. 613A applies only in the case of oil or gas that was *produced* after December 31, 1974, and to which gross income from the property is attributable after such year. Although the income was

attributable to 1975, the requirement of production after December 31, 1974 was not met. The same rationale apparently applies to the reduction of the percentage depletion rate.

Consequently, to apply to proper depletion rate it will be necessary for taxpayers in some cases to perform supplementary analyses of their oil and gas sales to determine the year of production.

SECTION 617

Sec. 617 election as an accounting method

Sec. 617(a) permits a taxpayer to elect current deduction of mine exploration expenses. In the case of expenditures by a partnership, such election is one of four under sec. 703(b) that are made at the partner, rather than the partnership, level.

Neither sec. 617 nor the regulations specify whether the election should be made on a mine-by-mine basis or whether an overall accounting method is involved. However, sec. 617 *does* refer to "expenditures paid or incurred during the taxable year." Notwithstanding this phrasing, and the election differing for each partner, it is understood that the national office has recently determined that such election constitutes an overall method of accounting, which cannot be changed for subsequent years absent permission from the IRS.

This result produces difficult reporting problems and is inconsistent with the result of Rev. Rul. 70-539, which concluded that a real estate development taxpayer could file amended returns, for all open years, to claim interest, taxes, and carrying charges as current deductions where the original returns had capitalized such carrying charges but did not make a formal sec. 266 election. The ruling reasons that no binding election had been made, and by inference does not consider the amended returns to constitute a unilateral change in accounting method.

However, in 1977 the IRS issued Rev. Rul. 77-236, which clarified Rev. Rul. 75-56 and holds that a change in treatment of carrying charges involves an accounting method change to which sec. 481 and Rev. Proc. 70-27 apply. The taxpayer in the 1975 ruling had capitalized carrying charges, but without the formal sec. 266 election, and was deemed to have adopted an accounting method.

This IRS position on the sec. 617 election is contrary to the provisions of regs. sec. 1.266-1(b)(1)(i) and (c)(2)(i), under which a taxpayer is allowed a new carrying charge election each year for

unimproved real property and may make separate elections for different properties within a single year.

It would appear more reasonable to treat sec. 266 and sec. 617 as an election for a particular expenditure to apply only to mines, construction projects, unimproved real estate, etc., for which an election has been specifically filed. Similar expenditures for other properties of the taxpayer could then be reported under its overall method of accounting.

SECTION 636

Capital gain on assignment of mineral property despite retention of royalty

The assignor of an oil and gas property frequently wants to retain a continuing interest in the property, either for bet hedging or because a complete agreement cannot be reached with the assignee regarding the value of the property.

Retention of an overriding royalty interest for the life of the property results in ordinary income for the assignor (seller) because of his retained economic interest. Furthermore, the assignor will not be able to apply part or all of the adjusted basis for his property against the disposition proceeds. These proceeds are treated as a lease assignment or sublease bonus, which is ineligible for percentage depletion because it is not derived from production (and because of the legislative history of the percentage depletion repeal included in the unenacted 1974 tax reform bill). Some observers have suggested that cost depletion might be taken on 100 percent of the disposition proceeds, up to the adjusted basis of the property sold, because of uncertain information on reserves or, for undeveloped properties, no information on reserves. The IRS, though, would only be likely to allow cost depletion on the basis of the taxpayer's demonstration of the total reserves and the portion associated with the retained overriding royalty (leaving the remainder for cost depletion against the assignment bonus on sale of the working interest).

Consideration should be given to the following techniques to achieve the economic objective sought with the royalty retention and still realize capital gain on the net difference between the sale proceeds and the adjusted basis of the property transferred:

- "Cap" or limit the interest so that it constitutes a production payment. This limitation could take the form of terminating payments on a specified date, receipt of a stated dollar amount

(with interest supplement), or receipt of a specified quantity in barrels or MCF of royalty oil or gas sold, whichever occurs first. In addition, the arrangement could provide for terminating the interest upon a reservoir engineering determination that the cumulative production reduced deliverable reserve to a specified percentage of the total reserves in place at the time the property was sold.

- Sell the royalty to a related taxpayer on or before sale of the underlying working interest.
- Give the royalty to a family member or charity on or before sale of the working interest.
- Transfer the royalty as a capital contribution to a related corporate taxpayer on or before the sale of the working interest.

The broad definition of the production payment in sec. 636(c) and regs. sec. 1.636-3(a) should permit a favorable IRS ruling that the nature of a reserved interest with stopper is tantamount to a production payment. This characterization may permit the seller to report royalty payments received as capital gain in an open transaction. If the royalty can be valued, however, deferred-payment-sale reporting would be required under regs. sec. 1.453-6.

The buyer, however, must treat the production payment as purchase-money debt. Therefore, he will be required to report as his taxable income 100 percent of the oil and gas sales, with a partial offset for cost depletion.

It is believed that the preliminary sale, gift, or capital contribution of the royalty will permit treatment of the working interest disposition proceeds as capital gain, since the working interest is the only property held by the taxpayer at the time of its sale.

Estates, trusts, beneficiaries, and decedents

SECTION 644

Sec. 644: planning opportunities for transfers to trusts

Sec. 644 was enacted as part of the 1976 Tax Reform Act to prevent a high tax bracket grantor from using a lower bracket trust to sell appreciated property. It provides that—

- If property is transferred to a trust after May 21, 1976,
- The fair market value of the property at the time of such transfer exceeds its adjusted basis immediately after the transfer, and
- The trust sells the property at a gain within two years of the transfer; *then*
- To the extent of the total gain, the difference between the fair market value at the time of transfer and the adjusted basis immediately after the transfer (i.e., the unrealized appreciation attributable to the grantor's ownership) is taxed to the trust as though includible in the grantor's income tax return (i.e., at the grantor's tax bracket).

For example, assume a 70 percent tax bracket grantor and an 18 percent bracket trust. The grantor has property with a basis of $1,000 and a fair market value of $7,000. He could transfer this property to a trust which would sell the property within two years. Without sec. 644, the trust's tax would be:

Total gain	$6,000
Less long-term capital gain deduction	3,600
Taxable portion	2,400
Less exemption	100
Taxable income	2,300
Tax	$ 351

Under sec. 644, the trust's tax on this gain is as follows:

Total gain	$6,000
Less long-term capital gain deduction	3,600
Taxable portion	2,400
Grantor's tax rate	× .7
Tax	$1,680

Thus, a potential tax saving of $1,329 ($1,680 − $351) is precluded by sec. 644.

However, suppose that the grantor owns only two capital assets which he wishes to sell. Each asset has been held for over a year. Their bases and fair market values are as follows:

	Basis	Fair market value
Asset *A*	$1,000	$7,000
Asset *B*	7,000	1,000

If the grantor sells both assets, the gain on *A* is netted against the loss on *B* and there is no tax effect. But if the grantor first transfers asset *A* to a trust which sells it within two years, secs. 644 and 1211 apparently combine to achieve a tax saving of $2,100 ($3,000 × 70 percent) in the following manner: The $6,000 gain on asset *A* meets the criteria of sec. 644 and therefore is taxed to the trust *as though* included in the grantor's tax return. In this example, if the $6,000 gain is included in the grantor's return, it would be offset by an equal amount of capital loss and thus precipitate no tax. On the other hand, it also appears possible for the grantor to claim the $6,000 capital loss on asset *B* in the return that he *actually* files. He, consequently, would have a $3,000 deduction against ordinary income. (See sec. 1211(b).)

Although there is no apparent statutory requirement that this offsetting $6,000 loss be ignored in determining the grantor's tax, it should be noted that the Joint Committee on Taxation's *General Explanation of the Tax Reform Act of 1976*, pages 163 and 164, states: "It is also expected that the Service will issue regulations providing rules where the transferor has *capital* or net operating *losses*. . . ." (emphasis supplied.)

Upon inquiry the IRS national office indicated that proposed regulations under sec. 644 are presently being drafted.

SECTION 661

Tax-free step-up in basis for beneficiary of complex trust

Discretionary trusts are not only complex by definition, but also are subject to highly complex tax rules. Accordingly, tax planning is

essential and often well rewarded. Consider the following situation where simply distributing trust property in one year and trust cash in the next can yield a lower overall tax burden on distributions:

A trust has been fully discretionary at all times since its creation some years ago by a gift from Father to Son (*S*). It is scheduled to terminate on Nov. 30, 1982, at which time all trust assets are to be distributed to *S* who, at all relevant times, was older than 21 years of age. The trustee elected to retain all income, so the trust has paid all federal income taxes ($5,000 in the aggregate). As of Dec. 31, 1981, the trust's undistributed (accumulated) net income (per Sec. 665(a)) is expected to be $25,000. Therefore, the aggregate distributable net income (DNI) for prior years is $30,000 ($25,000 + $5,000). At Dec. 31, 1981, the assets of the trust are expected to be as follows:

	Tax basis	Fair value
Cash	$50,000	50,000
Stocks	4,500	50,000
	54,500	$100,000

For purposes of this illustration, assume that the stocks in which the trust will invest for 1982 will be nonincome producing assets. Assume further that these stocks are expected to appreciate in value, so this policy comports with prudent investment rules. (The idea outlined below can be used by any trust which has undistributed net income and appreciated assets; it is not limited to trusts terminating within the near term.)

Alternative A. As a basis for comparison, assume distribution of all assets occurs in 1982. In 1982, there will be an accumulation distribution of about $100,000: the $50,000 cash plus the fair market value of the stock. The beneficiary-recipient (*S*) will be required to include in income the undistributed net income ($25,000), plus the income taxes deemed distributed ($5,000), for a total of $30,000, pursuant to the throwback rules of secs. 666 and 667.

In the case of the discretionary trust whose sole asset is cash, the basis of the cash distributed to the beneficiary will equal its face value. In the case of the discretionary trust holding both cash and other property the basis of the assets distributed will depend upon the amount of cash distributed. If the amount of cash distributed exceeds the amount required to be included in the beneficiary's income, the basis to the beneficiary of the noncash assets will be equal to the basis as determined under sec. 1014 or 1015, per regs. sec. 1.661(a)-(2)(f)(3). In the instant case, the basis of the assets distributed to *S* in 1982 will carry over as follows: cash—$50,000; stocks—$4,500. This rule obtains because the amount of the distributed cash ($50,000) will exceed the amount required to be included in the beneficiary's income ($30,000).

Alternative B. To see how the beneficiary's tax position can be improved, assume the distribution of assets is split between 1981 and 1982. In 1981, the trustee distributes to *S* the stock as a distribution in kind, triggering an income inclusion of $30,000 in 1981. Because the fair value of the stock will exceed the $30,000, the basis of the stock in the hands of *S* will be stepped up to the lesser of (1) the fair value of the stock ($50,000) or (2) the amount required to be included in *S*'s income ($30,000). (See regs. sec. 1.661(a)-2(f)(3).) The trust will not have to recognize any income on the $25,000 step-up (i.e., fair value of stock (to the extent of the $30,000 included in income) less the trust's $4,500) per regs. sec. 1.661(a)-2(f)(1), even though it will receive a distribution deduction equal to the stock's fair market value. (See regs. sec. 1.661(a)-2(f)(2).)

In 1982, the year of termination, the trustee will distribute the remaining $50,000 in cash. Because the 1981 accumulation distribution (via the stock) will have used all of the undistributed net income and the taxes deemed distributed, a distribution in 1982 will not have any tax consequences to *S* for 1982. The basis of the cash in *S*'s hands will obviously be $50,000. Thus, on December 1, 1982, the basis of the distributed assets in *S*'s hands (assuming no stock dispositions) will be as follows: cash—$50,000; stock—$30,000.

By effecting a distribution in kind in 1981 (which would have occurred in 1982 in any event), *S* receives a $25,500 increase in basis. The only tax cost associated with securing this tax benefit, considering both the trust and the beneficiary as taxpayers, is that *S* will pay the throwback tax for 1981 instead of for 1982. Other than losing the use of tax dollars for one year, *S* is significantly better off than if the stock distribution is delayed until 1982.

If a trustee discovers such a split-distribution benefit after year end, there still may be some recourse. If the discovery comes early in the year, the trustee may still be able to elect the 65-day rule of sec. 663(b) and consider an immediate distribution of property to have been made on the last day of the prior year. Ideally, assets with the lowest basis to the trust should be used since the trust will not have to recognize any gain.

Editors' note: One can be misled, however, by regs. sec. 1.661(a)-2(f)(3) as to the beneficiaries' basis in the distributed property, unless reference is made to Rev. Rul. 64-314. Under that ruling, it is clear that the basis in the example is indeed stepped-up tax-free, but to an even slightly higher figure than was calculated. Under the "throwback" rules of secs. 666 and 667, the maximum income to be recognized was $30,000. Under Rev. Rul. 64-314, the proper basis step-up would

be a fraction of 3/5 ($30,000 includible income as the numerator, $50,000 total fair market value as the denominator) times the $45,500 of appreciation in the stock, or a total of $27,300. The total basis of the distributed property in the hands of the beneficiaries, therefore, would be $4,500 plus the $27,300 step-up, or $31,800 in all—rather than the $30,000 basis computed without the ruling. (As to the complexities of holding periods for assets with this patchwork basis, see Rev. Rul. 72-359.)

SECTION 664

Annuity trust vs. unitrust: don't ignore the factors in making the choice

The two vehicles permitted by sec. 664 for gifts of charitable remainder interests are the charitable remainder annuity trust and the charitable remainder unitrust. The annuity trust will provide the noncharitable beneficiary with security, since the trust is required to pay a fixed amount annually that may not be less than 5 percent of the initial fair market value of the property placed in trust. Under a unitrust, the amount to be paid to the income beneficiary is based upon a fixed percentage (not less than 5 percent) of the fair market value of the trust assets as determined each year.

In addition to the basic economic differences, tax savings to the donor can be an important factor in choosing the right type of split-interest trust. The income tax deduction is limited to the fair market value of the remainder interest in both an annuity trust and unitrust. However, this remainder interest is computed differently for each. The fair market value of the remainder interest in an annuity trust is computed by subtracting the present value of the annuity (determined under estate tax regs. sec. 20.2031-10, table A(1) or A(2)) from the net fair market value of the property placed into trust. The fair market value of the remainder interest in a unitrust is computed by multiplying a factor from regs. sec. 1.664-4 by the net fair market value of the property placed in trust. The annuity and unitrust tables have been created assuming interest at the rate of 6 percent a year.

Under the tables in these regulations, a payout rate of *less* than 6 percent for an annuity trust will result in a larger value for the remainder interest, and thus a larger charitable deduction, because the tables assume a 6 percent rate of return on investments. By

having only a 5 percent payout, for example, the principal value of the annuity trust will increase over the years by 1 percent annually (the difference between the 5 percent payout and the assumed 6 percent income); since the 5 percent payout is based on the fair market value of property contributed, no part of the 1 percent increase will be paid out to the beneficiary.

In the case of a unitrust, on the other hand, the payout will be 5 percent of the net fair market value of the trust assets determined each year. Therefore, 5 percent of the annual 1 percent increase in the principal amount of the trust will be distributed to the income beneficiary. Thus, the annual increase in the value of the remainder interest in a unitrust will be less than the increase in the value of the remainder of an annuity trust.

For example, if $100,000 is placed in an annuity trust with a 5 percent quarterly payment to a male 60 years of age, the charitable deduction will be $54,123. If the same amount is placed in a unitrust, the charitable deduction would only be $49,972.

But what about a payout in excess of 6 percent? Assume an 8 percent payout under the same facts as the above example. The charitable deduction of the annuity trust would be $26,598, while the deduction for the unitrust would be $35,334. Once the payout rate exceeds the 6 percent assumed income figure of the IRS tables, the annuity trust will provide a smaller charitable deduction because the annuity trust provides for a guaranteed payment of more than 6 percent, while the IRS tables assume only 6 percent income.

The major consideration in choosing the best type of split-interest trust is economic—that is, whether you want a hedge against inflation (unitrust) or security (annuity trust). However, if a particular payout rate is decided upon, the relative amount of the charitable deduction computed under each type of interest should be compared and this comparison should be a consideration in making the choice.

SECTION 667

Multiple trusts: the code and the regs.

The often significant tax savings available from accumulation trusts before the enactment of the '76 act were multiplied when many trusts, rather than one, were set up for the same beneficiary (or beneficiaries). The tax benefits obtainable under the prior law through

the establishment of multiple accumulation trusts were probably best highlighted in the decision in *Estelle Morris Trusts*. In that case, the Tax Court determined that even though set up "principally for tax avoidance reasons" under the code as it then existed, 20 separate accumulation trusts for the same beneficiaries were entitled to be taxed as 20 separate, low-tax-bracket entities.

It was to reduce the abuses in this area that the accumulation trust provisions of the '69 act were enacted. By enactment of the unlimited throwback and the elimination of any exceptions to the throwback, Congress intended to tax the beneficiaries of accumulation trusts in substantially the same manner as if the income had been distributed to the beneficiary as it was earned. (See secs. 665 through 668.)

A special new penalty provision was included in the '76 act to deal with multiple trusts where a beneficiary receives an accumulation distribution from more than two trusts with respect to the same year. Under this rule, in the case of a distribution from the third trust (and any additional trusts), the beneficiary is to recompute his tax, except that the trust income thrown back will not include the gross-up for taxes paid by the trust. Further, and much more significantly, no credit is to be given for such taxes previously paid by the trust with respect to this income. (See sec. 667(c).)

This new penalty can prove to be a most effective weapon against the use of multiple accumulation trusts. The loss of the tax credit on the accumulated income distributed by a third (or additional) trust can result in an extremely high rate of tax on the income. In the extreme case, a 91 percent effective U.S. income tax rate can result where, for example, the trust pays a 70 percent income tax on a portion of the accumulated income and the beneficiary is also subject to the 70 percent tax rate on the remaining 30 percent distributed and taxable to him without gross-up or credit for the tax paid by the trust (70% + 70% of 30% = 91%). When state income taxes are added, the effective tax rate on multiple trust distributions can approach 100 percent!

Even before the 1976 act provisions, the IRS attempted to penalize multiple trusts through legislation by regulation. When the IRS issued the final accumulation trust regulations in 1972, it promulgated a new regulation applicable to all trusts taxed under subchapter J, which it hoped would curtail the benefits of the use of multiple trusts. Regs. sec. 1.641(a)-0(c) provided for a consolidated treatment of multiple trusts (i.e., treatment as one trust) that have "no substantially independent purposes," have "the same grantor and substantially the same beneficiary" and have "as their principal purpose the avoidance or mitigation of the progressive rates of tax."

Until recently there was no evidence that this regulation had ever been applied. In July 1979, however, the IRS issued a technical advice memorandum (IRS Letter Ruling 7942005), which applied it and held that two sets of trusts created in one instrument by the same grantor and having the same beneficiaries did "not have substantially independent purposes." Under the terms of the first set of trusts, referred to as the "income trusts," fixed percentages of the income were distributable to the beneficiary of each trust when he reached a specific age. The beneficiary of each income trust was given the right to demand the distribution of fixed percentages of trust principal upon reaching specified ages. The trust instrument also granted each beneficiary a testamentary power of appointment over his shares of the trust principal. The trust instrument further provided for another set of trusts, designated the "accumulation trusts," to receive the undistributed income of the income trusts. The beneficiaries were to receive the same portions of the accumulation trusts at the same ages as they were entitled to the income of the income trusts. The independent trustee of both sets of trusts was given the right to invade trust principal for the health, education, and support of a beneficiary. The grantor retained a testamentary power of appointment over all trusts in favor of his wife or children. The beneficiaries were not given the right to invade the principal of the accumulation trusts, as they were in the income trusts.

The ruling held that since the dispositive provisions of each set of income and accumulation trusts were identical in all respects but one they did not have "substantially independent purposes." The ruling also stated that since the grantor of the two trusts is the same and both trusts have substantially the same beneficiaries the second test in the regulations for consolidating multiple trusts was met. Finally, the service held that "the facts and circumstances in the present case strongly suggest that the principal purpose in creating the multiple trusts was the mitigation of the progressive rates of income tax," thus satisfying the third test of the regulations. These facts and circumstances included the trusts' holdings of greatly appreciated securities on which the potential capital gains realized on sale would be taxed at the lowest possible rates to the income trusts (since all of the trust ordinary income could be allocated to the beneficiaries or the accumulation trusts). Distribution of ordinary income of the income trusts to the beneficiaries and accumulation trusts, combined with the trustees' broad power to allocate receipts between income and principal, said the IRS, "provides an opportunity to spread income among the trusts in such manner as to avoid and mitigate progressive tax rates."

SECTION 673

Clifford trust for oil and gas property

An oil and gas property owner in a high marginal individual tax bracket may find that a gift to his children, using a sec. 673 reversionary trust, would be an attractive solution to tax planning problems relating to—

- The increasing value of the properties due to gradual crude oil price decontrol, as well as the possible repeal of the windfall profit tax for certain royalty income; and
- The new law rules which require federal estate taxation of adjusted taxable gifts made after 1976.

IRS Letter Ruling 7851112 considered a program under which a taxpayer and her husband transferred oil and gas properties to themselves as trustees in separate trusts for each of their three children. The trusts provided for a 10-year-one-month term, and required annual distribution of net income minus the income tax deduction for that year's depletion (percentage or cost), which depletion amount was allocated to the trust corpus. The settlor was required to report the depletion amount of trust income on her return, but, of course, subtracted the matching depletion deduction, leaving no taxable income. (See sec. 677(a)(2).) The currently distributed remainder of each trust's income was taxed to the beneficiary child at his or her marginal rate, presumably lower than the settlor's. The accumulated trust income (funded depletion reserve) will be transferred to the settlor upon termination of the trust.

The ruling explained that the gift tax value of the transfer would be computed by taking the present value of the property and multiplying it by the actuarial factor for a gift embracing a term of years. Although an unfamiliar table was referred to in the ruling, it would appear that table B in regs. sec. 2031-10 could be used, which produces a term-certain factor for 10 years and one month of approximately 44.5 percent. Where the property has an expected useful life of less than 10 years, the effect will be to transfer the value of the entire property to the trust beneficiaries, minus the funded depletion, and report the taxable gift for less than half of such value. The ruling confirms that such gift is a present interest gift, entitled to the $3,000 annual exclusions.

Although not covered in the ruling, it appears reasonable to conclude, inasmuch as the settlor continues to own a reversionary interest in the property and to receive the accumulated corpus income equal to the allowable depletion, that no disqualifying transfer

of property for percentage depletion occurs under sec. 613A(c)(9), either upon the original transfer into trust, or upon reversion of the property to the settlor upon termination of the trust. This conclusion is confirmed by IRS Letter Ruling 7938028.

Clifford trusts: use combined with grantor loan

The tax specialist is familiar with use of a short-term or reversionary trust under sec. 673 to shift income away from the grantor either to a minor child for an educational fund or to an elderly relative who would otherwise have to be supported by after-tax funds from the trustor. Less attention has been paid to combining borrowing by the grantor with the trust—i.e., augmenting the trust income shift with an interest deduction (subject, of course, to compliance with the sec. 163(d) investment-interest-expense rules).

Example. A father wishes to transfer $50,000 worth of General Motors stock to a trust for his five-year-old son. He borrows $25,000 for half of the purchase price. The stock is transferred to the trust unencumbered, and the father makes principal and interest payments on the loan. The dividends are currently taxable on the son's 1040 (assuming current distribution to the son), then placed in a custodian savings account for the son after tax. The father, in the meantime, should be able to deduct his interest expense. Sec. 265 does not apply since the interest expense is not associated with exempt income, but rather with income taxed to another party.

A variation of this plan involves the borrowing by the father of $25,000, which, with another $25,000 already held, is used to make a non-interest-bearing demand loan to the children's trust.

No gift is involved, under the case of *L. Crown*, because of the demand nature of the children's trust's note. After a sufficient educational fund has been accumulated, the trustee collapses the transaction by repaying the loan.

Partners and partnerships

SECTION 703

Elections at the partnership level that may be inapplicable to some partners

Sec. 703(b), with certain exceptions, provides that tax-accounting elections are to be made by a partnership, not by the individual partners. Some situations may arise in which an election made by a partnership may not be applicable to one or more partners by reason of the optional adjustment to basis rules contained in sec. 743. If an optional adjustment to basis election is in effect, and an interest in a partnership is transferred by sale or exchange, the transferee partner increases (or decreases, as the case may be) his share of the partnership's adjusted basis in the partnership property. This increase or decrease affects the transferee partner only.

An interesting problem arises when the optional adjustment to basis makes inapplicable at the partner level a treatment that may be appropriate for the partnership as a whole. This may be illustrated by a situation in which a partnership sells, for periodic payments, a capital asset for proceeds greater than its original cost. It is thus proper for the partnership to elect to report the gain on the installment method. However, assume that a partner has a basis adjustment (increase) with respect to that capital asset, which results in there being a loss to him. The installment method is applicable only to gains, not to losses (Rev. Rul. 70-430). It thus appears that the amount of loss, as computed for the partner with the basis adjustment, should be allowed to the partner notwithstanding the installment method election made by the partnership. This situation is not anticipated by the regulations.

As another example, the replacement for sec. 1033 of partnership property involuntarily converted can be made only by the partnership electing such nonrecognition treatment (Rev. Rul. 66-191). Sec. 1033 is applicable only to gains. In this case also, it is possible that a basis

adjustment could cause one or more partners to have a loss from the involuntary conversion so that sec. 1033 would not be applicable to such partner(s).

The reverse may also occur. An installment sale or an involuntary conversion may result in a loss at the partnership level. However, one or more partners may have a special basis adjustment (decrease) that results in a net gain with respect to their shares of the transaction. Should these partners be precluded from making an election under sec. 453 or sec. 1033 simply because the partnership as a whole is not eligible? In this case, perhaps the safest solution is for the partnership to make the election with the acknowledgment that such election is applicable only to partners whose basis adjustment would convert their share of the transaction to a gain.

SECTION 706

October 1 starting date for partnership formed by calendar-year partners

Calendar-year taxpayers who are planning to form a partnership can defer taxes by forming a fiscal-year partnership, since each partner reports his share of partnership income in the calendar year within which the partnership year ends. (See sec. 706(a).) For instance, assuming a partnership is on a fiscal year ending September 30, 1981, partnership income for the first three months of the partnership year (October 1 through December 31, 1980) will not be reported by a calendar-year partner until the calendar year ending December 31, 1981.

As suggested by Rev. Proc. 72-51, the service will generally approve the adoption of a fiscal year by a partnership if the maximum deferral of income is three months. Thus, calendar-year partners may form a partnership with a fiscal year ending September 30. In order to adopt a September 30 fiscal year, the partnership must file a return for the short period ending September 30 of the year of adoption. The IRS requires the partnership to include in the short-period return the excess of income over expenses for the three months immediately succeeding the short period, i.e., October 1 through December 31. This amount will be included in partnership income again in the partnership return for the 12-month period following the short period. The effect of this double inclusion is mitigated to some extent by the allowance of a deduction for one-tenth of the doubly included amount for the short taxable year and one-tenth for each of the nine succeeding taxable years.

The double inclusion can be avoided altogether if the partnership begins operations on October 1, since no short-period return will be required to effect the fiscal year adoption. For example, if a partnership begins operations on October 1, 1980, the first partnership return will include income for the 12 months ending September 30, 1981. Income for the three-month period ending December 31, 1980, will not be reported by a calendar-year partner until he files his 1981 individual return. Income for the three-month period ending December 31, 1981, will not be included in the first partnership return, since the IRS will not require a taxpayer to include more than 12 months of income in any return. In addition, the IRS has conceded informally that if the year of adoption begins on or after October 1 and before the end of the calendar year the three-month adjustment rule will not apply.

Beginning operation on October 1 also defers the deadline for filing the application for change in accounting period (Form 1128), which is required for fiscal-year adoptions. For example, if a partnership begins operation on September 1, 1980, and adopts a September 30 fiscal year, Form 1128 must be filed by October 31, 1980, i.e., within one month of the end of the short period required to effect the adoption. However, if business begins October 1, 1980, the short period required to effect the adoption ends September 30, 1981, and, consequently, Form 1128 can be filed any time up to, and including, October 31, 1981. (Note that the one-month deadline for a partnership to adopt a fiscal year differs from the rule applicable to a change of an existing year for which the filing date is the fifteenth day of the second month following the close of the new taxable year.) (See regs. sec. 1.706-1(b)(4)(i) and (ii).)

There may be other significant tax and nontax reasons for beginning partnership operation before October 1. However, if income from the partnership is anticipated in the three-month adjustment period, delaying formation of the partnership until October 1 should be considered.

Deceased partner's distributive share in final individual tax return

Sec. 706(c)(2)(A) provides that the taxable year of a partnership shall close with respect to a partner (not the partnership) whose entire partnership interest is sold, exchanged, or liquidated. Sec. 706(c)(2)(A)(ii), however, provides that upon the death of a partner, his taxable year with respect to the partnership shall not close. The latter was intended to be a relief provision since prior to 1954 a partner was frequently on a different fiscal year than that of his

partnership, which often resulted in a bunching of income of up to 23 months in a decedent's final return. However, this problem disappeared under the 1954 code, since sec. 706(b)(1) generally requires that partnerships and their principal partners have the same taxable year—normally the calendar year. Moreover, without careful planning, this relief provision can impose a substantial penalty, as a recent case shows.

In *Est. of S. Hesse*, the taxpayer's decedent was a general partner in a calendar-year limited partnership. He died on July 16, 1970, during a year in which the partnership sustained substantial losses. Decedent's wife reported his share of the partnership loss (approximately $400,000 for seven months) on their final joint return for 1970 in accordance with the partnership agreement, which provided that the decedent's interest in the partnership terminate at death. The Tax Court, however, held that sec. 706(c)(2)(A)(ii) governed, rather than the partnership agreement, and that the loss reported on the individual tax return must be reported by the decedent's estate in its income tax return. This result is supported by regs. sec. 1.706(c)(3)(ii), which provides that the last return of a decedent partner includes only his share of taxable income for the partnership taxable year ending within or with the decedent partner's last taxable year, and that the distributive share of partnership income for a partnership taxable year ending after the partner's death is includible on the income tax return of the estate or other successor in interest. The result in *Hesse* was that the decedent's widow lost a quarter of a million dollars in tax refunds from NOL carrybacks.

In order to avoid the problem described in *Hesse*, at least two possible alternatives should be considered:

- The decedent could name his spouse as his successor in interest. If this procedure is followed, regs. sec. 1.706-1(c)(3)(iii) provides that the designee is recognized as the partner's successor in interest for federal income tax purposes. Accordingly, the surviving spouse will succeed to the deceased partner's interest and his distributive share of partnership income (loss) for the partnership year during which death occurred; the entire distributive share is thus includible on her return, which may be a final joint return.
- A sale of the decedent's partnership interest pursuant to the partnership agreement can serve to close a partner's taxable year with respect to the partnership. (See sec. 706(c)(2)(A)(i); regs. sec. 1.706-1(c)(3)(iii).) In *Hesse*, the surviving spouse could have purchased her husband's interest in order to fully utilize the partnership losses for the year. In the case of unmarried partners,

a sale of the partnership interest to the existing partners or other party is the solution. (Note: In the case of a partner who owns a 50 percent or greater interest, a sale could result in the termination of the partnership taxable year pursuant to sec. 708(b)(1)(B).)

Absent congressional action—which was indeed urged by the Tax Court in *Hesse*—taxpayer-partners must consider the effect of sec. 706(c)(2)(A)(ii) as part of their overall tax and estate plan.

SECTION 708

Conversion of general partnership into limited partnership

The IRS appears to have resolved in favor of taxpayers the long-unanswered partnership issue concerning the tax consequences of conversion of a general partnership into a limited partnership (or vice versa). In a national office technical advice memorandum (IRS Letter Ruling 7937016), the IRS implied that the conversion of a general partnership to a limited partnership does not automatically cause a termination of the entity under sec. 708(b).

IRS Letter Ruling 7937016 dealt principally with whether limited partners entering a partnership via capital contributions on December 30, 1974, were entitled to 99 percent of the partnership loss for the entire year 1974. The technical advice memorandum held that the rationale of *Rodman* and *Moore* applies to prevent the limited partners from taking losses sustained by the partnership prior to their entry into the partnership.

The rationale used by the IRS appears to concede for the first time that the conversion of a general partnership to a limited partnership (via capital contributions of the new limited partners) is a continuation of the old partnership (though in a new form) and not a termination of the partnership under sec. 708(b). If the general partnership had been deemed to terminate through the conversion to a limited partnership, there would have been a closing of the partnership year for tax purposes prior to entry of the limited partners, thus making the rule of *Rodman* and *Moore* unnecessary and inapplicable. (See regs. sec. 1.708-1(b)(1)(iii).)

The service's apparent position in IRS Letter Ruling 7937016 was affirmed in a subsequent private ruling, IRS Letter Ruling 7948063, in which a partnership, which was changed voluntarily from general to limited, was held not to have terminated, since the conversion did

not constitute a sale or exchange of a partnership interest by any of the partners. The second ruling also held that there would be no change to the adjusted basis of each partner's interest in the partnership unless there were a change in any of the partners' shares of the liabilities of the partnership or unless there were an assumption of liabilities by a partner or the partnership.

SECTION 752

Liabilities in two-tier partnerships

There is some uncertainty about the treatment of liabilities in multitiered partnerships. Consider a case in which a limited partnership is a general partner in a general partnership that owns income-producing real property. The general partnership property is subject to a nonrecourse mortgage that is individually guaranteed by a partner in the general partnership who is not a partner in the limited partnership. Therefore, the mortgage is considered to be recourse to the general partnership; however, whether the debt is considered recourse to the limited partnership is unclear.

Sec. 752 treats a partnership as an aggregation of individuals, each partner being required to account for his share of the partnership liabilities. Thus, the first-tier limited partnership is considered to have liabilities to the extent of its proportionate share of the liabilities of the second-tier general partnership.

In order to determine if the liabilities are recourse or nonrecourse to the limited partnership, it is necessary to determine if any partner has personal liability. Regs. sec. 1.752-1(e) provides that where none of the partners has any personal liability with respect to a partnership indebtedness, then all partners, including limited partners, shall be considered as sharing such liability under sec. 752(c) in the same proportion as they share in the profits.

In this case, since no partner in the limited partnership has any personal liability with respect to the general partnership liability, it can be argued that the debt should be considered nonrecourse to the limited partnership, and thus the limited partners would share in that liability. However, the IRS would most likely take the position that the character of the liability should be determined at the second-tier partnership level, thus characterizing it as recourse, which would prevent the limited partners in the first-tier limited partnership from sharing in such liability.

The treatment of the debt as nonrecourse, however, would not

appear to be inconsistent with the holding in Rev. Rul. 77-309. In that ruling, the IRS allowed a share of the nonrecourse liabilities of a second-tier limited partnership to be allocated to the limited partners of a first-tier limited partnership. In that situation, however, the debt was nonrecourse at the second-tier partnership level.

However, there may be a simpler approach that essentially would have the same effect. Suppose one general partnership were formed with each of the partners as general partners. If only one of the partners were to guaranty the partnership's mortgage, then the other general partners would not have any liability as to that debt. Although the general partners would share personally in any actual liabilities regarding operations, they would have no personal liability for the mortgage. And if insurance can be obtained to cover liabilities arising from operations, then the nonguarantying partners would have achieved the effect of limited liability. Nevertheless, they would be able to share in the mortgage liability for tax purposes and thereby increase their basis because they are general partners.

Editors' note: The "at-risk" provisions of sec. 465 would preclude the limited partnership from taking losses beyond capital investment.

SECTION 754

Don't make unnecessary optional adjustment to basis election

The optional adjustment to basis election made under sec. 754 may be a useful device when a new partner purchases a partnership interest from another partner and pays a price in excess of his share of the underlying tax basis of the partnership assets. A special basis adjustment exists with respect to this particular partner, which can be used for the computation of future depreciation, gain or loss on sale, etc.

The optional adjustment to basis election is not one that should be automatically and unthinkingly made. The election continues in effect unless revocation is permitted by the service. Regs. sec. 1.754-1(c) requires, in effect, a significant change in circumstances before a revocation will be approved. Accordingly, an election must be made with the full recognition that at some future time there may result a step-down, rather than a step-up, of basis.

On occasion, there may be one or more sales or exchanges of partnership interests totaling in excess of 50 percent of the capital

and profits of the partnership within a 12-month period. Sec. 708(b)(1)(B) provides that the partnership is terminated under such circumstances. If such a sale or sales (and termination) take place under circumstances where a step-up in basis would result, it is not necessary to commit the partnership to the optional adjustment to basis election in order to secure the step-up. Regs. sec. 1.708-1(b)(1)(iv) provides that when such a termination takes place, it is deemed that (1) the old partnership distributed its properties to the purchaser and the other remaining partners, and (2) the purchaser and the other remaining partners contributed the properties to a new partnership. By this constructive termination of the old partnership and the subsequent formation of the new partnership, basis is automatically adjusted. Under sec. 732, the basis of partnership property received in liquidation is determined by reference to the basis of the distributors' basis. This new basis is the basis of the property to the new partnership under sec. 723.

Of course, under the same principles, a step-down in basis can occur involuntarily in a sec. 708(b)(1)(B) termination, even if the old partnership had never made the optional adjustment to basis election. If such a result is possible, consideration should be given to scheduling the sales of partnership interests so that the 50 percent, 12-month test will not be met.

Life insurance companies

SECTION 809

Sec. 809(f) limitations apply on a consolidated basis

At present, the service has not issued regulations under sec. 1502 that would provide guidance with respect to the proper interaction of the provisions under subchapter L, Part I (life insurance companies) and the consolidated-return regulations. Life insurance companies have, therefore, often had to rely on private letter rulings in determining the proper method of treating those items of income, deduction, or credit relevant to the computation of consolidated life insurance company taxable income.

In IRS Letter Ruling 8120034, the service revealed that its position on the proper method of applying the sec. 809(f)(1) limitation in the case of affiliated life insurance companies filing a consolidated return has changed. The service held that the sec. 809(f)(1) limitation for the aggregate deductions under sec. 809(d)(3), (5), and (6) that may be taken by each member is to be computed on a consolidated basis. Thus, only one $250,000 base amount plus the excess of gain from operations over taxable investment income (without regard to the special deductions) computed on a consolidated basis will be available to the group. This statutory amount is to be allocated to each member in the same ratio as its deductions under sec. 809(d)(3), (5), and (6) (before any limitation) bear to the aggregate of such deductions of all members.

In prior letter rulings, the service had ruled that the excess (if any) of gain from operations over the taxable investment income component of the sec. 809(f)(1) limitation was to be computed on a separate basis for each member. (See IRS Letter Ruling 7918106.) The requirement now imposed by the service that the entire sec. 809(f)(1) limitation must be computed on a consolidated basis, with a subsequent allocation among the members of the group, will probably result in an overall loss of benefits from the sec. 809(d)(3), (5), and (6) deductions for the group.

Regulated investment companies and real estate investment trusts

SECTION 852

Converting short-term capital gains to long-term gains

Obviously, since short-term capital gains are taxed at ordinary income rates, converting such a gain into a long-term gain would normally reduce applicable taxes by 60 percent. Several investment advisers have designed investment strategies to accomplish exactly that result.

One calls for an investor with a short-term capital gain to purchase shares, immediately prior to the ex-dividend date, in a closed-end mutual fund that pays substantial long-term capital gain dividends. For example, if a long-term capital gain dividend of approximately $2.00 per share had been declared, an investor who has realized a $20,000 short-term capital gain could purchase 10,000 shares immediately prior to ex-dividend date. When the stock goes ex-dividend, its price generally would drop in an amount equal to the distribution. Thus, in the above example, the 10,000 shares might be expected to decline $20,000 in value on the ex-dividend date.

After a holding period of 31 days, the mutual fund shares are sold and a short-term capital loss is realized in an amount approximating the decrease in value caused by the capital gain distribution. This short-term capital loss offsets the previously realized short-term capital gain and the investor is taxed on the long-term capital gain dividend at a much reduced effective rate.

Under sec. 852(b)(4), the shares must be held at least 31 days in order for the loss on the sale of the mutual fund shares to be short term. If held for less than 31 days, sec. 852(b)(4) provides that any loss realized is a long-term capital loss to the extent of the long-term capital gain dividend received.

Obviously, this transaction involves some economic risk since the investor must maintain a substantial position in the mutual fund for

at least a 31-day period. As far as tax risk is concerned, the IRS could conceivably dispute the above tax results on the basis that the transaction was not engaged in for profit, but for tax motives only. (See Rev. Rul. 77-185 (silver futures).) On the other hand, since Congress specifically dealt with this question by enacting the 31-day rule of sec. 852(b)(4), it appears that the intended results should occur if the 31-day holding requirement is met. Nevertheless, given the IRS's current attitude toward tax-motivated transactions, taxpayers should tread warily here.

SECTION 856

REITs: use of stock pairing arrangements to increase after-tax corporate distributions

In a typical stock pairing arrangement, a parent company transfers real estate to a new subsidiary and distributes the new subsidiary's stock so that it is paired with the common stock of the parent company. The new company, which is intended to qualify as a real estate investment trust (REIT), then leases the real estate back to the former parent company, which continues to use the real estate in its operations. Provided the new company has 100 or more stockholders and otherwise satisfies the code requirements for taxation as an REIT, it will elect that tax status. The paired shares typically can only be transferred or traded in combination as a unit—hence the terms "stock pairing," "stapled stock," and "back-to-back" arrangements. Each unit ordinarily consists of one share of each corporation's common stock, and, in most instances, the boards of directors of both companies are the same.

Advantages. The parent company usually issues a pro rata dividend to its shareholders in the form of all of the common stock of the new subsidiary. Typically, there will be the same number of outstanding common shares of each of the paired (brother-sister) corporations after the distribution.

Since the income of the REIT, derived from the rent paid by the former parent operating company, is distributed currently to the REIT's shareholders, and since sec. 857(b)(2)(B) permits the deduction from REIT taxable income of qualified income distributed to the REIT's shareholders, shareholders of the paired companies would, in effect, be receiving dividends out of pretax income. In order to characterize rental income received from the former parent as rents

from real property, sec. 856(d)(2)(B) requires that no shareholder of the REIT own, directly or indirectly, 10 percent or more of the paired stock. (According to sec. 856(c)(2), an REIT must derive at least 95 percent of its gross income from specified sources, including "rents from real property.") Therefore, no shareholder should own 10 percent or more of the paired stock.

Another advantage of stock pairing is that the REIT could raise funds externally by issuing preferred stock, the dividends on which are tax deductible to the REIT under sec. 857(b)(2)(B).

Distribution problem. A basic tax question with this type of pairing arrangement is whether the original distribution of the subsidiary's stock will be recognized for tax purposes. In the only case dealing with this issue, the Tax Court held that there was no distribution. (See *E. R. Wilkinson.*) If the distribution is not recognized, the parent company and the new company can still be deemed to be affiliated; thus, the new company will not be eligible to elect REIT status, since it will not have at least 100 shareholders. However, in IRS Letter Ruling 8013039, the IRS ruled favorably concerning this type of REIT stock-pairing arrangement. (See also Rev. Rul. 54-140.) It is understood that the IRS is currently restudying the question of whether there is a distribution or continued affiliation in pairing arrangements.

Disadvantages. If the pairing arrangement is recognized for tax purposes, the original distribution will involve a tax cost to the shareholders. If the distributing company has adequate earnings and profits, the distribution will be treated as a dividend to an individual shareholder to the extent of the fair market value of the distributed stock. It will not qualify for tax-free, spin-off treatment because maintenance of the REIT's status is inconsistent with the "active conduct of a trade or business" requirement of sec. 355(b). (See Rev. Rul. 73-236.)

If the pairing arrangement is recognized for tax purposes, several auxiliary problems arise upon a subsequent issuance of the operating company's paired stock. In this situation, it is uncertain whether the operating company will have to recognize a gain for tax purposes, since the normal nonrecognition provision of sec. 1032, protecting a corporation on the issuance of its stock for property, does not literally extend to a pairing arrangement. If a subsequent issuance includes a paired interest in the REIT, the existing operating company's shareholders' interest in the REIT will be diluted. If subsequent issues do not contain a paired interest in the REIT, then the operating company has in effect created a second class of stock, which would carry a lesser market value than the paired stock.

In addition, the ability of the operating company to be a party to a tax-free acquisition may be limited because of these pairing arrangements, since the paired stock may not represent solely voting stock, a requirement in certain reorganizations.

REITs management and advisory services performed by related corporations

In Rev. Rul. 74-471, the IRS took the position that a corporation that negotiated both a management and investment advisory agreement with a real estate investment trust (REIT) did not qualify as an independent contractor with respect to the management of the rental properties. Thus, the service held that the rentals could not qualify as rents from real property under sec. 856(c)(2)(C).

Sec. 856(d)(2)(C) sets forth the general rule that any amount directly or indirectly received or accrued by an REIT with respect to a property does not constitute qualified REIT income if the REIT manages or operates the property, or furnishes or renders services to the tenants of such property, other than through an independent contractor (defined in sec. 856(d)(3)) from whom the REIT does not derive any income. Regs. sec. 1.856-4(b)(3)(i)(B) states that this independent contractor "must not be subject to the control of the trust." In light of these provisions, the service apparently felt obliged to issue Rev. Rul. 74-471. It concluded that if the same corporation acted as both independent contractor-manager and investment adviser, the relationship gave the REIT control over the investment adviser.

As a result of the ruling, REITs have been forced to divide the management and independent advisory services between separate corporations. However, the service has agreed that these corporations may be owned and controlled by the same persons. Therefore, although most REITs have segregated the management and investment advisory services into separated corporations, most are apparently owned or controlled by the same persons.

Thus, in Rev. Rul. 75-136, the service took the position that the wholly owned subsidiary of an REIT's investment adviser can be the independent contractor merely if it operates as a separate entity, with separate officers and employees maintaining independent books and records that clearly reflect the management activity. The IRS reasons that "it is the relationship of the entity to the trust itself that precludes an entity (which is subject to control by the trust) from qualifying as an independent contractor." In addition to this published ruling, a private letter ruling has approved the formation of a

subsidiary by an independent contractor to assume the investment advisory role. Another letter ruling approved a plan whereby a corporation created a subsidiary to assume the independent contractor functions. In both rulings, the trustees of the REIT were the shareholders, directors, and officers of both corporations. (See also Rev. Ruls. 65-65, 65-66, and 77-23.)

Despite these recent distinctions, there appears to be no substantive difference in the operation of the two functions by a single corporation or by separate brother-sister or parent-subsidiary corporations owned and controlled by the trustees. Nevertheless, the service appears unwilling to revoke Rev. Rul. 74-471 because of regs. sec. 1.856-4(b)(3)(i)(B). Accordingly, it seems crucial that REITs and their professional advisers continue to maintain the formal distinction of corporate entities.

Tax based on income from sources within or without the United States

SECTION 861

Withholding on trust distributions of interest to nonresident aliens

Generally U.S.-source income of nonresident aliens that is not effectively connected with the conduct of a U.S. trade or business and that is investment or other fixed or determinable annual or periodic income is subject to a 30 percent withholding tax unless reduced or eliminated under a tax treaty. (See sec. 871(a).) Income distributions from an estate or trust are included in this category and, therefore, are subject to the 30 percent withholding tax. However, withholding is not required on interest income from U.S. bank deposits since it is not treated as U.S.-source income. (See sec. 861(a)(1)(A) and (c).)

Although a trust or estate is treated as an entity separate from its beneficiaries, the conduit principle has generally been applied which gives the income, in the hands of the beneficiaries, the same source and character that it had in the hands of the estate or trust. In Rev. Rul. 59-245, however, this principle ran into direct conflict with the separate entity principle. Interest on U.S. bank deposits, which is generally not taxable if received *directly* by a nonresident alien not engaged in a trade or business in the U.S., was held to be taxable and subject to withholding when distributed to a nonresident alien beneficiary by the domestic trust that had originally received the interest. The IRS reasoned that the exemption applies only to interest received *directly* by the depositor of the funds.

In a case involving substantially similar facts, the Tax Court ignored the ruling and concluded that the conduit theory clearly applied in accordance with secs. 652(b) and 662(b). (See *Isidro Martin-Montis Trust.*) Consequently, the income was not taxable and, therefore,

exempt from withholding tax. It did not matter that the income was initially payable to the trust and then distributed to the beneficiaries.

The conduit principle does not, generally, apply to accumulation distributions from complex trusts, except for tax-exempt state and municipal bonds. However, the conduit principle *does* apply if these distributions are made to a nonresident alien individual or foreign corporation. (See sec. 667(e).)

SECTION 871

Resident aliens: advantages of electing fiscal year

For years, United States multinational companies have been sending their executives overseas on extended tours of duty with their foreign subsidiaries. With the recent increase of foreign investment in the U.S., that path is becoming a two-way street as more and more foreign nationals now come to the U.S. on tours of duty for three or four years.

In some cases, it may be advantageous for these foreign nationals to adopt a fiscal year for U.S. tax purposes, rather than the more common calendar year. A foreign national here for an extended period of time will generally be classified as a resident alien from the date he establishes residency and will accordingly be taxed as a U.S. citizen. (See regs. sec. 1.871-1(a).)

For example, suppose a foreign national arrives in the U.S. on June 1, 1980, with his wife and three children and plans to leave in November 1983. If a calendar year is adopted, the foreign national will file income tax returns for the four calendar years 1980 through 1983, and two (1980 and 1983) will cover dual-status years—i.e., both as a resident and nonresident alien in the same calendar year. However, if an August 31 fiscal year is adopted, income tax returns will be filed for five different taxable periods, with the first and last returns both being dual-status years.

One benefit of creating an additional taxable year is the allowance of another $5,000 of personal exemptions which do not have to be prorated in a short-period, dual-status year. (See regs. sec. 1.433-1(a)(2).)

An additional benefit, which can be very significant, is the effect on the maximum tax calculation. A married individual is entitled to use the maximum tax rate only if a joint return is filed. (See sec. 1348(c).) A joint return is not allowed in a dual-status year except

where an election is made under sec. 6013(h). Assuming it is not beneficial to make the joint return election in the above example, the maximum tax limitation is available only for two calendar years, the 1981 and 1982 calendar years. When the fiscal year is used the maximum tax is available for three years, the fiscal years ended August 31, 1981, August 31, 1982, and August 31, 1983. For the taxpayer with high earned income this can be an important benefit.

There is a disadvantage: the impact of the rule that determines the taxable year in which the taxpayer receives credit for taxes withheld from his salary. Sec. 31(a)(2) provides that taxes withheld in a calendar year are allowed as a credit for the last fiscal year beginning in such calendar year. Thus, taxes withheld in calendar year 1980 would be allowed as a credit in the fiscal year ending August 31, 1981. On that same return the taxpayer would, of course, report as income four months' salary received in 1980 and eight months' salary received in 1981, but the taxes withheld from the 1981 salary would not be allowed as a credit until the fiscal year ending August 31, 1982.

Tax planning ideas for U.S.-bound nonresident aliens

The federal income tax impact on a nonresident alien individual who becomes a resident alien can be overwhelming. However, careful tax planning in advance of obtaining resident status can mitigate this impact because there are many income tax choices available to inbound foreign nationals.

Resident aliens and U.S. citizens are taxed in a similar fashion, i.e., on their worldwide income, whereas foreign corporations, foreign trusts, and nonresident individuals generally are taxed in the U.S. only on their U.S.-source income. (See, e.g., secs. 871 and 872.)

The taxable year in which a nonresident alien becomes a resident alien is divided into two parts; the individual during this period is a dual-status taxpayer. Foreign-source income which is not effectively connected with a U.S. trade or business is not taxable if received by a cash-basis, nonresident alien; however, the same income will be taxable once he obtains resident alien status, even though earned while a nonresident alien.

A common preimmigration tax planning device is the acceleration of the receipt of income that is free of U.S. tax by virtue of being received by the individual while still a nonresident alien. Examples of such income include dividends, interest, and compensation for services rendered outside the U.S.

Consideration should also be given to deferring the payment of

deductible expenses and the recognition of deductible losses until resident alien status is obtained. A nonresident alien is generally not entitled to many of the deductions available to U.S. citizens and resident aliens. (See sec. 873.) The tax law applicable to the nonresident alien must always be considered before accelerating income or deferring deductions.

Unless an election is made under sec. 6013(g) or (h), a joint return cannot be filed where either spouse is a nonresident alien at any time during the tax year. (See sec. 6013(a)(1).) If an election is made, a joint return is permitted to be filed if both spouses agree to be taxed on their worldwide income for the entire taxable year. Benefits of such an election include use of maximum tax on earned income, foreign tax credit, and special deductions for U.S. citizens living abroad.

Sales and exchanges of appreciated capital assets were not, until recently, subject to U.S. taxation so long as the income was not effectively connected with a U.S. trade or business, or so long as a nonresident alien was not present in the U.S. for 183 days or more during the taxable year. However, at this writing, new legislation changing this rule (H.R. 7765) has been signed into law (P.L. 96-499).

Since nonresident aliens are now subject to tax on U.S. capital gains, nontaxable exchanges (e.g., like-kind exchanges) should be considered. The tax laws of the nonresident alien's country must not be ignored in these situations.

An inbound foreign national should be aware of the potential problems associated with the ownership of stock in non-U.S. corporations. Such corporations may become controlled foreign corporations (CFC), foreign personal holding companies (FPHC), or foreign investment companies causing the resident alien to be taxed currently on his share of certain types of undistributed income of CFCs and FPHCs. In addition, gain on the sale of a foreign investment company will result in ordinary income to the extent of the resident alien's share of the corporation's post-1962 earnings and profits.

It is quite often advantageous to make gifts in trusts, foreign or domestic, prior to becoming a resident alien. Such gifts are generally not subject to U.S. gift tax provided the property which is the subject of the gift does not have *situs* in the U.S. However, care must be taken to avoid classification of the trust as a grantor trust or a foreign trust with a U.S. beneficiary since the income would be taxed to the grantor upon attaining U.S. resident status. Where a nonresident alien is the grantor of existing grantor trusts, such trusts should be restructured (if possible) prior to immigration to the U.S. If a

nonresident alien does not wish to alter or terminate an existing grantor trust, an alternative is to withdraw from the trust certain income-producing assets.

SECTION 873

Nonresident aliens: deduction of nonbusiness interest and . . .

It is generally assumed that nonresident aliens cannot claim itemized deductions for interest, taxes, and other personal expenses. A typical case involves a nonresident alien employee in the U.S. who incurs nonbusiness interest expense (e.g., mortgage on home located in country of origin or interest on personal loans). The allowance of deductions by nonresident aliens is governed by sec. 873. Sec. 873(a) provides, in part, that deductions are allowed only "to the extent that they are connected with income which is effectively connected with the conduct of a trade or business within the United States." In addition, sec. 873(b) enumerates other deductions which are allowed, whether or not effectively connected with the conduct of a U.S. trade or business (sec. 165(c)(3) losses, charitable contributions, and personal exemptions).

Sec. 864(b) provides that employment in the U.S. by a nonresident alien constitutes a U.S. trade or business. Since nonbusiness interest is not connected to a U.S. trade or business, the nonresident alien is apparently denied a deduction for such interest under sec. 873. The question, however, is what interest is business related or personal for this purpose.

Sec. 861(b) states that from U.S. source gross income "there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of *any* expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. . . ." (Emphasis added.) Regs. sec. 1.861-8 provides rules to determine the amount of deductions related to U.S. effectively connected income of a nonresident alien. Deductions under regs. sec. 1.861-8 are classified into three categories—

1. Those definitely related to specific classes of gross income;
2. Those definitely related to all gross income; and
3. Those not definitely related to any class of gross income.

Deductions in the last category (including nonbusiness interest) are to be ratably apportioned to *all* gross income. (See regs. sec. 1.861-8(b).)

It can therefore be argued, with substantial justification, that nonbusiness interest (and other itemized deductions) may be apportioned to, and deducted from, income which is effectively connected with the conduct of a U.S. trade or business, e.g., salary income.

SECTION 897

Carrying charges and new rules taxing foreign realty investors

As a result of the recent enactment of sec. 897, gains on the sale of U.S. real estate by foreign investors are treated as income effectively connected with a U.S. trade or business and generally will be subject to U.S. income taxes.

In many cases foreign investors will not have filed income tax returns in the past. No returns are required where the real estate owned has been unproductive, such as undeveloped land held as an investment. However, during the period of ownership of such property, the foreign investor may have incurred substantial carrying charges, such as interest, real estate taxes, and insurance, for which the investor has received no tax benefit. On sale of the property, can the investor capitalize such costs, thereby decreasing the taxable gain (or increasing the realized loss)?

Generally, in the case of an unproductive real estate investment, an investor is allowed to elect under sec. 266 to capitalize such costs. Regs. sec. 1.266-1(c)(3) provides that the election is to be made with the original return filed for the year in which the charges were paid or incurred. If no return was filed for such year, apparently the election can be made by filing a return after the due date since no time period is prescribed.

However, in the case of a foreign investor not required to file a return because of ownership of unproductive real property, it appears that the sec. 266 election is inapplicable. A foreign investor not receiving income which is effectively connected with a U.S. trade or business cannot claim any deductions. (See secs. 873 and 882; regs. secs. 1.873-1 and 1.882-4.) The election available under sec. 871(d) which permits deductions to be claimed for real estate expenses attributable to real property held for investment is not available unless income is derived from such property. (See regs. sec. 1.871-10(a).) Moreover, regs. sec. 1.266-1(b)(2) states that charges which are not otherwise deductible may not be capitalized under sec. 266.

Still, it appears that nondeductible carrying charges paid or incurred

by a foreign investor in years prior to the year of sale of the property are entitled to be capitalized in determining gain or loss on the sale. Failure to allow such costs to be capitalized, because the foreign investor was not eligible to make the sec. 266 election, would be contrary to the purpose of sec. 266, which is designed to avoid wastage of deductions. Since a return is required to be filed for the year in which gain or loss is realized on the sale, treatment of carrying charges incurred in such year poses no problem. They can be deducted, or capitalized under the rules of sec. 266, because the gain or loss is now treated as effectively connected income.

SECTION 901

Who gets the foreign tax credit—simple trust, income beneficiary, or neither?

The question appears simple, but what is the correct answer in the following actual case (amounts understated)?

Facts. Each of three testamentary simple trusts holding similar investment portfolios reported the following on its 1977 Form 1041.

Dividend from foreign corporations (gross)		$ 1,000,000
Long-term capital gain on sale of foreign corporation stock		15,000,000
		16,000,000
Deduct state and local income taxes paid on capital gain (prepaid on 12/29/77)		3,000,000
		13,000,000
Deduct distributions to income beneficiary:		
Lower of—		
Income required to be distributed (dividend less 15% foreign income tax withheld) or	$850,000	
Distributable net income as defined in sec. 643(a)	none	
		none
		13,000,000
Deduct 50% net long-term capital gain deduction		7,500,000
Taxable income (before exemption)		$ 5,500,000

Question. Who is entitled to the credit (or deduction) for the $150,000 foreign tax withheld from the dividend?

- The income beneficiary, who was charged under local trust law for the foreign tax but who, because of the DNI concept, received

the benefit of $1,000,000 of the state capital gains tax actually charged to principal under local trust law and thus properly reported *no* income from the trust, or

- The trust, which under the facts of this case, could have used the full $150,000 foreign tax paid as a credit against its U.S. capital gains tax liability (chargeable under trust law to principal), or
- Neither of the above.

Discussion. Under sec. 901(b)(5), a U.S. citizen who is the beneficiary of a trust is allowed a credit (subject to the limitations of sec. 904) for his proportionate share of foreign income taxes paid by the trust. A credit for such taxes is allowed to the trust only to the extent such taxes are not properly allocable under sec. 901 to the income beneficiaries. (See sec. 642(a)(1) and the regulations thereunder.) There is no question that the dividend income from which the foreign taxes were withheld was allocable to the income beneficiaries, but here the beneficiaries properly reported no taxable income from the trusts. The trusts (principal) paid very substantial capital gains taxes (and minimum taxes) based on the sale of the stock of foreign corporations, which had paid the reported dividend; the foreign country, in this case, levied no capital gains tax on the profit.

In the 25 years since the enactment of the 1954 code, this question has undoubtedly arisen countless times, but no specific answer could be found in the code, regulations, published rulings, or court decisions. The trustees asked for guidance from the IRS in the form of a request for a letter ruling.

Who received the benefit of the foreign tax credits—the income beneficiaries, the trusts (principal remainderman), or neither? The service came out on the side of the trusts, reasoning that "no portion of the foreign dividends to which the foreign income relates will be includable in the taxable income of the beneficiaries" but rather "will be includable in the taxable income of the trusts."

SECTION 902

Foreign corporation's carryback refund may not affect shareholder's prior year sec. 902 credit

Under sec. 902 a U.S. shareholder is deemed to have indirectly paid foreign taxes, for credit purposes, when it receives a dividend from a foreign corporation in which it owns at least 10 percent of the voting stock. The amount deemed paid is computed under the following formula:

$$\text{Dividend received} \times \frac{\text{Foreign taxes paid by FC}}{\text{Earnings \& profits of FC}} = \text{Foreign taxes deemed paid}$$

When the foreign corporation sustains a loss for a taxable year, questions may arise concerning the computation of earnings and profits (E&P) and foreign taxes paid for prior years. The problems may be best discussed in light of a simple example.

X, a U.S. corporation, owns 100 percent of the stock of *Y*, a foreign corporation. *Y*'s income (loss) and tax expense (refund) are as follows:

	Year 1	Year 2
Pretax income (loss)	$4,000	$(4,000)
Income tax expense (refund)	2,000	(2,000)
Net income (loss)	$2,000	$(2,000)

The tax refund in year 2 resulted from a carryback of the loss to year 1. In year 1, *X* received a $1,500 dividend from *Y* and claimed a sec. 902 credit of $1,500 ($1,500 × $2,000/$2,000).

Must *X* reduce its sec. 902 credit (FTC) for year 1 to reflect the refund of the tax paid by *Y* for the same year? Similarly, as a result of the year 2 loss, should *Y*'s E&P be adjusted currently or prospectively? The questions cannot be answered with certainty. The code, regulations, rulings, and case law fail to provide definitive rules.

Rev. Rul. 64-146 provides some guidance for calculating E&P. In the ruling, an accrual-basis taxpayer carried back a net operating loss (NOL) sustained during the current year and received a refund of income taxes paid for a prior year. The IRS held that the income tax refund should be reflected in the E&P computation for the year in which the NOL was sustained and the right to the tax refund arose.

Rev. Rul. 74-550 concerned a foreign corporation that sustained a loss in the current year. Under applicable foreign tax law, the loss could not be carried back to obtain a tax refund. The ruling held that the foreign corporation need not adjust its prior year's E&P because of the loss and that the U.S. shareholder need not redetermine the FTC claimed in the prior year. The fact that the prior year's taxes were not refundable appears to have influenced the IRS to rule that the foreign corporation's prior year's E&P need not be adjusted for purposes of recomputing the sec. 902 FTC.

In light of these two rulings, it could be argued that a foreign corporation's current-year loss does not affect its prior year's E&P for sec. 902 FTC purposes. Consistent with these rulings, the taxes paid for the prior year should not be adjusted, even though a tax refund has been received. If the foreign taxes paid must be adjusted for a prior year, that year's E&P would also have to be adjusted, and the latter would be inconsistent with the rulings. Thus, it appears that

an adjustment for a current-year loss should be made to E&P or taxes paid only in the current or future periods.

An alternative view is that when a foreign corporation receives a tax refund for a prior year, the U.S. shareholder must adjust the sec. 902 FTC claimed for that year. This view is supported by some court decisions and by sec. 905, which states in part that if any foreign tax paid is refunded in whole or in part the taxpayer must notify the secretary, who will redetermine the amount of the tax credit for the year or years affected. However, as many commentators believe, if the service redetermines a prior year's sec. 902 FTC, it must also adjust that year's E&P in order to avoid distorted results.

To date, the service has not adopted a definitive position. Accordingly, Rev. Ruls. 64-146 and 74-550 may enable a taxpayer to contend successfully that, when the foreign corporation is required under foreign law to carry back its NOL, the U.S. shareholder's sec. 902 FTC claimed in the prior year(s) need not be adjusted.

Conceivably, if the foreign corporation has an option to carry an NOL either back or forward, this contention may be more difficult to sustain. In such a case, the service may adopt a stricter position on the theory that not requiring the U.S. taxpayer to adjust its prior year's sec. 902 FTC (when the foreign corporation elects to carry back its loss and receive a refund) would permit taxpayers to manipulate results.

Until the development of definitive rules concerning the effect of a loss carryback on the prior year's sec. 902 credit, there is reasonable support for adopting either of the positions discussed above.

SECTION 904

Foreign tax credit: planning to use bank's carryover

A bank that has limited use of its foreign tax credit carryover (from foreign withholding taxes or direct tax on foreign branch earnings), perhaps because of its low effective U.S. income tax rate (from municipal bond investments), should consider investment in bonds of the International Bank for Reconstruction and Development (World Bank). The service has privately ruled that the interest on the World Bank bonds constitutes foreign-source income. Since no foreign taxes are incurred on this bond interest, "daylight" is provided for use of the credit carryover. A bank investor is, of course, exempt from the separate-limitation provisions of sec. 904(d) because its bond interest income is derived from the conduct of a banking, financing, or similar business. (See sec. 904(d)(2)(B).)

SECTION 933

Taxation of Puerto Rican residents' U.S. pensions

The IRS recently issued Rev. Proc. 80-57, which prescribes procedures for resolving issues of inconsistent tax treatment by the IRS and the tax authorities of Puerto Rico (or the Virgin Islands). The U.S. and Puerto Rican tax treatment of pension payments from a qualified U.S. pension plan to a U.S. citizen who is a long-time resident of Puerto Rico provides an example of why coordination between the two taxing jurisdictions is needed.

A U.S. citizen who has been a resident of Puerto Rico for more than one year is taxed by Puerto Rico on his worldwide income. As a U.S. citizen he is also taxed by the U.S. on his worldwide income, except that his income from Puerto Rican sources is excluded under sec. 933. To avoid double taxation, he is also generally entitled to claim a foreign tax credit against Puerto Rican tax on non-Puerto Rican source income for taxes paid to the U.S. (section 131, Puerto Rico Income Tax Act of 1954).

If such an individual receives a distribution from a qualified U.S. pension plan, the income will be taxed either by the U.S. or Puerto Rico, or both, depending on how the distribution is sourced. Puerto Rico sources pension distributions entirely by where the services which entitled the employee to receive the pension were performed (Puerto Rico Administrative Determination 76-3). If, therefore, a Puerto Rican resident receives a distribution from a U.S. pension plan attributable solely to services performed in Puerto Rico, the entire distribution is considered to be from Puerto Rican sources and is subject to tax in Puerto Rico.

The U.S. rule is similar for the portion of a pension distribution which represents employer contributions. However, the remainder of the distribution (i.e., the portion which represents the earnings of the trust) is treated as U.S. source income. (See Rev. Rul. 79-389.) Therefore, a U.S. citizen resident in Puerto Rico can exclude from his U.S. gross income the portion of a distribution attributable to employer contributions (i.e., if related to Puerto Rican employment), but will be taxed on the part of the distribution that represents the earnings of the trust.

As a result of this sourcing inconsistency, a U.S. citizen who is a resident of Puerto Rico is taxed both in the U.S. and Puerto Rico on the portion of U.S. pension distributions attributable to the earnings of the trust. Further, there is no provision in this case to relieve double taxation by claiming a tax credit in either jurisdiction, since both treat the income as from domestic sources.

An amendment to the Agreement on Coordination of Tax Administration between the U.S. and Puerto Rico provides that the two jurisdictions will attempt to resolve inconsistent tax positions (e.g., they will endeavor to agree to the same determination of the source of particular items of income). In order to have an inconsistency resolved, a taxpayer should file a written request for assistance with the director of international operations, which should include an explanation of the tax issue and inconsistencies and the general information required by Rev. Proc. 80-57, section 9. In addition, the taxpayer is responsible for preventing the expiration of the period of limitations with respect to a claim for credit from both jurisdictions.

SECTION 951

Controlled foreign corporations: a flowchart for coping with the complexities and . . .

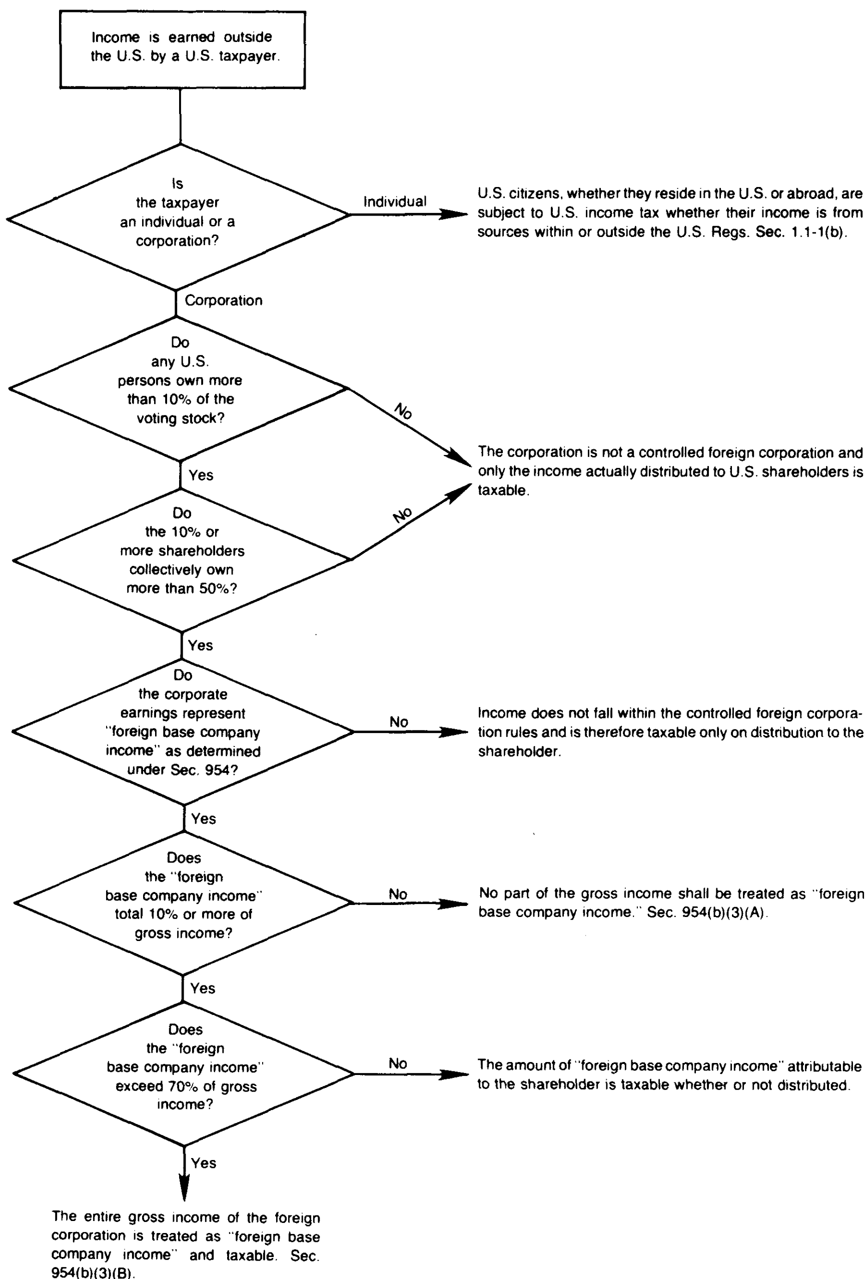
The rules dealing with controlled foreign corporations (CFC) are complex and often make a determination of CFC status difficult. The flowchart that follows may be useful for situations in which there is only foreign base company income. Where there is income from insurance of U.S. risks, or any involvement in international boycotts, bribes, kickbacks, etc., additional steps will be necessary. Naturally, possible foreign personal holding company (FPHC) status of the corporation would have to be considered as well. (See also related item, ". . . interplay of CFC and FPHC provisions," which follows.)

CFC's purchase of U.S. parent's accounts receivable may not be investment in "U.S. property"

Under certain circumstances, subpart F of the code provides for the taxation of "U.S. shareholders" on earnings of a controlled foreign corporation (CFC) before actual distribution. A CFC is a foreign corporation whose stock is more than 50 percent owned, directly or indirectly, by U.S. shareholders. A U.S. shareholder is a U.S. person (including a corporation, a citizen, or a resident) who owns, directly or indirectly, 10 percent or more of the CFC stock.

A tax on the undistributed earnings of a CFC is triggered by, among other things, its increase in earnings invested in U.S. property. In that event the U.S. shareholder is taxed on a pro rata share (based on stockholdings) of the increase (sec. 951(a)(1)(B)). This rule is based on the theory that a CFC investment of earnings in U.S. property

Flow chart summary of CFC rules



is substantially equivalent to a dividend distribution to the U.S. shareholder.

U.S. property is defined in sec. 956(b)(1) so broadly that the term includes virtually any property with a U.S. *situs*, except those items that are specifically excluded by sec. 956(b)(2). This definition apparently had a detrimental effect on the U.S. balance of payments, since it discouraged investments in the United States by foreign corporations.

The Tax Reform Act of 1976 excepted from U.S. property, effective for CFC years beginning after 1975, the stock or obligations of unrelated U.S. persons. More specifically, sec. 956(b)(2)(F), added by the 1976 act, provides that U.S. property does *not* include—

> the stock or obligations of a domestic corporation which is neither a United States shareholder (as defined in section 951(b)) of the controlled foreign corporation, nor a domestic corporation, 25 percent or more of the total combined voting power of which, immediately after the acquisition of any stock in such domestic corporation by the controlled foreign corporation, is owned, or is considered as being owned, by such United States shareholders in the aggregate.

A literal interpretation of this provision may provide a significant tax planning opportunity. A CFC may, for example, purchase from its U.S. parent accounts receivable that are due from customers who are unrelated third parties. The purchase of such accounts receivable could be considered, pursuant to sec. 956(b)(2)(F), as not constituting an investment in U.S. property. As a result, the U.S. parent may effectively obtain the immediate use of its CFC's available profits without the adverse tax consequences flowing from an investment in U.S. property.

When structuring this transaction, the tax planners should eliminate any factor that could taint the transaction. Thus, provisions or procedures that might make the CFC's acquisition of the accounts receivable appear as essentially a loan to the parent—for example, by the CFC's purchase of uncollectible accounts receivable—would be ill-advised.

Additionally, the purchase of the parent's accounts receivables frequently is at a discount. Upon the debtor's payment in full, the CFC may recognize U.S. source gain. The character of this gain has been debated; however, assuming that the gain is interest income, sec. 881 withholding may be required. Furthermore, such income might be foreign base company income and thus, ultimately, subpart F income.

Notwithstanding the pitfalls, the sec. 956(b)(2)(F) exception may provide significant benefits. The provision must be used with care, but its use should be considered in appropriate situations.

SECTION 959

Previously taxed subpart F income: dividends paid after a foreign reorganization

Sec. 959(a) provides that dividends received from a "controlled foreign corporation" (CFC) are nontaxable to a "U.S. shareholder," to the extent attributable to the CFC's earnings and profits (E&P) that were previously taxed as subpart F income under sec. 951(a). Sec. 959(c) provides ordering rules for E&P that are designed to prevent the U.S. shareholder from being taxed more than once on the same income, i.e., as imputed subpart F income and again when actually received.

Temp. regs. sec. 7.367(b)(12(c) sets forth E&P ordering rules for dividends paid to U.S. shareholders subsequent to certain foreign reorganizations: It provides that dividends will be considered as distributed—

- First, from E&P accumulated subsequent to the reorganization.
- Second, from E&P attributed to the acquiring CFC in the reorganization.
- Third, from any remaining E&P.

The sec. 367 regulations, which do not expressly address the question of whether a dividend should be considered as distributed first from previously taxed subpart F income, conflict with sec. 959(c) and the related regulation (regs. sec. 1.959-3(b)), which specify that a dividend is considered distributed first from previously taxed income. The following example will illustrate the conflict:

P, a U.S. corporation, has a wholly owned CFC, *S*. In year 1, *S* has $50 of E&P, all of which is subpart F income; in year 2, *S* has no E&P. *X*, an unrelated foreign corporation, has $100 of E&P in year 1, none of which is subpart F income. *S* acquires all of *X*'s assets in a tax-free sec. 368(a)(1)(c) reorganization on the last day of year 1. In year 2, *S* pays a dividend of $50 to *P*.

Under the sec. 367 regulation, the dividend paid to *P* is considered distributed first from *S*'s postreorganization E&P (none), second from E&P attributed to *S* from *X* as a result of the reorganization ($100), and third from *S*'s prereorganization E&P ($50), the previously taxed subpart F income. Thus, according to ordering rules of the sec. 367 regulations, *S*'s $50 dividend is fully taxable to *P*. On the other hand, under the sec. 959 ordering rules, *S* is deemed to have received a nontaxable distribution out of previously taxed subpart F income.

The sec. 367 regulations are questionable because they fail to give effect to the sec. 959 ordering rules. Nevertheless, in tax planning it is not advisable to assume that the sec. 367 regulations are invalid.

Whenever possible, as a matter of tax planning, it is preferable to avoid the situation illustrated above. For example, *P* could have caused S to distribute all of its previously taxed subpart F income prior to the merger.

SECTION 964

Using lifo to increase foreign tax credits

Using the lifo inventory method often proves beneficial in the foreign tax credit area. By electing to use lifo to determine the earnings and profits (E&P) of a foreign subsidiary, the amount of deemed foreign taxes attributable to a dividend from that subsidiary can often be substantially increased.

This is because lifo usually results in a reduction of E&P as compared to other available inventory methods, such as fifo. E&P is the denominator of the deemed foreign tax formula, which is as follows:

$$\frac{\text{Dividend}}{\text{E\&P}} \times \text{Foreign taxes} = \text{Deemed foreign taxes}$$

In performing the arithmetic, it becomes obvious that the lower the E&P, the greater the deemed foreign taxes.

In the determination of a foreign subsidiary's E&P, there are generally two sections of the code to be consulted. One is sec. 902, and the other is sec. 964. Depending on the type of income from the foreign subsidiary (subpart F income, actual dividend, etc.) and whether an election was made under regs. sec. 1.902-1(g), the E&P will be calculated under one of these two sections. There appears to be much more certainty about the results obtained using the sec. 964 regulations. Moreover, the availability of making elections, such as for lifo, appears to be spelled out when sec. 964 is used.

See, e.g., regs. sec. 1.964-1(c) and IRS Letter Ruling 7951058. The letter ruling appears to confirm the service's thoughts in regard to the application of the conformity rules dealing with lifo as extended to controlled foreign subsidiaries. In the letter ruling, the service held that a foreign subsidiary did not have to keep its books and records on lifo for purposes of filing separate reports. In fact, an example in the regulations under sec. 964 specifically allows the lifo method for computing E&P even though the foreign subsidiary maintains its books, in accordance with the laws of the foreign country in which it operates, under the fifo method. (See regs. sec. 1.964-

1(c)(8), example 1.) However, the service appears to consider the conformity rule to be met only so long as the U.S. parent uses the lifo method of inventory in reflecting its foreign subsidiary's earnings in its consolidated (worldwide) financial statements.

A recent Tax Court case may have an impact on this conformity rule as applied to foreign subsidiaries. In *Insilco Corp*. the Tax Court held that the taxpayer in sec. 472 referred to the subsidiary in the case of a parent/subsidiary consolidated financial statement. As such, the court held that the non-lifo financial statements issued by the parent did not violate the conformity rule of sec. 472 because those statements were not issued by the taxpayer (taxpayer in that case being a domestic subsidiary). The taxpayer-subsidiary had reflected its separate financial statement information using lifo, but the parent had converted those amounts to a non-lifo (moving-average) basis for purposes of its consolidated financial statements. Had the subsidiary not prepared its separate-earnings information on a lifo basis, the conformity rule would appear to have been violated under the court's rationale.

Extending the *Insilco* case to a foreign subsidiary might produce some interesting results. For example, could the foreign subsidiary prepare its own books on the basis of fifo (apparently allowable under regs. sec. 1.964-1(c)(8), example 1) and be included in its U.S. parent's consolidated financial statements on the basis of fifo, under the holding of the *Insilco* case? Had the court in *Insilco* been faced with a foreign subsidiary that had not issued its separate statements using lifo, it might well have reached a different result. However, as long as the service's regulations under sec. 964 are outstanding, it would appear that a taxpayer could rely on those regulations to the effect that the subsidiary-taxpayer does not need to use lifo. (See sec. 7805(b).) In any case, under the right set of circumstances, the taxpayer may have nothing to lose by trying.

Lifo: foreign subsidiary's E&P and . . .

Sec. 964 provides general rules for the computation of earnings and profits (E&P) of a controlled foreign corporation for purposes of subpart F. Taxpayers are also permitted to elect the sec. 964 rules (exclusive of the translation rules and treatment of exchange gains and losses provided in regs. sec. 1.964-1(d) and (e)) for purposes of computing the deemed paid foreign tax credit under sec. 902. (See regs. sec. 1.902-1(g).)

In computing E&P under sec. 964, effect is given to any election made in accordance with the code or regulations. Consequently, a

taxpayer is entitled to make an election to account for inventories on the last-in, first-out (lifo) basis. This raises the question, however, of the applicability of the conformity requirements contained in sec. 472(c) and (e).

This issue was apparently first addressed by the IRS in 1965, at which time the IRS ruled privately that a taxpayer could elect and use lifo in computing E&P for some or all of its controlled foreign corporations without conforming either the subsidiaries' financial statements or the consolidated financial statements of the parent. (See IRS Letter Ruling 6508235710A.)

More recently, the IRS has stated in a private letter ruling that "either the controlled foreign corporation, or the United States shareholders, on behalf of the controlled foreign corporation, must satisfy the requirements of sections 472 and 964 of the code" (IRS Letter Ruling 8028069). Under the particular facts of the ruling, the conformity requirement was found to be satisfied by the inclusion of the subsidiary's lifo earnings in the consolidated financial statements even though the subsidiary itself issued financial statements on a non-lifo basis. This recent ruling represents a change in IRS position and suggests that the IRS considers the lifo conformity requirement to apply to a lifo election made under sec. 964. The IRS has also informally indicated that the conformity requirement might also be satisfied by issuing financial statements of the foreign subsidiary on a lifo basis, even though the subsidiary's earnings are reflected in consolidated financial statements on a non-lifo basis. Compare the IRS position in the case of *Insilco Corp*.

Taxpayers that have made a sec. 964-lifo election or plan to make such an election should be aware of the IRS policy that conformity is required. Furthermore, serious consideration should be given to obtaining a protective private letter ruling because of the potential for a change in position. Such a ruling can probably be obtained if the taxpayer agrees to conform either the foreign subsidiaries' financial statements or the consolidated financial statement.

Thor's impact on foreign corporation's E&P

Sec. 964 provides that the earnings and profits (E&P) of a controlled foreign corporation for any taxable year shall be determined according to the rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the IRS. Regs. sec. 1.964-1(c)(1) provides that certain tax adjustments must be made to the profit and loss statement of the foreign corporation for the purpose of determining its E&P. One such adjustment is that inventories

shall be taken into account in accordance with the provisions of sec. 471. Regs. sec. 1.964-1(c)(1)(iv) provides, in essence, that effect shall be given to any election made in accordance with an applicable provision of the code and the regulations. In addition, the regulation further provides that any requirements imposed by the code or applicable regulations with respect to making an election or adopting or changing a method of accounting must be satisfied by, or on behalf of, the foreign corporation just as though it were a domestic corporation, if such election or such adoption or change of method is to be taken into account in the computation of its E&P.

The Supreme Court decision in the *Thor Power Tool Co.*, Rev. Proc. 80-5 as clarified by IR 80-48, and Rev. Rul. 80-60 all require the restoration of excess stock inventory reserves pursuant to the criteria under sec. 471. When coupled with sec. 964, those authorities require that, in determining E&P of a foreign subsidiary, any excess inventory reserves of such corporation must be restored. Thus, for example, in determining the foreign tax credit for a foreign corporation's dividend, an excess inventory reserve of such corporation would have to be restored pursuant to Rev. Proc. 80-5. Also, where there is a transfer pursuant to sec. 367(b), notice of the transfer must be supplied under regs. sec. 7.367(b)-1(c). Included in such notice is a statement which sets forth the amount of E&P of the foreign corporation. Consequently, the E&P would have to include the restoration of excess stock reserves in accordance with the *Thor* rule. Failure to do so may invoke regs. sec. 7.367(b)-1(c)(3) and thereby cause the transfer to fall without sec. 367(b).

SECTION 991

Foreign ownership of DISCs

A Domestic International Sales Corporation (DISC) may be an effective tool in reducing or completely eliminating the U.S. tax liability of a nonresident alien or a foreign corporation engaged in the business of exporting U.S. goods. Best results are achieved through the use of a DISC owned by a Swiss or Netherlands Antilles corporation that is not a controlled foreign corporation (CFC) under subpart F.

A U.S. corporation qualifying as a DISC pays no federal income tax. Instead, its shareholders are taxed on actual or deemed distributions from the DISC. The amount of the deemed distribution is at least 50 percent of the DISC's current year taxable income and

may be a higher percentage based upon baseyear computations (sec. 995). To remain qualified, a DISC must, under sec. 992, meet strict tests relating to the company's receipts and assets. As to receipts, a corporation, to qualify, must derive at least 95 percent of its gross receipts from the export sale of property produced or grown in the U.S. by a corporation other than the DISC.

The effect of *foreign* ownership of a DISC is best illustrated by way of example. Assume *A*, a citizen and resident of France, decides to establish a business in the U.S. for the purpose of purchasing new and used data processing equipment for resale in Europe. He plans to have employees and offices located in this country. If the business is conducted by an existing French corporation owned by *A*, the foreign corporation would be taxable under sec. 882 on its income which is effectively connected with the conduct of a trade or business in the U.S. If *A* establishes a new U.S. corporation (owned by him or his French corporation) to conduct this business, it will be taxable in the U.S. on the income derived from these sales. If, however, the new U.S. corporation elects to be treated as a DISC and satisfies the receipts and assets tests, U.S. income tax may be entirely avoided.

Secs. 861 and 862 provide that both deemed and actual distributions from a DISC constitute foreign source income. Sec. 996(g) provides that if a DISC shareholder is a nonresident alien individual or a foreign corporation, trust, or estate, the distribution is treated as effectively connected with a trade or business conducted through a permanent establishment of such shareholder within the U.S. Thus, what would normally be a nontaxable dividend (foreign source income earned by a foreign person) is subjected to U.S. taxation. The application of sec. 996(g), however, is unclear where there is an applicable tax treaty.

Most income tax treaties to which the U.S. is a party contain clauses which exempt a foreign enterprise from taxation in the U.S. if the company maintains no permanent establishment within the U.S. In our example, neither *A* individually nor his French corporation has a permanent establishment in the U.S. because the business is conducted by a separate U.S. corporation. Ostensibly, then, either he or his corporation may look to the U.S./France treaty to provide exemption from taxation on deemed or actual distributions from the DISC. The service may argue, however, that Congress specifically intended that sec. 996(g) have the effect of creating a permanent establishment in the U.S. for a DISC shareholder. The strength or weakness of this argument may depend upon the date of adoption of the applicable tax treaty as compared with the date of enactment, December 10, 1971, of sec. 996(g). Generally, when a treaty provision

and a code section conflict, the treaty will prevail unless the code section was enacted subsequent to the signing of the treaty and is specifically contrary to the treaty provision.

Even if the service is able to prevail under this line of reasoning, the taxpayer may look to certain income tax treaties between the U.S. and other countries for additional relief. Both the treaties with Switzerland and with the Netherlands (as it applies to the Netherlands Antilles) provide that if the foreign enterprise is engaged in a U.S. business through a permanent establishment, the U.S. may tax only that income which is derived from sources within the U.S. A Swiss or Netherlands Antilles corporation receiving a DISC distribution has income which, pursuant to secs. 862 and 996(g), is foreign source effectively connected income. Thus, the applicable treaties provide that the corporation may not be taxed by the U.S. on that income because it is not U.S. source income. So even if the service is successful in its assertion that sec. 996(g) creates a permanent establishment in the U.S., a Swiss or Netherlands Antilles corporation may look to the treaty for complete exemption from U.S. taxation because of the lack of U.S. source income.

SECTION 992

Avoiding DISC disqualification for personal holding company status

Export customer receivables purchased by a DISC from an affiliated manufacturer constitute qualified export assets, and the discount income generated on collection of the receivables constitutes qualified export receipts. (See Rev. Rul. 75-430.)

Some DISCs have satisfied the 95 percent-qualified-export-assets test by purchase of obligations issued by the Export-Import Bank, the Foreign Credit Insurance Association, or the Private Export Funding Corporation. Interest on such obligations constitutes personal holding company income, and the DISC may be a personal holding company and, therefore, an ineligible corporation under sec. 992(d)(2), if its parent corporation is closely held or if the DISC is a sister company and itself closely held. Discount income on purchased customer receivables, however, does not constitute personal holding company income, according to *Elk Discount Corp*.

Since most DISCs are established on a commission, rather than purchase and resale basis, disqualification for personal holding company status of a closely held operation is a constant threat. In

order to avoid the deemed distribution taxation of accumulated DISC income, consideration should be given to the purchase of customer receivables and curtailment of interest-bearing investments.

SECTION 994

DISC owned by exporter's shareholders' children

The advantages of structuring a closely held exporter's DISC as a brother-sister corporation rather than a subsidiary of the operating company have been confirmed in a recent technical advice memorandum which concluded that the sec. 482 income reallocation rules could not be applied to a DISC's income properly computed under sec. 994, and, therefore, the deemed and actual DISC distributions to the controlling individual shareholders should not be construed as an indirect dividend from the related corporation, which contracted for the manufacture and installation of engineering foundry products.

The DISC operated under an agreement for purchase and resale of the related company's products, rather than using the sales commission format. The memorandum also approved use of separate contract and revenue accounting for identifiable equipment units by the DISC, even though the related company used the completed contract method of accounting.

Consideration should be given by the shareholders of a closely held exporter to ownership of the DISC by their children or trusts for their children. Only a nominal capitalization is required, and presumably no gift tax cost is incurred. The following tax advantages will result:

- The profits earned by the DISC are not subject to corporate level taxation.
- The shareholders of the DISC (the younger generation) pay a low tax on the DISC dividends due to their low tax brackets.
- Wealth has been transferred from the older generation to the younger generation at no transfer tax cost.

SECTION 995

Tax-free merger of three DISC subsidiaries allowed by IRS

A manufacturing corporation had three wholly owned DISC subsidiaries. To eliminate duplications and promote economies and effi-

ciencies in administration, a merger of two of the DISCs, Corporation *Y* and Corporation *Z*, into the third, Corporation *X*, was proposed. The service ruled that the mergers would constitute sec. 368(a)(1)(A) reorganizations. In addition to the usual rulings given in connection with a merger, the IRS held as follows:

1. The proposed transaction will not cause the recognition of gain under sec. 995(c).
2. The accumulated DISC income of Corporation *Y* and Corporation *Z* will be carried over to Corporation *X* upon completion of the merger.
3. The previously taxed income of Corporation *Y* and Corporation *Z* will be carried over to Corporation *X* upon completion of the merger.
4. As provided by sec. 381(c)(2) and regs. sec. 1.381(c)(2)-1, Corporation *X* will succeed to and take into account the earning and profits, or deficit in earnings and profits, of Corporation *Y* and Corporation *Z* as of the date of transfer. Any deficit in earnings and profits of either Corporation *X*, Corporation *Y*, or Corporation *Z* will be used only to offset earnings and profits accumulated after the date or dates of the transfer.
5. It will be necessary to aggregate the export gross receipts of the DISCs for each taxable year of the base period in order to compute the surviving DISCs adjusted base-period export gross receipts under sec. 995(e)(8).

Dispositions of brother-sister DISC stock

Many individual shareholders of closely held corporations own domestic international sales corporation stock directly, rather than having the DISC be a subsidiary of the operating corporation. Such a brother-sister DISC permits some corporate earnings to be shifted to the shareholders at a single tax cost, which is particularly advantageous where a reasonable compensation issue for shareholders' salaries and bonuses may arise.

Installment sales. Generally, when the shareholder disposes of this DISC stock in a sale or redemption, any gain recognized will be included in gross income as a dividend (sec. 995(c)). To avoid the bunching of dividend income in one year, which may be taxed at rates of up to 70 percent, the shareholder should consider spreading the gain over a number of years by electing the installment method sec. 453. It appears that a sale of DISC stock should qualify for installment reporting since sec. 995(c) merely provides that recognized gain is to be included in income as a dividend. (See also Rev. Rul.

60-68, dealing with the reporting of the ordinary gain on the sale of stock of a collapsible corporation under sec. 341 on the installment method.) Since the purpose of both sec. 341 and sec. 995(c) is essentially to convert all or part of the gain to ordinary income, it may be inferred from Rev. Rul. 60-68 that installment reporting is also available for the disposition of DISC stock. Installment reporting of a gain on a sale of DISC stock is also consistent with the fact that the imputed dividend upon revocation of the DISC election or disqualification as a DISC is reported over a period of years under sec. 995(b)(2).

An installment sale of DISC stock may be more likely to occur when stock of both the operating company and the related DISC are sold to outside interests, or when one of the shareholders sells to other shareholders. A shareholder whose stock is redeemed by the DISC could also qualify for installment reporting if the redemption qualifies for sales or exchange treatment under sec. 302, e.g., a complete termination of interest under sec. 302(b)(3). However, the long-range effect of an installment redemption on the DISC would have to be evaluated.

Sec. 995(c) may characterize only a portion of the gain on disposing of the DISC stock as dividend income, resulting in both ordinary income and capital gain being reported under sec. 453. (See sec. 995(c)(2).) In a somewhat analogous situation, regulations require sec. 1245 gain to be recognized prior to other gain when the taxpayer elects installment reporting (regs. sec. 1.1245-6(d)). However, it is not clear how this problem would be handled under sec. 995(c). In any event, taxpayers generally have little or no capital gain on the disposition of DISC stock.

Other dispositions. In addition to installment reporting, there are other alternatives for disposing of brother-sister DISCs. It should be possible for the shareholders to make the DISC a subsidiary of the operating corporation by, e.g., a sec. 351 transfer. Such a transaction would not be subject to sec. 995(c) and might enable the shareholders to eventually sell their interests at capital gain rates.

Another possible approach would be to permit the selling shareholders to retain their brother-sister DISC, whose assets are normally liquid assets anyway. The revocation of the DISC election or disqualification as a DISC will trigger an imputed dividend under sec. 995(b)(2), but the dividend can be reported over the lesser of 10 years or twice the number of years the corporation was a DISC. Such treatment might even be more advantageous than installment reporting in some cases. The new shareholders of the operating company could then establish a new DISC if desired.

Gain or loss on disposition of property

SECTION 1001

Swapping mortgage portfolios to recognize unrealized losses

The mortgage portfolios of many lending institutions contain mortgage loans at interest rates below current levels. As a result, the market value of these loans is less than their face amount. Through the use of a portfolio swap, a lending institution may be able to obtain a tax deduction for the loss in value while at the same time maintaining or improving its investment position.

Sec. 1001 of the code provides for the recognition of gain or loss from the "sale or other disposition of property." Sec. 1.1001-1(a) of the income tax regulations provides that the gain or loss is generally recognized if property is exchanged for "other property differing materially either in kind or in extent."

While neither the code nor the regulations define "materially different property," the Internal Revenue Service has ruled, in Rev. Rul. 73-558, that a cash-basis savings and loan association that exchanged discounted *residential* mortgages for discounted *commercial* mortgages received "property differing materially in kind or in extent." The service concluded that the taxpayer was allowed to deduct as an ordinary loss the amount of the discount. The facts presented in that ruling indicate that, although the commercial mortgage portfolio had the same aggregate face value and discounted fair market value as the residential mortgage portfolio, the two differed in respects that were considered significant. The interest rates, mortgage obligors, and, apparently, the composite maturity periods of the two portfolios were different, as was the underlying nature of the property securing the mortgage notes.

Nevertheless, informal discussion with the Internal Revenue Service national office has revealed that the service will not take a liberal

position on such transactions. For example, the exchange of 8 percent residential mortgages for other 8 percent residential mortgages would probably not be viewed as an exchange of substantially different property. It is uncertain what factors must be present to win IRS acceptance, and the service has informally indicated that it will not rule on this issue.

SECTION 1014

Basis: beneficiaries of sec. 2036 trusts

Many tax practitioners are aware of the estate tax and gift tax consequences of lifetime transfers, but perhaps few consider the income tax rules with respect to basis of the transferred assets, the effect of which is crucial to the tax consequences of a subsequent sale.

Consider the situation in which a decedent during his life created a 25-year irrevocable trust, with all net income payable to him (with a contingent income beneficiary in the event of his death prior to trust termination) and corpus distributable on termination of the trust to designated remaindermen. The trustee has no power to invade corpus for the benefit of any beneficiary, and the grantor retained no power to revoke, alter, or amend the trust. The grantor died after 20 years and the trust, which consists of substantially appreciated real estate, is now about to terminate. What is the income tax basis of the trust assets to the trustee and the remaindermen?

It seems clear that, for federal estate tax purposes, the grantor's estate includes the trust corpus at its fair market value at date of death. (See sec. 2036(a)(1).) But has the income tax basis of the trust corpus been stepped up under sec. 1014(a) both in the trustee's hands and, ultimately, in the hands of the remaindermen?

Fortunately, sec. 1014(b)(9) provides a catch-all provision for property acquired from a decedent by reason of death, form of ownership, or other conditions, if by reason thereof the property is required to be includible in the decedent's gross estate for federal estate tax purposes. In that case, the property's basis is stepped up or down to date of death (or alternate valuation date) value but reduced by such deductions as depreciation on such property allowed to the donee in computing taxable income between date of gift and date of death. In this case, the trust property would receive a new stepped-up basis as of the date of the decedent's death, which would

ultimately be transferred to the remaindermen. Without this subsection, the basis step-up would be unjustly denied to the recipients even though the property was includible in the decedent's estate at fair market value. As it is, there is still some loss of basis for depreciation taken during the decedent's lifetime.

SECTION 1031

Exchange of partnership interest: is it tax-free?

The IRS and Tax Court don't agree on the tax consequences of exchanging general partnership interests. The disagreement concerns the limitation in sec. 1031(a) that neither certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest nor inventory-type property may be exchanged tax-free. The IRS maintains in Rev. Rul. 78-135 that general partnership interests, as equity, fall within this limitation. The IRS position is inconsistent with two decisions of the Tax Court.

In *Est. of R. E. Meyer, Sr.*, the Tax Court held that the exclusion of some equity interests from tax-free exchange treatment does not encompass partnership interests, at least under the facts presented. However, although the court found an exchange of general partnership interests to be like-kind, an exchange of a general partnership interest for a limited partnership interest was held taxable. These interests were not considered like-kind property due to the differing rights and obligations of general and limited partners. Moreover, the *Meyer* opinion is expressly limited to its facts under which the underlying properties of both partnerships were the same, i.e., rental real estate.

In *Gulfstream Land and Development Corp.*, the Tax Court reaffirmed its opinion in *Meyer* that partnership interests are not equity interests that violate the securities prohibition of sec. 1031(a). However, in *Gulfstream Land,* the court expressed concern about the other limitation under sec. 1031(a): that inventory-type property may not be exchanged tax-free. The court held that the underlying assets of the two partnerships must be compared to determine if, in substance, the transaction is merely an exchange of inventory.

The *Gulfstream Land* opinion arose in the context of a pretrial motion for summary judgment by the taxpayer. The Tax Court denied this motion, and presumably the case will go to trial to determine the nature of the underlying partnership assets.

Gulfstream Land presents some problems for taxpayers seeking

tax-free treatment. For example, consider a partnership that has both inventory assets and noninventory assets. Will the exchange be fragmented for nonrecognition treatment? Or will a *de minimis* rule apply and the exchange be tax-free so long as the substance of the transaction is not an exchange of inventory? Finally, *Gulfstream Land* is itself inconsistent with an unreported district court opinion, *Miller*, holding that partnership interests are like-kind property without inquiry into the nature of the underlying partnership assets.

Thus, taxpayers seeking to exchange partnership interests will find no unanimity in the opinions and rulings to date.

Delayed like-kind exchanges and the statute of limitations

Sec. 1031 has allowed a variety of two- and three-way tax-free exchanges, but until recently it was generally thought that a substantially simultaneous exchange of like-kind property was necessary for tax-free treatment. The case of *T. J. Starker* provides the possibility of delayed tax-free exchanges, which could remove the time pressure from the search for suitable exchange property.

In squarely holding that simultaneity is not necessary, the court acknowledged that its ruling might cause some administrative difficulties. Among the problems that might arise is the question of how the IRS can tax the transaction if it is not closed within the period allowed by the statute of limitations for assessment of tax. If the transaction becomes taxable (because, e.g., no suitable like-kind property is found), the *Starker* court said that the taxable event would occur in the year of the exchange agreement; so it is conceivable that an exchange could subsequently be held taxable and relate to an earlier taxable year that is closed by the statute of limitations. Many transactions will involve enough gain to trigger the statutory extension periods, but others may not. A related problem could arise if a transferor surrenders mortgaged property in one year pursuant to a deferred exchange agreement. Since the possibility of receiving property with a smaller mortgage (and, hence, taxable boot) is still open, it appears that a transaction that could potentially close well after the limitations period ends on the exchange year might cause collection difficulties for the IRS even though the mitigation provisions (secs. 1311 through 1315) might apply.

The *Starker* case should probably be used with caution; but in cases that will clearly be taxable without the alternatives provided by *Starker*, the taxpayers may have little to lose by casting their transaction in the *Starker* mold.

Installment Sales Revision Act—effect on *Starker*-type exchanges

The new Installment Sales Revision Act of 1980 may have introduced further tax deferral opportunities in *Starker*-type exchanges.

In *T.J. Starker*, the concept of nonsimultaneous tax-free exchange under sec. 1031 gained approval from the ninth circuit. On May 31, 1976, T.J. Starker (T.J.) transferred certain timberlands to Crown Zellerbach Corporation (Crown). Crown was obligated to acquire and transfer to T.J. 12 parcels of real estate over a five-year period. The IRS challenged the transaction on several grounds.

Two of the parcels were transferred by Crown directly to T.J.'s daughter. As to these, the court held that the requirements of sec. 1031 were not met because T.J. never took title to the property, and that, therefore, gain had to be recognized by T.J. The court further held that the recognition of gain occurred in May, 1967, when the contract was executed.

Under sec. 453, as revised, installment reporting is automatic for deferred payment sales unless an election out is made (i.e., that installment reporting not apply). It appears reasonable to conclude that a defective or cancelled *Starker*-type exchange would qualify for installment reporting. Also, the new rules of sec. 453 no longer require two or more payments, and, accordingly, the proceeds from a cancelled or defective nonsimultaneous exchange may be taxable in the year when title to the property is actually transferred, rather than in an earlier year when the contract was executed.

Sec. 1031 available where replacement property disposed of shortly after exchange

The IRS has long taken the position that to qualify for tax-free treatment under sec. 1031, the taxpayer must hold the subject property in his trade or business or for investment before (or after as the case may be) the exchange. In Rev. Rul. 77-337 it was held that an individual's prearranged transfer of a shopping center received on the liquidation of his wholly owned company for like-kind property does not qualify for tax-free exchange status, on the grounds that the business use by the corporation could not be attributed to the shareholder. In Rev. Rul. 75-292, an individual exchanged a building and land used in his trade or business for like-kind property; immediately after the exchange, he transferred the property to a newly created company under sec. 351. Here again the IRS ruled that sec. 1031 does not apply since the property received in the

exchange is not to be used in the individual's trade or business or held by him for investment.

However, the IRS position was rejected in *Fred S. Wagensen*, in a situation in which a year after a like-kind exchange occurred, the replacement property was gifted to the taxpayer's children. The court held that the property was used by the taxpayer in his trade or business after the exchange, even though a year later he parted with the replacement property. It should be noted that an important element in the decision was the fact that the gift was not contemplated at the time of the exchange.

Sometimes a disposition by the taxpayer is predetermined at the time of the exchange for reasons beyond the control of the taxpayer. In a recent private letter ruling a trust, which was due to terminate in less than six months, wanted to exchange a farm for like-kind property. The trust had been set up in accordance with a will for the benefit of a decedent's three sons. The trust agreement provided that the trust was to terminate and the assets distributed to the beneficiaries when the youngest son reached the age of 25. The trustees were concerned that the trust would hold the replacement property for only a short period of time before the trust was terminated pursuant to its terms and the property distributed. It was feared that the IRS might hold that the required disposition of the assets by the trust shortly after the exchange would cause the trust to fail to meet the "before and after" requirement. However, the IRS held that the fact that the trust was to terminate shortly after the exchange would not disqualify it from entitlement to sec. 1031 treatment. The IRS apparently gave significant weight to the fact that the trust would use the replacement property until the trust was terminated. It was only because of the provisions of the will that the property was to be distributed to the beneficiaries. This situation was seen as different from those in the two revenue rulings in which the change in ownership had been voluntary.

The letter ruling illustrates that the IRS does not regard all predetermined changes in ownership as necessarily prohibiting tax-free status under sec. 1031. Actual usage, although only for a short period of time, may be sufficient where a change in ownership is not voluntary.

New hope for three-party exchanges

A long line of Tax Court and other decisions has given very liberal treatment to so-called three-party like-kind exchanges under sec. 1031. These are transactions in which the seller of property avoids

recognition of gain by locating like-kind property that is then acquired by the purchaser for exchange with the seller. Only the seller avoids gain recognition in these transactions because the purchaser acquires and holds the like-kind property solely for exchange, and not for investment or productive use in a trade or business. However, this is normally not detrimental to the purchaser. Since the property is acquired from a third party for fair market value, there is no gain recognized when that property is the subject of an arm's-length exchange with the seller shortly afterwards. The courts have sanctioned these three-party transactions, with IRS acquiescence, even though effected for the sole purpose of avoiding taxes. So liberal is the judicial precedent that a contract of sale can be amended to provide for the exchange of like-kind property right up to the date of closing without jeopardizing the tax-free nature of the subsequent exchange.

However, the service has had some success in strictly construing the form of the transaction. In the service's view, the transaction must be cast as an exchange of properties owned by each party at the time of the exchange, and not as a cash sale with a subsequent purchase of like-kind property by the seller. In *J. P. Carlton*, the taxpayer-seller had from the outset negotiated to exchange a ranch for like-kind property. Suitable replacement property owned by a third party was located, which the purchaser then contracted to buy. But instead of closing the sale and then exchanging the property for the taxpayer's ranch, the purchaser paid cash to the taxpayer and assigned to the taxpayer its contractual right to purchase the replacement property. Two days later, the seller used the cash to purchase the replacement property under the contract. Despite the clear intent of the parties and the final result of the transaction, the fifth circuit agreed with the IRS that the transaction constituted a cash sale by the taxpayer followed by a purchase of like-kind property. Gain was, therefore, recognized by the taxpayer.

The Tax Court last year refused to follow the lead of the fifth circuit in exalting form over substance. In *F. B. Biggs*, the facts were more complicated than in *Carlton* and the three-party exchange actually involved more than three parties, but the essence of the transaction was the same. The purchaser of the taxpayer's property was either unable or unwilling to accept title to replacement property located by the taxpayer. Therefore, the taxpayer financed the purchase of the replacement property by a third party acting on his behalf, who then entered into a contract to sell the property to the purchaser of the taxpayer's property. On the closing of the taxpayer's sale to the purchaser, the purchaser assigned to the taxpayer his contractual

right to purchase the replacement property, which the taxpayer immediately exercised. Thus, the purchaser never actually acquired title to the property exchanged for the taxpayer's property.

The Tax Court looked through the form of the transaction and saw, in substance, a three-party like-kind exchange of the two properties. The taxpayer's transfer of property and receipt of other property, the court held, were interdependent parts of a single overall plan. They were not construed to be a separate sale and a separate purchase, as the IRS contended.

Since the appeal in *Biggs* lies in the fifth circuit (it has in fact been appealed by the IRS), the Tax Court was very careful to distinguish the facts in the *Carlton* case to avoid application of its self-proclaimed *Golsen* rule, under which it will follow the law of the circuit to which a case is appealable even if contrary to its own precedent. However, viewed realistically, the Tax Court decision leaves very little, if any, room for a *Carlton*-like raising of form over substance.

Besides helping to salvage a poorly structured transaction, *Biggs* is helpful where a three-party exchange cannot be properly carried out because, for some reason, the purchaser is unable or unwilling to take title to the replacement property. If financing is the purchaser's problem in acquiring the property to be exchanged, the seller may lend a hand directly, but, of course, he runs the same risks as in a *Biggs*-type deal. (Cf. *124 Front Street, Inc.*, wherein seller lends purchaser purchase price of replacement property.)

Prudence still dictates arranging the transaction to avoid IRS challenge where possible, especially with a decision of the fifth circuit going the other way.

SECTION 1034

Newly married taxpayers selling residences and jointly purchasing replacement

The general rule of sec. 1034 provides for nonrecognition of gain on the sale of a taxpayer's principal residence if the taxpayer purchases a replacement residence 18 months before or after the sale of the old residence. Gain on the sale is recognized only to the extent that the adjusted sales price of the old residence exceeds the cost of purchasing the new.

Some difficulty arises in applying this section when two principal residences are replaced by a single principal residence, as may occur when two individual house owners marry and jointly purchase one replacement residence.

Two IRS pronouncements deal with this situation: Rev. Rul. 75-238 and IRS Letter Ruling 7952004. The more general, Rev. Rul. 75-238, concerns two taxpayers who each owned their separate principal residences prior to their marriage. Soon after marriage, taxpayers purchased a new residence for $45,000 and sold their separate former residences, the husband for $21,500 and the wife for $19,500. Each realized a gain from the sale of the former residence. Rev. Rul. 75-238 holds that the nonrecognition provisions of sec. 1034(a) applied to the respective gains realized by husband and wife so that neither recognized a gain.

Rev. Rul. 75-238 dealt only with the case in which the purchase price of the new residence exceeded the sum of the adjusted selling prices of the old residences. What if the purchase price of the new residence is less than the total of the selling prices of the old residences? If gain is to be recognized in such a situation, how should it be computed? Are the taxpayers required to add together the two selling prices of their old residences or is the purchase price of the new residence to be divided between them?

IRS Letter Ruling 7952004 deals with one of these issues. In it the service states that taxpayers will *not* be required to combine the selling prices of both former residences in applying sec. 1034 and sec. 121. In explaining this position, the service emphasized the word "respective" (as in Rev. Rul. 75-238) as evidence that the intention was to treat the two sale transactions separately under secs. 121 and 1034.

Although the letter ruling is at least partially helpful in explaining how to apply sec. 1034, it does not address the issue of how the husband and wife should divide the purchase price of the new residence. This is particularly important when one spouse recognizes a significantly larger gain than the other. For example, a couple jointly purchases a replacement residence for $80,000, after selling their two former residences. The selling price of the husband's former residence is $55,000 yielding a gain of $5,000, and the selling price of the wife's former residence is $75,000 yielding a gain of $35,000.

Assuming other taxable income, credits, etc., of each seller to be equal, the taxpayers would benefit by the attribution of the majority of the cost of purchasing the new residence to the wife. This would defer the gain taxable in higher tax brackets. The basic problem, however, seems to be one of proving each joint owner's appropriate share of the cost of purchase of the replacement residence. In situations where the spouses are co-owners and contribute equally to the purchase of the new residence, any unequal allocation of the purchase price could be difficult to defend.

Because of these difficulties in applying sec. 1034, the best course

in this example might be to deliberately avoid qualifying the gain on the husband's residence under sec. 1034. The husband's residence could, perhaps, be converted to rental property prior to sale and the new residence could be purchased in the wife's name alone.

This is complicated further by the sec. 121 one-time exclusion of gain for taxpayers age 55 or older. For instance, if sec. 121 is available to each party, a premarriage sale of each house may be advisable simply to have the benefit of two exclusions rather than the one a married couple would be allowed.

SECTION 1037

Interest income: planning for Series E savings bonds

On February 12, 1979, the Federal Reserve banks, as fiscal agents for the U.S. Treasury, announced that no further maturity extensions will be granted on Series E savings bonds issued during the period from May 1, 1941, through April 30, 1952, and that these bonds will therefore mature 40 years from the date of issue with no further interest increment accruing thereafter. The banks further announced that bonds issued between April 1952 and November 30, 1965, will receive only one further 10-year extension. The announcement also explained that all Series E bonds can be exchanged on a tax-deferred basis for the new Series HH bonds starting January 2, 1980, provided the exchange takes place within one year after the final maturity date of a particular Series E bond. In like fashion, no further extensions will be granted for Series H bonds issued through May 31, 1959, but H bonds issued after that will receive another 10-year extension, with final maturity 30 years after purchase. No mention was made of exchanging Series H bonds for Series HH bonds.

Many investors have continued to hold Series E and Series H bonds, notwithstanding the somewhat inferior rate of return, because of the deferred reporting available for the interest income (unless current accrual reporting was elected under sec. 454). In addition, many Series H bonds were issued in a tax-deferred exchange for Series E bonds.

There is some indication in Rev. Rul. 58-2 that the accrued interest income or increment will be immediately taxable to the holder on the final maturity date. This is inconsistent with the one-year tax-deferred HH bond exchange opportunity and a recent press release that quoted an unnamed treasury official as declaring that there

would be no taxable income event until actual redemption of the bond; i.e., the constructive receipt doctrine would not be applied.

An outright gift of the bond, presumably to a lower-bracket donee, will not shift taxable income to the donee; rather, under Rev. Rul. 54-327, it will precipitate recognition of the accrued interest or increment to the donor. Under Rev. Rul. 55-278 and IRS Publication 550, the holder can transfer the bond into a co-ownership between the donor and the donee without precipitating recognition of the accrued interest. Subsequent redemption by either co-owner will require that the reportable income be prorated largely to the donor, based on the period of ownership prior to the transfer.

IRS Letter Ruling 7925054 points to other solutions. The ruling confirms that a bondholder may bequeath the Series E savings bond, and accumulated interest, by will. The accumulated interest will not be taxable on the decedent's final individual return or the estate's fiduciary income tax return when ownership of the bond is distributed to the beneficiary. If the beneficiary is a tax-exempt organization, the increment never will be taxable; if not, the bond can be bequeathed to a number of lower-income beneficiaries in order to reduce the ultimate tax on the accumulated interest.

Capital gains and losses

SECTION 1221

Commodity futures contracts on Treasury bills

The IRS in Rev. Rul. 78-414 held that futures contracts on Treasury bills purchased by an investor are capital assets even though Treasury bills themselves are not capital assets. The service reasoned that a purchase of a futures contract is the acquisition of a right to Treasury bills, rather than the acquisition of the actual Treasury bills, and yields capital gain or loss rather than ordinary.

The ruling does not discuss the case in which the investor accepts or makes delivery of the Treasury bill to satisfy the futures contract. This omission from the ruling seems to allow for considerable tax flexibility since the investor would be purchasing or selling Treasury bills in that situation at a predetermined contract price. If the futures contract has appreciated, the disposition of the contract would result in capital gain. On the other hand, if the contract has depreciated and if the investor takes delivery of the Treasury bill and subsequently disposes of the actual bill, the result should be ordinary income or loss rather than capital. (See sec. 1221(5).)

This ruling also amplifies Rev. Rul. 77-185, which describes the tax consequences to a taxpayer who entered into a commodity futures straddle involving silver futures. Rev. Rul. 77-185 attempts to create an administrative wash sale rule under sec. 165. There the service not only denied gain or loss treatment for the separate legs of the straddle, but also did not allow a deduction for the net loss resulting from the straddle, including the costs of entering into the transaction. Rev. Rul. 78-414 states that the conclusion of Rev. Rul. 77-185 would be equally applicable to a spread transaction in commodity futures contracts on Treasury bills. We are now on notice that the service will attempt to use this same attack on spreads in Treasury bill futures.

SECTION 1232

Deep discount bonds—a debt-financing alternative

The deep discount bond (DDB) is a debt-financing alternative that has become increasingly popular lately. DDBs are issued carrying a low (e.g., 7 percent) coupon rate at a substantial discount (e.g., 50 percent). Zero coupon bonds have also been issued. These bonds typically mature in periods ranging from 10 to 30 years. Due to the low coupon rate, a DDB sells at a substantial discount from the principal amount. This discount is treated as original issue discount (OID) under sec. 1232. For example, a $1,000 bond sold for $530 would have $470 of original issue discount. Assuming other factors are held constant, lowering the coupon rate on the bond will increase the amount of the original issue discount. The tax treatment of OID is the primary advantage of issuing this type of bond.

The issuer of an obligation with OID is entitled to prorate or amortize the discount as interest over the life of the obligation. (See regs. sec. 1.163-4(a)(1).) The regulation does not specify the straight-line basis for amortizing the discount, but it appears that this is the proper method since the holder of the obligation is required to report the discount as ordinary interest income on a straight-line basis. (See sec. 1232(a)(3)(A).) Specifically, the holder reports as ordinary interest income an amount equal to the ratable monthly portion of original issue discount multiplied by the sum of the number of complete months and any fractional part of a month the holder held the obligation during the taxable year.

Each year, the amortization of original issue discount by the issuer results in a tax saving equal to the deduction multiplied by the company's marginal tax rate. In effect, the issuer does not pay for this deduction until the DDB matures. In the meantime, the issuing company benefits from this deduction without a current cash payment. For example, assume a corporation (with a marginal tax rate of 46 percent) issues $100 million of 30-year bonds with a 7 percent coupon rate to yield 14 percent to maturity. Because of the low interest rate, assume the bonds would be offered at about 51 percent of face value (i.e., a 49 percent discount). The annual tax saving resulting from the amortization of the OID would be $751,333 ($49 million of OID ÷ 30 years × 46 percent tax rate). The following table illustrates the value of this annual tax saving, assuming various rates of return on capital.

	Rate of return		
	6%	10%	14%
	(in $ millions)		
Future value of annual tax saving compounded quarterly for 30 years	$62	$138	$328
Less payment of premium at maturity	49	49	49
Net cash saving	$13	$ 89	$279

The tax saving attributable to the amortization of the OID can also be viewed as a reduction in the effective cost of borrowing. To illustrate, assume that the issuer needs $68 million in bond proceeds, regardless of the coupon rate and years to maturity selected, and is willing to sell the bonds to yield 14 percent to maturity. Example 1 illustrates the effect of OID on the effective *after-tax* cost of issuing the bonds, assuming various periods of maturity and coupon rates. This table shows that the effective cost of the bond decreases as the coupon rate is decreased and as the years to maturity are increased. For example, at a 4 percent coupon rate, the effective after-tax cost of the issue decreases 90 basis points (7.29 − 6.39) as the years to maturity are increased from 10 to 30 years.

An additional benefit of a DDB is that it can be priced at a lower yield to maturity than a bond issued at par with a coupon reflecting current market rates. This is possible because a DDB provides significant advantages to certain investors. For example, since DDBs offer greater call protection, investors have more assurance that their investments will not be converted into cash within the relatively near future. Since these bonds are typically redeemable at par, a company would have little economic incentive to redeem a DDB soon after it is issued, barring a substantial decline in interest rates. Further, a DDB can minimize the need to reinvest coupon payments since a significant portion of the investor's return has been incorporated into the principal payment at maturity. Moreover, a DDB may be more attractive to bullish investors since a given decline in interest rates will result in a proportionately greater increase in the price of a DDB than a bond with a coupon closer to the prevailing market rate.

Typically, these bonds have been targeted for sale to tax-exempt investors (such as pension funds and private foundations) and certain foreign investors. Life insurance companies may also find these bonds attractive investments. These bonds hold little appeal for taxpaying investors, however, since a purchaser (whether on the cash or accrual method of accounting) of a DDB must amortize the original issue discount as ordinary interest income. Note that a taxpaying investor can't circumvent this rule by purchasing a DDB from a tax-exempt holder. In the event an obligation with OID is sold by the initial

holder, any subsequent holder is also required to report a ratable portion of the OID. (See sec. 1232(a)(3)(B).)

Example 1

	Coupon								
	4%			7%			10%		
Years to maturity	Face (a)	OID (b)	Effective cost (c)	Face (a)	OID (b)	Effective cost (c)	Face (a)	OID (b)	Effective cost (c)
				(in $ millions)					
10	$142	$ 74	7.29%(d)	$107	$39	7.40%	$86	$18	7.49%
20	201	133	6.77	127	59	7.14	92	24	7.33
30	227	159	6.39	133	65	6.95	94	26	7.27

(a) Principal amount of bonds which must be issued to obtain $68 million in proceeds to yield 14% to maturity compounded annually.
(b) Face amount of bonds issued less $68 million.
(c) Effective annual after-tax cost (assuming a 46% marginal tax rate). The effective after-tax cost of the bond is the discount rate which equates the present value of the after-tax coupon payments (reduced by the tax saving attributable to the amortization of OID) plus the present value of the redemption price to the issue price of the bond.
(d) This combination actually produces a positive cash flow since the tax saving attributable to the deduction for interest and OID exceeds the annual coupon payment.

Tax planning with bonds carrying detachable interest coupons

Bonds carrying detachable interest coupons provide financial institutions and other taxpayers with unique tax planning opportunities. For example, taxpayers who want to accelerate the recognition of income for tax purposes can do so by selling detached bond coupons while retaining the bonds. Both court decisions and published IRS letter rulings support this technique. Taxpayers may want to accelerate income to use an expiring net operating loss, for example.

In IRS Letter Rulings 7934003 and 8108108, banks accelerated gains on U.S. Treasury securities by selling interest coupons and including in income in the year of receipt the full amount realized from the sale. The service took the position that the taxpayers' basis should not be allocated between the bonds and the detached interest coupons on the grounds that the sale of the coupons represented the sale of the right to receive future income rather than the investment itself. As a result, the banks did not have to allocate a portion of their basis in the securities to the detached coupons to reduce the gain realized on the sale.

The IRS based its conclusion on *Est. of Stranahan*. There the court held that a father's sale of anticipated dividend rights to his son was

a valid transaction, resulting in the acceleration of income to the father. The father was required to recognize ordinary income to the full extent of the sale proceeds in the year of receipt, since the court did not require an allocation of basis to the right to future dividend income.

If the service's position is carried to its logical conclusion, it would appear that taxpayers might be able to accelerate loss deductions by selling bonds or other obligations without the coupons attached. Since the taxpayer would be selling the investment itself, rather than the right to receive the future interest income, full basis would be allocated to the bond. Consider the following example involving no allocation of basis between the note and the interest coupons:

> A taxpayer has a $200,000, 9¼% Treasury note due March 1983 which was purchased in 1980 at par. Also assume that on the date of sale the fair market value of the note with coupons attached is $188,000 and the value without coupons is $156,000. Provided the taxpayer could sell the note for its fair market value of $156,000, the sale would generate a $44,000 tax loss ($200,000 basis less $156,000 in proceeds).

Sec. 1232(c) will require the purchaser of the note to recognize a portion of the redemption price as ordinary income rather than capital gain when the bond matures. Thus, the purchaser will recognize the artificially created discount of $32,000 ($188,000 less $156,000 purchase price) as ordinary income when the note matures. The remaining gain of $12,000 will be treated as capital gain at maturity.

Although the service has apparently conceded that income may be accelerated by selling detached interest coupons, it has not been squarely faced with the question of loss acceleration. Since a loss acceleration will have an adverse effect on tax revenues, the IRS may attack both the failure to allocate basis and the amount of loss claimed.

SECTION 1237

Condominium conversion: capital gains or ordinary income?

The recent proliferation of condominium conversions throughout the country raises an interesting tax question: are the sales proceeds from such conversions capital gains or ordinary income?

Sec. 1237, concerning the tax treatment of real property subdivided for sale, appears to be an ideal solution in some cases to the capital gains/ordinary income dilemma. However, it is highly unlikely when sec. 1237 was enacted back in 1954 that anyone could have foreseen

the current condominium conversion phenomenon. The wording of the provision clearly refers to the typical situation in which a plot of land is subdivided and the lots are sold off. Until recently, neither the courts nor the IRS had dealt with whether sec. 1237 applies to such conversions, thus limiting the usefulness of the provision as a planning tool in this area.

But a recent revenue ruling deals squarely with this issue. In Rev. Rul. 80-216, the IRS held that the benefits of sec. 1237 (i.e., that a lot or parcel that is part of a tract of real property shall not be deemed to be held primarily for sale to customers in the ordinary course of business solely because of the subdivision of the tract for sale) do not apply to conversion of rental units into condominiums and sale of such units to the public. The rationale of the ruling is that the terms "lot" and "parcel" in sec. 1237(a) refer only to land, not the subdivision and sale of improvements.

But the inapplicability of sec. 1237 does not preclude capital gains treatment of the sale of condominiums under other available theories—it only removes one string from the seller's bow.

Perhaps of help in obtaining capital gains treatment is an IRS private letter ruling issued in 1971 (IRS Letter Ruling 7109280430A). This ruling allowed the income from a partnership's condominium conversion to be treated as a capital gain where the conversion was undertaken in order that the owners could liquidate their investment in the building. Under the facts of the ruling the taxpayers had acquired, and were operating, an apartment building as an investment. For personal reasons they decided to sell their interests in the property. The partnership owned no other property, the partners did not engage in any active sales campaign, and no substantial improvements were made to the individual units before the sale. The IRS ruled that since the sale of the separate apartment units as condominiums was an orderly liquidation of an investment and not a sale in the ordinary course of a real estate business, the proceeds were not ordinary income.

An alternative approach which should result in capital gains treatment is the sale by the partners of their partnership interests to an unrelated entity which could then carry out the conversion sales. The partners should get capital gains treatment and the purchasing entity, having received a stepped-up basis, can undertake the conversion sales.

Readjustment of tax between years and special limitations

SECTION 1311

Mitigation provisions apply to estate tax determinations

It was generally thought that the mitigation provisions of the code (secs. 1311–1314) were only applicable to income tax determinations. (See regs. sec. 1.1311(a)-2(b).) However, in a U.S. District Court case, *J. O. Chertkof,* it was held that the mitigation provisions also apply to the estate tax.

Chertkof involved the hearing of three related petitions brought before the court on cross-motions for summary judgment. Each petition questioned whether the taxpayer could claim a refund for overpaid federal income taxes in a closed year. The claims resulted from a redetermination of certain asset values which were held to be too low in the estate's federal tax return.

In holding against the taxpayers on other grounds, the court pointed out that while section 820(b) of the '39 code expressly limited the circumstances under which the mitigation provisions would apply, the current statute contains no such express provision. Moreover, current sec. 1314(e) specifically provides that secs. 1311–1314 will not apply to determinations of employment taxes under subtitle C. "Such a provision . . . would have been totally unnecessary had the mitigation provisions meant . . . that the provisions apply solely to *income* tax determinations," said the court. Furthermore, there would have been no need to substantially amend the '39 code by both the Technical Changes Act of 1953 and the '54 code.

SECTION 1348

Maxi-tax: personal service income of partnerships

The '78 act eliminated the 30 percent test in the determination of personal service income from a trade or business where both capital and personal services are material income-producing factors. Thus, reasonable compensation is now the standard for measuring the amount of personal service income from a partnership. Partnership agreements should be reviewed for changes that might be appropriate as a result of the new law.

Under prior law, a reasonable allowance as compensation for the personal services rendered by the taxpayer was treated as personal service income, but this amount could not exceed 30 percent of his share of the net profits of the trade or business. (See sec. 911(b).) For taxable years beginning after December 31, 1978, the '78 act eliminated the 30 percent limitation; therefore, according to the committee reports, an amount equal to reasonable compensation is now considered personal service income. (See sec. 1348(b)(1)(A), last sentence.) This legislative change could be extremely beneficial to certain capital-intensive partnerships; however, there will still be some situations in which the old 30 percent test would have produced greater personal service income. Although the prior law read "not in excess of 30 percent," in practice the 30 percent figure had become a safe harbor.

There are a number of planning opportunities available for increasing the amount of partnership net income qualifying as reasonable compensation to partners. There is no single planning point that can apply to all partnerships; therefore, a number of suggestions are presented below for consideration. Some of these may require that amendments be made to the partnership agreement.

Partners should be treated just as corporate executive-shareholders have traditionally been treated. Thus, many corporate tax planning points should apply equally to partnerships. A partner's salary should not be proportionate with his interest in the partnership. A partner may be able to claim a large salary for prior services to the partnership. Corporations have used their minutes to document salary matters; a partnership should consider similar documentation. The partnership agreement can call for guaranteed salary payments to the partners. These guaranteed payments should not be in proportion to the partner's capital accounts.

The partnership agreement may call for a nonguaranteed salary to

the partners. Under this arrangement, the salary will be paid only if and when there is cash flow to pay it.

A partnership could hire an outside salary consultant to determine compensation paid by other comparable companies in the same industry. A partnership should be able to claim larger amounts as reasonable compensation than a corporation, since the partners must personally pay for retirement and payroll-type benefits (e.g., medical and life insurance).

A partnership may assume a certain rate of return on partners' capital and treat the balance of a distributive share of partnership income as compensation. The rate to be used might be the partnership's cost to borrow. Thus, if that rate were 12 percent and if partners' capital were $2,000,000, $240,000 could be subtracted from net income and treated as nonpersonal service income, with the balance of net income treated as personal service income.

If there are limited partners, a partnership could determine the amounts received by the limited partners and use the resulting percentage to determine the general partners' nonpersonal service income. For example, assume that the total capital contribution of the limited partners is $300,000, that they receive a 6 percent guaranteed return plus a share of the profits, and that their total income comes to $36,000. Thus, it could be assumed that each general partner should treat 12 percent of his distributive share of partnership income as nonpersonal service income and the balance as personal service income.

The partnership may determine the amount of its nonpersonal-service-type income, subtract that amount (net of related expenses) from total income, and treat the balance as personal service income. The partnership may also consider an allocation of the passive-type income to the limited partners. This allocation would have to have substantial economic effect. (See sec. 704(b).)

If the partnership is large enough, it may organize a compensation committee to determine the salary component of a partner's distributive share of income.

Partnerships that have been using the old 30 percent test as a safe harbor may now have a problem if they attempt to continue with that method. Some experts believe that the change in the law was intended to make the maxi-tax provisions available to more companies (particularly brokerage companies) and, therefore, should not result in less personal service income than the 30 percent test; however, nothing in the legislative history indicates that this was the congressional purpose.

Partnership agreements should be reviewed; wherever there is a

reference to partner's salary and this is really an advance or a draw, the wording should be changed to indicate a partner's draw. This precaution should be taken to prevent the IRS from alleging that only the draw qualifies as personal service income.

Finally, it may be possible for each partner to adopt a different test; however, it would be best to have consistency among the partners.

Maxi-tax qualification of lump-sum distribution

Sec. 1348(b)(1)(A) defines personal service income as "any income which is earned income within the meaning of section 401(c)(2)(C) or section 911(b) or which is an amount received as a pension or annuity." Sec. 911(b) defines earned income as amounts received as compensation for personal services actually rendered. Under this definition, payments received as a lump-sum distribution from a qualified plan appear to qualify as earned income.

Sec. 1348(b)(1)(B), however, excludes, *inter alia*, amounts to which secs. 402(a)(2) and 402(e) apply. Sec. 402(a)(2) provides for the taxation of the capital gains portion of the lump-sum distribution, and sec. 402(e) provides for the taxation of the ordinary income portion of the lump-sum distribution, whether or not the special election to treat all of the lump-sum distribution as ordinary income is exercised. Therefore, under this exception, it appears that no part of the lump-sum distribution qualifies for maximum tax on personal service income treatment.

P.L. 95-458 (10/13/78), however, enables taxpayers to roll over a portion of a lump-sum distribution. (See sec. 402(a)(5).) The law provides that the portion not rolled over is not subject to the capital gains or special 10-year averaging treatment provided by secs. 402(a)(2) and 402(e)(1). (See sec. 402(a)(6)(C).) The committee reports indicate that the amount not rolled over will be taxed in the year of receipt as ordinary personal service income. Therefore, it appears that a taxpayer receiving a lump-sum distribution may effectively obtain the benefits of the 50 percent maximum tax by rolling over a minimum amount, such as $1.00, and having the balance taxed as personal service income.

Based on discussions with the joint committee on taxation, the intent of Congress was to allow the portion of a lump-sum distribution that is not taxed under the favorable capital gains or ten-year averaging provisions to be taxed as personal service income. However, unless corrective legislation is passed, it would appear that it is safer to make a nominal rollover, rather than retain the entire lump-sum

distribution, to obtain the 50 percent maximum tax rate for the substantial portion of the lump-sum distribution.

As to when a taxpayer would prefer the maxi-tax to the sec. 402(e) tax, note the high tax rates (up to 70 percent) on very large lump-sum distributions and also see sec. 402(e)(4)(B) for a prohibition of multiple elections after age 59½.

Election of certain small business corporations as to taxable status

SECTION 1371

Subchapter S trap: sale of partnership interest

A subchapter S corporation is one that elects to be taxed in a manner similar to a partnership. There is generally no tax at all at the corporate level; income, gains, and losses flow through and are taxed to the individual shareholders. (See sec. 1373; cf. sec. 1378.)

The election of, and operation under, subchapter S status entail a maze of technicalities. For example, subchapter S status can be involuntarily terminated for a number of reasons, one of which is the corporation's realization of more than 20 percent of its gross receipts from passive investment income. (See sec. 1372(e)(5).) If a subchapter S corporation owns an interest in a partnership, which it sells at a profit that exceeds 20 percent of its total receipts, subchapter S status will be in jeopardy. The IRS has taken the position, in IRS Letter Ruling 7922083, that the corporation will lose its sec. 1371 status because the sale of a partnership interest is analogous to the sale of securities and thus results in passive investment income.

This problem may be avoided either by liquidating the partnership and then selling its assets or by selling the partnership interest on the installment basis.

Recently the Joint Committee on Taxation's staff circulated a discussion draft of recommended changes in subchapter S rules. Among those was a recommendation that the 20 percent passive income rule be eliminated.

SECTION 1372

Termination of subchapter S election—retroactively or prospectively?

Taxpayers who wish to sell a subchapter S corporation should consider whether a retroactive or a prospective termination of the sec. 1372(a) election would be more advantageous. The new sec. 11(b) bracket amounts and the consequent reduction in corporate tax rates for many small corporations will bear on this decision. Practitioners should determine whether there is an opportunity to enjoy a flexible demise of the subchapter S election upon sale of the corporation.

For example, recent IRS Letter Ruling 7914004 holds that where the stock of the subchapter S corporation is sold and the corporation immediately becomes a member of an affiliated group that had previously elected to file a consolidated return, the election terminates prospectively. This ruling relies upon two previously issued published rulings that involve A-type reorganizations. The election is terminated prospectively since the event that caused the corporation to be disqualified, i.e., bringing it into an affiliated group, *also* terminated its taxable year (Rev. Rul. 64-94; Rev. Rul. 70-232). The newly acquired corporation is required to file a separate return under regs. sec. 1.1502-76 for the period of time prior to its membership in the affiliated group.

This theory suggests that a seller should be able to terminate the election retroactively and prevent all of the current year's subchapter S income from being taxed to the shareholders if the buyer is a member of an affiliated group that is *not* filing a consolidated return for the year of the acquisition. In such a sale there is no event that results in a short taxable year.

At apparent odds with LTR 7914004, though based on somewhat different facts, is Rev. Rul. 72-201. This ruling holds that the acquisition of the stock of a subchapter S corporation by another corporation in a B-type reorganization will result in a retroactive termination of the election even though a consolidated return and a short-period return for the new subsidiary are involved. It is understood that Rev. Rul. 72-201 is being reconsidered in view of the position taken in LTR 7914004.

Subchapter S: IRS challenges voluntary terminations

A revocation of a subchapter S election must be made within the first month of the year to be effective for that year, but terminations

can occur at any time. (Cf. sec. 1372(e)(2) with (e)(1), (3)–(5).) One of the most frequently used ways to terminate the election voluntarily is to make a gift of a share of stock to a spouse or child, who then fails or refuses to consent to the election. Pre-1977 law required a new shareholder to consent within 30 days to prevent termination; under present law, he must affirmatively refuse to consent within 60 days. (See sec. 1372(e)(1).)

The IRS refused to recognize such a planned termination in IRS Letter Ruling 7928001. In the case addressed by the letter ruling, *X* corporation had incurred losses but then turned profitable. Shareholder *A* did not want the income passed through to him, but it was too late for a revocation; so he gave one of his 90 shares to his minor children and then, as their legal guardian, intentionally failed to consent. The IRS said that the gift was not bona fide and had no economic substance, and it refused to view the children as new shareholders. Thus, there was no termination of subchapter S status, according to the IRS. (Cf. *W. B. Wilson.*) If *A* had used an *independent* trustee or legal guardian, the result might have been different.

The IRS approach opens the door for attack on other planned termination, such as those effected by issuing preferred stock, acquiring a subsidiary, or having a corporate or other prohibited shareholder. If these transactions have economic substance, however, they should be recognized to retroactively terminate the subchapter S election. In regard to economic substance, see regs. sec. 1.704-1(b)(2) and the examples thereunder dealing with allocations of partnership income, loss, etc.

SECTION 1374

Subchapter S: restoring basis of debt reduced by losses

Subchapter S problems tend to be aggravated by thinking of a subchapter S corporation simply as one that is taxed as a partnership. This misconception is critical in the area of deductions by shareholders of corporate operating losses. One particular trap concerns a shareholder's use of his basis in corporate liabilities as his basis for deducting his share of operating losses.

Sec. 1374(c) provides, generally, that a shareholder is entitled to deduct his share of corporate operating losses up to the amount of his adjusted basis in (1) corporate stock and (2) indebtedness of the corporation to him. Losses are offset first against the adjusted basis in his stock and then, after that has been fully depleted, against his basis in his indebtedness.

The subchapter S rules further provide that a shareholder's basis in his stock is increased not only by his contributions to capital but also by income taxed to him as a shareholder. Basis in his stock is reduced (but not below zero) by distributions to him and by his share of losses. (See sec. 1376.) Thus, depletion of his basis in *stock* by his share of operating losses may be restored either by subsequent contributions to corporate capital or by his share of future income.

Not so, however, in regard to losses offset against his basis in corporate debt. Once reduced, the basis in corporation debt has been *permanently* reduced and may not be restored. Subsequent earnings taxed to the shareholder increase only his basis in stock. It does not matter that indebtedness has previously provided the basis for the deduction of losses. Further, the reduction of basis in corporate debt may not be made up by the shareholder's repayment of it. The courts have said that this constitutes a new loan, not a restoration of the old loan. (See *P.D. Cornelius.*)

The effect of these rules, like a number of other provisions in the subchapter S area, should be minimal if they are understood. If not, however, they will cause the shareholder to recognize additional income unnecessarily should the liability be repaid by the corporation at some future date, perhaps even in a year, when the subchapter S election has long since been revoked and the problem forgotten. This is caused by the repayment at face amount when shareholder basis in the liability is less than face amount. (This income would be taxed at capital gain rates if the liability is evidenced by a written document.)

There may be several solutions to this disparity between face and basis. Living with the situation is one possibility, although risk of inadvertent repayment often makes this unacceptable. An alternative course of action is for the shareholder to contribute his debt to the corporation's capital. In this way, the basis and face amount will again be the same.

Example. Assume an electing subchapter S corporation with one individual shareholder.

Year 1

	Financial basis		Tax basis	
	Debt to S/H	Equity	Debt to S/H	Equity
Beginning of year 1	$2,500	$1,000	$2,500	$1,000
Loss—year 1		(2,500)	(1,500)	(1,000)
End of year 1	$2,500	$(1,500)	$1,000	—

The loss of $2,500 has been charged to equity for financial purposes, creating an equity deficit of $1,500. For tax purposes, however, this deficit is charged to the liability to the shareholder.

Year 2

	Financial basis		Tax basis	
Beginning of year 2	$2,500	$(1,500)	$1,000	—
Profit—year 2		5,000		$5,000
End of year 2	$2,500	$3,500	$1,000	$5,000

In each case, the year 2 profit (i.e., "restoration") has been credited to equity. For financial purposes, this effectively restores the deficit created by the year 1 loss. For tax purposes, however, the "restoration" does not restore the deficit because the deficit was charged to the corporation's debt to its shareholder. Thus, the corporation's repayment of the $2,500 debt will cause the shareholder to recognize income of $1,500 (the excess of the repayment of $2,500 over the shareholder's adjusted basis of $1,000) even though a *distribution* of earnings, if done properly, would not result in any additional income recognition to the shareholder.

Contribution of the debt to equity by the shareholder will equalize the financial and tax basis, as follows:

	Financial basis		Tax basis	
	Debt to S/H	Equity	Debt to S/H	Equity
End of year 2	$2,500	$3,500	$1,000	$5,000
Contribute debt to equity	(2,500)	2,500	(1,000)	1,000
Balance	—	$6,000	—	$6,000

Cooperatives and their patrons

SECTION 1381

Pass through to co-op apartment owners

Section 316(h) of the '78 act provides that the portion of the investment tax credit that cannot be used by a cooperative organization described in sec. 1381(a) passes through to the patrons of the organization. The conference committee reports indicate that it is anticipated that the allocation of the credit to patrons will be on a basis similar to that used for patronage dividends under sec. 1388(a).

The leading case of *Park Place, Inc.*, clearly establishes that a sec. 216 cooperative housing corporation is subject to the provisions of sec. 1381 *et seq*. The case also establishes that tenant-stockholders who patronize common facilities such as laundry rooms, recreation areas, etc., and who are assessed charges with respect to the use thereof are patrons, and any reimbursement of assessments in excess of expenses distributed to such patrons are patronage dividends pursuant to sec. 1388(a).

It therefore seems clear that section 316(h) of the '78 act applies, in general, to cooperative housing corporations and their tenant shareholders even though the latter use their apartments solely as a personal residence.

Consolidated returns

SECTION 1502

Consent dividend gives more flexibility than deemed dividend

Much has been written about the deemed-dividend election in regs. sec. 1.1502-32(f)(2) of the consolidated-return regulations. One of the advantages of the deemed dividend is that it increases the basis of a subsidiary by the amount of earnings and profits (E&P) accumulated during separate but affiliated non-SRLY years and during pre-1966 consolidated-return years. Another advantage is that it precludes the effect of the adjustment-on-disposition rule of regs. sec. 1.1502-32(g), which provides for the reversal, on the first day of a separate-return year, of net positive investment adjustments made during previous consolidated-return years.

The deemed-dividend election, however, can be made only for subsidiaries that were wholly owned by the affiliated group on every day of the subsidiary's taxable year. Further, the deemed dividend is effective on the first day of a consolidated-return year and represents a dividend of all the subsidiary's E&P.

Contrast this with the consent-dividend treatment of sec. 565(c)(1) and (2). The consent dividend may apply to a subsidiary that was not wholly owned during the full taxable year, and the subsidiary need not be wholly owned at all. Also, the amount of the E&P may be selected and may not necessarily be *all* of the earnings and profits of the subsidiary. Finally, the consent dividend affects a subsidiary's E&P at the end of its taxable year.

It should be apparent, therefore, that the consent dividend allows more flexibility than the deemed dividend. The service has pointed out that the consent-dividend provisions are not limited solely to use by regulated investment companies, foreign personal holding companies, personal holding companies, and corporations subject to the accumulated earnings tax; they are available to all corporations subject

to the general taxing provisions of sec. 11. Thus, the service has held in Rev. Rul. 74-59 and in IRS Letter Rulings 7832023 and 7911035 that a consent dividend is deemed distributed by a foreign corporation for purposes of the allowance of the foreign tax credit under sec. 902.

The consent dividend, therefore, should be available for corporations filing consolidated returns, and it provides more flexibility than the deemed dividend while allowing all of the latter's advantages.

Consolidated returns: eliminating the effect of the inventory adjustment

The consolidated-return regulations, in regs. sec. 1.1502-18, provide for an adjustment to limit, in certain situations, the profit deferral on intercompany sales of inventory. This adjustment, made for the first consolidated-return year and each succeeding consolidated-return year, limits the amount of profit deferral during any consolidated-return year to the excess of the purchasing member's inventory over the selling member's profit (as of the last day of the last separate return year of the selling member). For this adjustment to apply, the selling and purchasing members must be members of the same affiliated group in the last separate return year and in the first succeeding consolidated-return year.

Example. A group consists of *P* and *S*; *P* is the purchasing member, and *S* is the selling member. A separate return was filed for the taxable year 1977, in which S realized a $100 profit on sales that are in *P*'s inventory as of December 31, 1977. In 1978 *P* sold to outsiders the inventory items on which *S* had realized the $100 profit in 1977. A consolidated return was filed for that year; and at the end of the taxable year, the intercompany profit amount in inventory was $120. As a result of the inventory adjustment, only $20 of the inventory profit was deferred.

Regs. sec. 1.1502-18(e) provides that if the selling member transfers or distributes the inventory to another member of the group in a transaction governed by sec. 381(a) the acquiring corporation will inherit the limitation. Since the inheritance rule only applies to a transaction described in sec. 381(a), it may be inferred that in a transaction governed by sec. 351 the limitation would not be inherited by the transferee corporation. Thus, in the illustration, if S transferred its manufacturing function to another member, the limitation would not apply, and the amount of the deferral at the end of 1979 would be $120.

This interpretation of regs. sec. 1.1502-18(e) has been confirmed in a technical advice memorandum (IRS Letter Ruling 7839003). The IRS held that, based on the strict language of the section, the

limitation is lifted in a transaction governed by sec. 351. Thus, assuming that business circumstances permit, any member of an affiliated group that is subject to the inventory adjustment can realize the full benefit of the deferral of intercompany profit by making a sec. 351 transfer of its operations to a new subsidiary.

Purchase of loss subsidiary from affiliated group

When purchasing stock of a corporation that has been a member of an affiliated group, the buyer should be alert to unexpected tax results since circumstances arising after the sale can affect the tax attributes of the acquired company. Consider the following situation.

For the taxable years 1973, 1974, and 1975, an affiliated group incurred consolidated net operating losses (NOLs) that remained as carryforwards to 1976. In May 1976, *P* (parent of the group) sold all of the stock of *S* (subsidiary) to several individuals. After the sale of the *S* stock but prior to the end of 1976, *P* (a building contractor employing the completed contract method of accounting for its long-term construction contracts) closed several large and profitable long-term contracts. The taxable income generated by *P* upon completion of these contracts was sufficient to absorb not only the consolidated NOL carryovers but also the current year's four-month loss while *S* was a member of the group. *S*'s four-month 1976 loss plus its share of the consolidated NOL carryover was $1 million. The sales contract contained no provision relating to the allocation of consolidated federal income tax liability, nor reimbursement for utilization of *S*'s losses against consolidated taxable income.

The new shareholders of *S* were informed that no carryovers were available to *S* since the 1976 consolidated taxable income was sufficient to absorb all such carryovers. Regs. sec. 1.1502-79(a)(1)(ii) specifically provides,

> If a corporation ceases to be a member during a consolidated return year, any consolidated net operating loss carryover from a prior taxable year must first be carried to such consolidated return year, notwithstanding that all or a portion of the consolidated net operating loss giving rise to the carryover is attributable to the corporation which ceases to be a member. To the extent not absorbed in such consolidated return year, the portion of the consolidated net operating loss attributable to the corporation ceasing to be a member shall then be carried to such corporation's first separate return year.

Thus, due to events that occurred entirely after the date of sale, *S* was precluded from using any of its losses for the current four-month period and prior years. Moreover, since the sale contract was silent on reimbursement for *S*'s losses usable by the affiliated group,

and since no formal tax allocation agreement was in effect, legal counsel advised that it is doubtful that S's new owners would be entitled to reimbursement.

If planning for the seller, consideration might be given to accelerating income of the remaining members of the affiliated group in the year of sale to eliminate any NOL carryover to the postaffiliation years of the divested subsidiary. However, as indicated above, the purchasers should foresee this possibility and take appropriate steps to protect their interests.

When acquiring a subsidiary of an affiliated group, it is also important to consider the possibility that the subsidiary will subsequently incur NOLs that may be carried back to a consolidated-return year. See "Establish right to future carryback refund when subsidiary acquired from consolidated group," *Working With the Revenue Code—1976*, AICPA, p. 320 (sale contract should provide for the handling of carrybacks), and "Consolidated returns: elections to waive NOL carrybacks and allocate taxes," *Working With the Revenue Code—1978*, p. 356 (parties should contractually agree about whether the subsidiary may waive NOL carryback under sec. 172(b)(3)(E)).

Acceleration of income to reduce tax on sale of consolidated subsidiary

The consolidated-return investment adjustment rules sometimes produce seemingly anomalous tax results. Most tax professionals are aware of the beneficial step-up in tax basis that may result from a deemed-dividend election upon sale of a consolidated subsidiary (regs. sec. 1.1502-32(f)(2)). Not as well known, however, is the technique of accelerating taxable income of a subsidiary prior to sale of its stock in order to effect a similar increase in tax basis. This tactic may effectively transform tax timing differences into permanent savings.

A simplified example will illustrate the substance of this planning technique.

Assume that a consolidated subsidiary, whose sale is being contemplated, reports income for tax purposes on the installment method and has $1,000,000 of such income deferred for tax purposes. As is common in such cases, this income has already been recognized for financial reporting purposes and the company's balance sheet reflects a "deferred" federal tax liability of $480,000, as required by Opinion no. 11 of the Accounting Principles Board.

The parent company has been permitted by regs. sec. 1.1502-32 to increase its tax basis in this subsidiary for earnings and profits accumulated during affiliation. However, adoption of the installment method has delayed the recognition of earnings and profits (as well as taxable income), and therefore

the parent's tax basis in the subsidiary does not reflect the untaxed installment sale profits. (See regs. sec. 1.312-6(a).)

If the subsidiary were to sell the installment receivables immediately prior to its disposition, consolidated taxable income would be increased by this $1,000,000 of deferred income. But, more importantly, the parent's tax basis in the subsidiary would be increased by $520,000 ($1,000,000 of income less an assumed sec. 1552 tax allocation of $480,000). The parent's 30 percent capital gain tax on the sale of the subsidiary's stock would therefore be reduced by $156,000, a permanent tax savings.

Admittedly, the consolidated tax liability would also be increased by $480,000 as a result of the acceleration of this timing difference. However, this $480,000 liability is effectively "covered" by the deferred tax liability already provided on the subsidiary's books, which it could then pay up to its parent. The purchaser presumably would have no practical objection to this tactic—or to the subsidiary's payment of the tax—since it should in no way alter net worth. In fact, the purchaser might welcome this action since the subsidiary would then come to him with more cash in place of an installment receivable that had a $480,000 tax liability attached to its realization. And, of course, the sale of existing installment receivables in no way precludes the subsidiary from using the installment method for future sales.

The net result of this acceleration of income is a permanent tax saving of $156,000 achieved at the cost of temporarily accelerating a deferred tax liability that would have had to be paid eventually in any event. (The tax saving could even be greater than $156,000 if the group were subject to minimum tax liability. Not only will this tactic reduce taxable capital gain preferences directly, but the acceleration of deferred tax liabilities can indirectly reduce a minimum tax liability by increasing the current tax offset.)

While this simplified example involves installment receivables, similar results may be obtained from accelerating taxable income associated with other types of timing differences. *Depreciation is an exception*. Because of the provisions of sec. 312(k), a switch from accelerated to straight-line depreciation does not directly affect the recognition of earnings and profits and, therefore, presumably would have no impact on consolidated return investment adjustments. (In fact, there could be a substantial benefit to remaining on accelerated depreciation since the additional depreciation deduction may not have to be reflected as a reduction of stock basis.)

Some caveats for this tax planning technique are as follows:

- For technical reasons, the desired tax-free step-up may not result, in whole or part, if there are unused consolidated or separate losses attributable to the subsidiary that would otherwise be spun off with it pursuant to regs. secs. 1.1502-79 and 1.1502-11.
- The efficacy of this maneuver may depend upon the cooperation of the purchasing party, particularly with regard to the payment of deferred taxes to the parent. Since it can be demonstrated that the purchaser should not be adversely affected, it should be discussed with him in advance to avoid any misunderstanding.

- There can be acquisition situations where a completely reverse strategy would be in order—for example, if the acceleration of a subsidiary's deductions or the deferral of its income by the selling parent would not require collateral purchase price adjustments because of deferred taxes. Interpretation by legal counsel of the pertinent provisions of the contract of sale (particularly the tax allocation provisions) would therefore be in order before finally adopting any position with respect to the timing of taxable income or deductions.

Consolidated loss carrybacks after a reverse acquisition

A recent IRS technical advice memorandum to a bank holding company affiliated group (IRS Letter Ruling 7932006) sheds some light on the mechanics of carrying back consolidated net operating losses (NOLs). The ruling is illuminating in two ways. First, it deals with an affiliated group having different carryback periods, since bank members of the group were entitled to extended 10-year carrybacks under sec. 172(b)(1)(f). Second, it concerns the application of the regs. sec. 1.1502-79(a)(2) nonapportionment rule to a reverse acquisition.

The affiliated group in question consisted of holding company parent *A* and bank *C*. Both *A* and *C* had been newly formed in 1974 for the purpose of creating a holding company structure. *C* was the surviving entity after a merger with existing bank *B*. The merger constituted a reverse acquisition for consolidated-return purposes; and, pursuant to regs. sec. 1.1502-75(d)(3)(v)(*b*) (which pre-empts the normal sec. 381(b) rules), bank *B*'s prior years remained open for carryback purposes.

In 1976 (the first year for which the special 10-year carryback rules applied), the affiliated group incurred a consolidated NOL, part of which was attributable to *A*. Since it had been newly formed in 1974, *A* did not have a complete three-year carryback period of its own. The affiliated group attempted to carry *A*'s loss back 10 years to *B*'s prior taxable years, relying on the nonapportionment rule for newly formed affiliates.

An IRS examining agent challenged this carryback and referred the matter to the IRS national office. The national office upheld the agent and, despite the literal language of the regs. sec. 1.1502-79(a)(2) nonapportionment rule, refused to permit any nonbank losses to be included in the 10-year carryback.

A number of bank holding companies could be similarly affected by this ruling.

Sale of depletable property to group member in consolidated-return year

Tax planning is required for any transfer of depletable property among members of an affiliated group filing consolidated returns, especially if the transfer takes the form of a sale from one member to another.

Assume a parent of a consolidated group owns property that has a tax basis of zero and a fair market value of $1 million. Percentage depletion is taken in the amount of $100,000. Assume also that the parent sells the property at its fair market value to a subsidiary in a consolidated-return year and that the subsidiary will take a percentage depletion deduction of $100,000.

The sale of property is a deferred intercompany transaction as defined in regs. sec. 1.1502-13(a)(2). The $1 million gain on the sale will be a deferred sec. 1231 gain and reported ratably by the parent as the subsidiary claims depletion deductions in the following manner pursuant to regs. sec. 1.1502-13(d):

$$\frac{\$100{,}000 \text{ depletion}}{\$1{,}000{,}000 \text{ basis}} \times \$1{,}000{,}000 \text{ deferred gain} = \$100{,}000 \text{ income}$$

The $100,000 profit that is triggered into income annually would, under regs. sec. 1.1502-13(c)(4)(ii), be converted from sec. 1231 gain to ordinary income.

Thus, in effect, the group as a whole will lose $1 million of depletion deductions. Prior to the transaction, the group was entitled to a $100,000 depletion deduction. Although the subsidiary will receive that same deduction, the parent will simultaneously offset the deduction by a like amount of income. Thus, the group effectively will be losing annually $100,000 in depletion deductions until the full $1 million deferred income is reported. Proper tax planning would have found it preferable in this case if the property had been transferred to the subsidiary by way of a contribution to capital.

IRS extends SRLY rule to preference tax carryovers

The consolidated-return regulations severely limit the use of certain carryovers from a separate-return-limitation year (SRLY) of a subsidiary included in a consolidated return. (See, e.g., regs. sec. 1.1502-21(c), concerning limitation on NOL carryovers.) When the present consolidated-return regulations were adopted in 1966, the SRLY taint

was made applicable to all then-existing carryovers, except for charitable contributions. (It is not known why charitable contributions were excepted from this rule, but it appears to have been a deliberate exclusion, prompted, perhaps, by a feeling that abusive trafficking did not occur with respect to such carryovers.)

A recent IRS private ruling (IRS Letter Ruling 7910008) indicates that the IRS national office has a more expansive view of the SRLY rule, notwithstanding the absence of specific implementing regulations. In that ruling, the IRS held that the SRLY limitation applied to the tax carryover deductions that were available to taxpayers for preference tax purposes prior to the enactment of the Tax Reform Act of 1976.

This ruling may be an indication that the IRS intends to extend the SRLY rules not only to preference tax carryovers but also to other carryovers that have been enacted since the 1966 promulgation of the consolidated-return regulations—e.g., WIN credits and job tax credits. There would appear to be no more abusive trafficking in these carryovers than in charitable contributions. Nevertheless, the attitude expressed in this recent ruling may presage a stiffening attitude by the service towards the SRLY limitation.

Consolidated returns: accelerated depreciation on consolidated-return investment adjustments

Under the consolidated-return regulations, the basis in stock of a subsidiary is increased by the subsidiary's net earnings and profits (E&P) for the year or decreased by the net deficit in earnings and profits (regs. sec. 1.1502-32(b)). Another required investment adjustment is an increase in the subsidiary's stock basis by any subsidiary net operating loss of which the affiliated group has availed itself either currently or by way of a carryback. Under sec. 312(k), corporations are required to recognize, for E&P purposes, an allowance for depreciation in an amount that would be allowable for the year if the straight-line method had been used.

IRS Letter Ruling 7946008 addressed a situation in which these rules caused some strange results. In that case, the parent company realized taxable income of $233,000, while its subsidiary sustained a loss of $550,000, thus creating a consolidated net operating loss of $317,000, attributable solely to the subsidiary. Because of accelerated depreciation, the deficit E&P of the subsidiary was only $278,000. The result of these figures was that the parent decreased the basis of the subsidiary's stock by the $278,000 negative E&P and increased the basis by the $317,000 NOL. Thus, even though the subsidiary suffered an NOL, its basis was increased by $39,000.

The same type of situation can occur without the existence of a consolidated NOL. For example, a subsidiary may have large accelerated depreciation deductions that create an NOL, of which the group avails itself, but at the same time generate positive E&P.

The dichotomy was created when the predecessor of sec. 312(k) (sec. 312(m)) became effective for taxable years beginning after June 30, 1972. The investment adjustment provisions of the consolidated-return regulations were effective for taxable years beginning after December 31, 1965, and were never amended to reflect the sec. 312(k) rule. Obviously, the service has not felt it necessary to amend the regulations, probably believing that accelerated depreciation is merely a timing item that will ultimately wash out.

Consolidated returns: excess loss accounts in a multitier disposition

A member of an affiliated group that owns stock in a subsidiary must apply the subsidiary's losses as a reduction of its basis in the subsidiary's stock. This is required only to the extent that the losses are used to offset current or previous group earnings as reported for federal income tax purposes on a consolidated basis. If the required application of losses exceeds the member's basis in the stock, an excess loss account results (regs. sec. 1.1502-32(e)(1)).

In general, a member disposing of a subsidiary's stock must include in income, immediately before the disposition, an amount equivalent to any excess loss account that exists in respect of the disposed-of stock (regs. sec. 1.1502-19(a)(1)). An election is provided, however, whereby the excess loss account may reduce the basis of any other stock or obligation of the subsidiary (whether or not evidenced by a security) that is held by the disposing member immediately before the disposition. Any portion of the excess loss account that is not absorbed in this manner must be taken into income (regs. sec. 1.1502-19(a)(6)). If the member disposes of the stock of more than one subsidiary in the same transaction, the application of these rules will be carried out in the order of the tiers, from the lowest to the highest (regs. sec. 1.1502-19(c)(1)).

To understand the consequences of these rules, consider the following example:

> Corporation *P* owns all the outstanding stock of corporation *S*; *S* owns all the outstanding stock of corporation *T*. The group files its federal income tax returns on a consolidated basis. Over the years, the operations of *P* and *S* have been profitable, while the operations of *T* served only to generate losses that were offset against the income of the other members of the group. The accumulated losses of *T* are such that *S* maintains an excess loss account in

respect of *T*'s stock. Immediately before the time at which *P* consummates a sale of its *S* stock to an unrelated entity, the excess loss account maintained by *S* amounts to $300,000.

It seems clear that the transfer of the *S* stock by *P* constitutes a disposition within the meaning of the excess-loss-account rules. Furthermore, it appears from the regulations that a disposition by *S* of the *T* stock is considered to have occurred. Regs. sec. 1.1502-19(b)(2) specifies the following:

A member shall be considered . . . as having disposed of all of its shares of stock in a subsidiary—
(i) on the day such *subsidiary* ceases to be a member, [or]
(ii) on the day such *member* ceases to be a member. . . ." [Emphasis added]

If this passage is applied to *P*, *S*, and *T*, it seems even clearer that two dispositions are recognized. First, a member, *P*, is considered to have disposed of all of its shares of stock in a subsidiary, *S*, on the day that the subsidiary, *S*, ceases to be a member of the affiliated group. Second, a member, *S*, is considered to have disposed of all of its shares of stock in a subsidiary, *T*, on the day that the member, *S*, ceases to be a member of the affiliated group. The disposition by *P* of *S* stock presents no significant problems, since no excess loss account exists with respect to *S*'s stock. Due to the disposition of the *T* stock by *S*, however, the excess loss account in respect of *T*'s stock is triggered, and *S* must include $300,000 in its income immediately before the disposition. This, of course, could have a serious effect on the group's normal tax liability.

Assume further that a receivable in favor of *S* from *T* in the amount of $275,000 is held along with the other assets owned by *S*. *S*, the disposing member, can elect to apply the excess loss account in reduction of its basis in the other obligation of *T* that was held immediately before the disposition. Upon an election by *S*, the basis in the *T* receivable can be reduced to zero; thereafter, only the unapplied portion of the excess loss account ($25,000) must be included in the income of *S*.

The regulations specify no time at which the election to apply the excess loss account to the basis of other investments should be made, nor is any manner provided for carrying out the application. Presumably, an election can be effected at any time before the statute of limitations has expired for the year in which the excess loss account was triggered. Furthermore, it seems possible that the disposing member can apply the excess loss account to the other investments in any way that it wants (e.g., pro rata).

. . . election to postpone or eliminate excess loss account

If an excess loss account is triggered, an affiliated shareholder can elect under regs. sec. 1.1502-19(a)(6) to reduce the amount of excess losses restored to income to the extent of the basis of other stock or obligations of the subsidiary that the disposing member owns immediately before the disposition. Other stock owned may be common stock with a higher basis or other classes of common or preferred stock. Obligations for this purpose include advances, accounts payable, notes, bonds, and other evidences of indebtedness. The regulations give no priority as to the application of the excess loss account against stock or obligations.

If such election is made, consideration should be given to which stock or obligation will be satisfied in the near future, the extent of any expiring carryovers, future liquidations, and whether a separate return may be filed in the near future.

The regulations are silent as to the time and manner of making the election. Thus, the election presumably can be made in a timely filed return or should be allowed later if the excess loss recapture is first raised on examination. IRS Letter Ruling 7836004 implies that the election can be made at a later time. The regulations are also silent as to whether the election, once made, is binding both in respect to the triggering of the excess loss account and the selection of securities whose basis is reduced. In view of this silence as well as the fact that the regulation section is remedial in nature, the IRS should permit revocation or modification of the election.

Consolidated returns: sale of subsidiary's stock within consolidated group could be a trap for the unwary

Rev. Rul. 81-84 illustrates a trap for the unwary where the stock (possessing an excess loss account) of a second-tier subsidiary is sold to the common parent of an affiliated group during a consolidated-return year.

A transfer of stock of a subsidiary by one member of the group to another in a consolidated return is not deemed a disposition for purposes of the excess-loss provisions, provided the basis of the stock of the subsidiary is transferred to the affiliate. Examples of such a transfer would be contributions of capital or tax-free mergers. However, an intercompany sale of the stock requires the determination of a new basis in the hands of the seller member under regs. sec.

1.1502-31(a) and therefore would constitute a disposition under regs. sec. 1.1502-19(b)(1)(i) with the result of triggering the excess loss account. But because the sale is a deferred intercompany transaction such triggering of the excess loss account gain is deferred, and is includible in the seller's income pursuant to regs. sec. 1.1502-13(d), (e), and (f).

The problem occurs because there is a deferred gain outstanding without any member leaving the affiliated group; there is a mere restructuring of the group. Care is required or the deferred intercompany gain will be triggered into income. For example, if the transferred subsidiary is later liquidated into the common parent, the deferred excess loss amount must be taken into income, even though there had not been an economic change of the group. The same problem would occur even if no excess loss existed and the stock of one member was sold to another member at a gain during a consolidated-return period.

An alternative transaction was available: the first-tier subsidiary transfers the stock of the second-tier subsidiary to the common parent as a dividend. Such a dividend would not qualify as a disposition of an excess loss account since the common parent would inherit the stock basis. Thus, the common parent would succeed to the excess loss account. However, the regulations do not expressly cover the basis adjustments that should be made to the stock of the first-tier subsidiary. A review of the pertinent provision indicates that the intent of the regulations is to place the members in the same position as if the transferee member always owned the transferred stock. Under this interpretation, the basis of the stock of the first-tier subsidiary should be increased by any excess loss account with respect to the transferred shares.

Structuring the transaction in the form of a sec. 355 spin-off does not ease the problem, since the same result will occur as with the sale of stock. Thus, careful planning is required in transferring affiliated members within the group, especially where an excess loss account is present.

Consolidated returns: *ITT* case poses challenge to regs. on source of income rules

A recent Court of Claims decision casts doubt on the IRS approach to determining income from sources within the United States (regs. sec. 1.861-8), the foreign tax credit limitation (sec. 904), and the credit limitation on foreign oil and gas income (sec. 907) with respect to affiliated groups of corporations filing a consolidated return. In

International Telephone and Telegraph Corp. the government unsuccessfully argued that (1) specified items of foreign-source gross income and deductions should be allocated to individual members of the affiliated group that filed a consolidated return, (2) items of gross income and deductions not specifically allocable to foreign or domestic sources should be ratably apportioned on a per-company basis, and (3) foreign-source taxable income should be computed on a per-company basis and then aggregated to produce the consolidated foreign tax credit limiting fraction. The taxpayer successfully contended that the portion of the not definitely allocable expenses deducted from foreign source gross income should be computed as if the affiliated group were one unit to which all foreign-source gross income and all foreign-source deductions are allocated.

Although the *ITT* case did not specifically mention regs. sec. 1.861-8(a)(2), that regulation plainly is inconsistent with the overall limitation prescribed by the Court of Claims under sec. 904. For example, the regulation provides—

> If an affiliated group of corporations joins in filing a consolidated return under section 1501, the provisions of this section are to be applied separately to each member in that affiliated group for purposes of determining such member's taxable income.

Regs. sec. 1.861-8(f)(1)(vi) provides—

> The rules provided in this section also apply in determining . . . [t]he amount of foreign oil and gas extraction income and the amount of foreign oil related income under section 907. . . .

The government may or may not seek review of the *ITT* case by the U.S. Supreme Court, but in any event it does not appear likely that the Court will address the issue in the near future. Consequently, affected taxpayers should consider contending that, based on the *ITT* case, regs. sec. 1.861-8 is invalid to the extent that it requires that the section be applied separately to each member in (the) affiliated group. It is likely that treating a consolidated group as one unit to which all foreign oil and gas extraction income (sec. 907) and all allocable and apportionable deductions are ascribed will produce greater foreign oil and gas extraction income than a computation made by netting income and deductions company by company. It is also highly possible that total creditable foreign income will be increased by this same method of computation, and that approach should be examined closely in each case.

Editors' note: Certiorari *was not authorized in the* ITT *case*.

Temporary "at risk" regs. for closely held corporations filing consolidated returns

The Revenue Act of 1978 amended sec. 465 to provide that a corporation that meets the stock ownership test for a personal holding company (whether or not the adjusted-gross-income test is met) may deduct losses attributable to any of its activities (except for the holding of real estate and equipment leasing) only to the extent that it is at risk in the activity. The House Ways and Means Committee report on the '78 act states that in the case of an affiliated group the revised sec. 465 will apply to all corporations in the group if it applies to the common parent (H. Rep. No. 95-1445, 95th Cong., 2d sess., 1978, p. 69).

According to the literal terms of the statute, taxpayers can adopt a plan whereby a subsidiary corporation is formed with nominal capital and goes at risk in some activity. The parent corporation then can use the subsidiary's losses in a consolidated return, since the subsidiary is technically "at risk" in the activity and deductions are not barred by sec. 465. On the other hand, if the parent corporation conducts the activity directly without risk of loss, sec. 465 disallows the loss.

According to the IRS, to permit such a loss through the use of a subsidiary would frustrate the congressional intent of sec. 465. So, pursuant to its broad power under sec. 1502, the IRS has issued temp. regs. sec. 5.1502-45, providing that, if a parent meets the stock ownership test for a personal holding company, a subsidiary's loss from an activity to which sec. 465 applies will be allowed as a deduction on a consolidated return only to the extent that the parent is at risk in the activity of the subsidiary under the principles of sec. 465 as of the close of the subsidiary's taxable year. The temporary rules are effective for taxable years for which the due date (without extension) for filing returns is after March 14, 1980.

Editors' note: As of this time, the temporary regulation has not been modified, retracted, nor finalized.

Consolidated returns: an alternative to the sec. 334(b)(2) liquidation

The Revenue Act of 1962 added a number of recaptures to the code, such as the depreciation recapture under secs. 1245 and 1250, and investment credit recapture under sec. 47. In the years since 1962, taxpayers and their advisers have often found that because of these

and other recaptures subsequently enacted into law, it has become increasingly expensive, and in some cases prohibitive, to liquidate—pursuant to secs. 332 and 334(b)(2)—subsidiaries acquired by purchase at prices reflecting appreciated current values considerably higher than the tax basis of the underlying assets.

The problem is that the immediate cost of paying the recapture tax frequently exceeds the present value of future tax savings available from the stepped-up bases of the assets distributed on liquidation. There are available, however, a number of alternatives to the sec. 334(b)(2) approach which may avoid some of its disadvantages and thus permit unalloyed enjoyment of the tax benefit from the step-up for which the acquiring corporation has paid.

Where a consolidated return is filed, regs. sec. 1.1502-31(b)(2)(ii) can give a result comparable to that under sec. 334(b)(2). In substance, this regulation provides that the adjusted basis (which includes investment adjustments under regs. sec. 1.1502-32) of the stock of a subsidiary, increased by liabilities assumed and by liabilities to which the underlying assets of the target company are subject, will be allocated among the assets received in a distribution in cancellation or redemption of stock between members of a consolidated group, except in a transaction to which sec. 332 applies.

To fall within the cited regulation, however, the distribution must—

- Fail one of the tests provided in sec. 332 (if a complete liquidation is involved), or
- Qualify as a partial liquidation under sec. 346.

Although gain or loss would normally be recognized by the transferee in either of these cases, regs. sec. 1.1502-14(b), dealing with distributions in respect of the stock of members of an affiliated group filing a consolidated return, provides for nonrecognition during consolidated-return years of gain or loss under most circumstances and for deferral of any gain or loss that would otherwise be recognized in a partial liquidation.

Application of sec. 332 to a complete liquidation may be avoided in various ways, of which the following two are probably most common.

- Having the transferor (target) corporation adopt its plan of liquidation *prior* to the transferee corporation's obtaining the requisite 80 percent stock ownership of voting control.
- Stretching out a series of liquidating distributions over a period longer than three years following the close of the taxable year of the first such distribution. (See sec. 332(b).)

The result under the consolidated-return regulations would be a

step-up under the cited regulations and avoidance of immediate investment credit recapture under regs. sec. 1.1502-3(f)(2)(i) and (iii). The potential for recapture of the assets would, of course, carry over to the transferee and would be triggered by an early disposition of the assets by that member.

Because the transferor corporation remains in existence as a member of the consolidated group, a partial liquidation can not only avoid immediate investment credit recapture, but also defer the tax impact of recaptures of gain under secs. 336, 1245, 1250, 1254, the tax benefit rule, and similar provisions. Under regs. sec. 1.1502-14(c), such gains, otherwise recognized in a partial liquidation, are treated as deferred intercompany transactions. As a result, the gain is recognized by the transferor corporation only when—

- The transferee corporation obtains a corresponding deduction for depreciation, depletion, and amortization;
- The property is disposed of outside the consolidated group.

By taking advantage of these provisions in the consolidated regulations, the up-front tax cost can be virtually eliminated (in the case of investment credit recapture) and at least deferred (in the case of recaptures for depreciation, intangible drilling costs, and the like).

SECTION 1504

Sec. 1504(d) elections: IRS answers some questions

A domestic corporation may elect to treat a wholly owned Mexican or Canadian subsidiary as a domestic corporation to be included in a consolidated tax return. Under sec. 1504(d) the subsidiary must be a corporation organized under the laws of a contiguous foreign country and maintained solely for the purpose of complying with that country's laws regarding title and operation of property.

The service, in IRS Letter Ruling 7942001, has cleared up several questions in connection with sec. 1504(d). In the case addressed by the ruling, a domestic corporation acquired all of the stock of an existing Mexican corporation. First, the service held that the Mexican corporation need not be organized by the electing domestic corporation. Secondly, the foreign corporation does not have to be *organized* to comply with foreign law; it is sufficient that the foreign law requires the subsidiary corporation to be maintained and operated as a foreign corporation at the time the benefits of sec. 1504(d) are sought. Finally, the maintained solely requirement relates to the

reason that the subsidiary is maintained as a foreign corporation rather than to the reason that it is maintained as a subsidiary. The ruling did state, though, that the maintained-solely requirement would be involved in cases in which a subsidiary corporation's activities requiring foreign incorporation are so insubstantial in relation to its other activities that they appear to be conducted merely for purposes of qualification under sec. 1504(d) rather than for bona fide business purposes.

Controlled corporations

SECTION 1552

Consolidated returns: tax allocation agreements

Members of an affiliated group may choose among various alternatives for allocating the consolidated tax liability. The three basic methods are the separate taxable income method, the separate return liability method, or a hybrid of the two (sec. 1552, and regs. sec. 1.1552-1). The three basic methods do not permit a loss member to be compensated for the use of the loss in the consolidated return. It is possible to provide for such compensation under the supplementary methods of allocation under regs. sec. 1.1502-33(d). If actual payments differ from the amount calculated under the affiliated group's tax election, the difference gives rise to dividends or capital contributions, as the case may be. (See Rev. Ruls. 73-605 and 76-302.)

The allocation under the tax rules frequently does not correspond to the accounting treatment. For example, accounting principles may require recognition of investment credit that is not reflected in the method elected for tax purposes. It is not uncommon for the difference to end up in an intercompany account that is not actually paid, or is paid only by offset.

The tax allocation problem is further complicated when there is no allocation agreement among the members of the affiliated group, or when members are to be given credit for losses utilized in the consolidated return. The absence of a tax allocation agreement can result in disputes with the service over disguised dividends or the basis of stock in a subsidiary. It can result in disputes over handling the intercompany account that may arise from differences in tax election and accounting principles, e.g., with respect to bad debts or forgiveness of indebtedness. It may also lead to disputes with minority shareholders, trade creditors, lenders, or other interested parties if one of the members of the group is financially troubled. For a recent example, see *Jump* v. *Manchester Life & Casualty Manage-*

ment Corp. As a result, it is generally advisable that members of the affiliated group have a legally binding tax allocation agreement.

If a group has no tax allocation agreement and minority shareholders are about to acquire stock in a member of the group, consideration should be given to whether the agreement should be negotiated before or after the minority shareholders have representation on the board of directors. (See Peel, *Consolidated Tax Returns*, 2d ed., p. 280.) This and other legal issues have to be resolved by legal counsel, but the CPA should also work closely with counsel on the accounting and tax implications of tax allocation agreements. The importance of tax allocation agreements in the event of dispositions of members of the group is illustrated by the following item.

SECTION 1561

Maximizing surtax exemptions

The maximization of tax benefits arising from proper utilization of the corporate surtax exemption has always been an important tax planning goal. With multiple surtax exemptions no longer available, members of a controlled group will be limited to a single surtax exemption. However, proper tax planning may increase the allowable exemptions when an affiliated corporation is acquired, sold, or liquidated.

Acquisition of related corporation. A corporation is not limited to its allocated share of the surtax exemption of the controlled group with which it is affiliated on December 31 if it has been a member of such group for less than one-half of the days in its taxable year preceding December 31. For example, assume both *P* and *S* are calendar-year corporations and neither is a member of a controlled group. If *P* acquires 100 percent of the stock of S on June 15, 1977, *P* and S must each share a single surtax exemption in computing their respective 1977 income tax liability since S has been a member of the controlled group for at least one-half of the days in its taxable year that precedes December 31, 1977. However, if *P* acquires 100 percent of the stock of S on July 15, 1977 (i.e., one month later), each will be entitled to its own exemption since S has been affiliated with *P* for less than one-half of the days in its taxable year preceding December 31, 1977.

Sale of related corporation. Even though a corporation is not a member of an affiliated group on December 31, it may nevertheless be limited to its allocated share of the surtax exemption if it has been a member of an affiliated group for one-half or more of the days in

its taxable year that precedes December 31. For example, assume *P* and *S* are calendar-year corporations that are not affiliated with any other corporations. *P* owns 100 percent of the stock of *S*. If *S* is sold to an unrelated individual who owns no stock in any other corporation on June 15, 1977, *P* and *S* will each be entitled to surtax exemptions in computing their 1977 income tax liability since *S* has been affiliated with *P* for less than one-half of the days in its taxable year that precedes December 31, 1977. However, if *S* is sold to the same individual on July 15, 1977 (i.e., one month later), *P* and *S* will each be limited to their share of a single surtax exemption in computing their respective 1977 income tax liability since *P* was affiliated with *S* for more than one-half of the days in its taxable year that precedes December 31, 1977.

Liquidation of related corporation. When a component member of a controlled group is no longer in existence on December 31, it does not affect the surtax exemption allowed other members of the controlled group for that December 31. For example, *P* and *S* are calendar-year corporations and the only members of a controlled group. On December 1, 1977, *S* is liquidated. *P* will be entitled to a surtax exemption in computing its 1977 income tax liability even though *S* has been affiliated with *P* for more than one-half of the days in its taxable year preceding December 31, 1977.

When a member of a controlled group of corporations is liquidated prior to December 31, resulting in a short period, it is also entitled to a pro rata portion of the controlled group's exemption determined as of the last day of its short taxable year. This exemption is in addition to the normal exemption allowed surviving members of the controlled group. For example, assume *P* and *S* are calendar-year corporations and neither is a member of a controlled group. *P* acquires 100 percent of the stock of *S* on April 1, 1977. If *S* is liquidated on April 30, it will be entitled to a full exemption in computing its income tax liability for its short taxable year ended April 30, 1977, since *S* was a member of a controlled group for less than one-half of the days in its taxable year that preceded April 30, the date of liquidation. However, if *S* is liquidated on November 30, 1977, its surtax exemption would be limited to one-half in computing its income tax liability for its short taxable year ended November 30, since it had been a member of a controlled group for at least one-half of the days in its taxable year preceding November 30, 1977. *P* will be entitled to a full exemption on December 31 if *S* has been liquidated by such date.

Estate and gift taxes

SECTION 2001

Estate tax: 1976 act can reduce benefits of Clifford trusts

The '76 act requires that adjusted taxable gifts made after December 31, 1976, be added to the taxable estate to arrive at the amount subject to tax for decedents dying after 1976 (sec. 2001(b)). Thus, if a taxpayer creates a 10-year trust (Clifford trust) that results in a taxable gift, even though the property in trust reverts to the taxpayer after ten years (or sooner if it terminates on the prior death of the beneficiary), the taxable gift will also be included in the taxpayer's estate. This is illustrated by the following example:

> On July 1, 1977, taxpayer *A* transfers in trust securities with a fair market value of $100,000. The trust's term is for ten years and one day. The trust provides that income be distributed to the taxpayer's son *B* for the term of the trust, the remainder to revert to *A* at termination.

Tax consequences. The gift tax on the above transfer is computed as follows:

Value of securities transferred to trust	$100,000
Value of income interest for 10 years and one day [regs. sec. 25.2512-9(f), table B]	.441605
Value of gift (rounded)	44,160
Annual exclusion	3,000
Taxable gift (taxpayer made no prior gifts)	41,160
Tentative tax	8,478
Unified credit	8,478
Gift tax liability	0

The gift results in no tax due because of the unified credit. However, the taxable gift of $41,160 will be added to the taxable estate of the taxpayer. Thus, the benefits derived from a 10-year

trust that results in a taxable gift are reduced by the additional estate tax due in the future. One must weigh the present value of the benefit of transferring income to the taxpayer's beneficiaries against the additional estate tax cost (if any).

Tax planning. The tax adviser should consider maximizing the annual exclusions available by using a trust for a period greater than 10 years. Thus, if property is contributed in December of one year and January of the next, two annual exclusions apply and the trust can be for 10 years and one month or longer. However, note that the value of the gift is increased by the length of the trust.

Editors' note: With the increase in the unified credit pursuant to the Economic Recovery Tax Act of 1981, Clifford trusts appear more attractive.

Gifts to parents for donor's children's benefit

Due to the add-back of adjusted taxable gifts required by sec. 2001(b)(1)(B), gifts in excess of $3,000 each year for each donee, which are taxable to the donor, are not removed from his estate tax base under the unified transfer tax system.

Consider the situation of *A*, a well paid executive who is more affluent than his parents, and who would like to make gifts to his children to save estate taxes. Because he has two children, the most that he can give each child annually, without using his unified credit, is $6,000, if his wife will split the gifts with him. Since he will not need additional income or property, his parents will leave their small estates directly to *A*'s children. Current gifts of up to $6,000 to each parent can, in effect, double the amount of excludible gifts that *A* can give to his children, assuming that his parents' estates pay no estate taxes. If *A*'s wife's parents are alive, and in similar circumstances, even greater tax-free transfers can be accomplished.

Editors' note: This technique is made even more attractive by the increase in the annual exclusion to $10,000 pursuant to the Economic Recovery Tax Act of 1981.

SECTION 2013

Estate tax: sec. 2013 credit and intangible property

Two recent similar estate tax situations illustrate the importance of understanding and taking advantage of the estate tax credit for tax on

prior transfers under sec. 2013. Both situations involved life interests bequeathed to surviving spouses in testamentary trusts and resulted in aggregate estate tax savings of hundreds of thousands of dollars.

Since the advent of the '54 code, the estate of a decedent who died after inheriting property that had been subject to estate tax in the estate of a prior decedent is entitled (within certain limitations) to a credit for the estate tax attributable to the same property in the first estate. Generally, the tentative tax credit is based on the lower estate tax on the property in either estate. This tentative credit for property previously taxed is gradually phased out after the period between the deaths of the two decedents has exceeded two years. If the interval between the deaths is from two to four years, only 80 percent of the tentative credit is allowed. For each additional two years the percentage of tentative credit allowable is reduced by 20 percent; after 10 years there is no credit allowable (sec. 2013(a)).

Although most tax practitioners are generally familiar with this credit, there is a prevalent misconception that it applies only to tangible personal and real property. This is not so. The term "property" in this context means *any beneficial interest* in property, including a general power of appointment, annuities, life estates, contingent remainders, and other future interests. In addition, there is *no tracing requirement;* the property need only have been subject to estate tax in the estate of the first to die, and the interest in the property must have been transferred to the second person to die. Thus, for example, if *A* leaves a bequest of $100,000 in cash to *B* and *B* dies within 10 years, *B*'s estate would be entitled to a credit for the estate tax on $100,000 (subject to the limitations explained above) even though *B*, prior to his death, had disposed of the entire $100,000.

Both situations under discussion involved an income interest in a nonmarital trust (B Trust) bequeathed to a surviving spouse. The surviving spouse was also given a regular power of appointment marital deduction trust (A Trust). (There is no prior tax credit allowed for the surviving spouse's interest in the *A* Trust because that property was eligible for the estate tax marital deduction and was not, therefore, subject to tax in the husband's estate.) The *B* Trust gave to the surviving spouse a life income interest. In such a case, which is common, if the surviving spouse dies within 10 years, the tax adviser must be alert to the possibility that her estate will be entitled to a credit against the estate tax otherwise due for prior tax on the life interest bequeathed to her as part of the *B* Trust.

In both situations, the surviving spouse died within months after the husband. How is the interest of the surviving spouse in the income of the *B* Trust valued? Generally, the IRS insists on valuing

a life estate using the 6 percent actuarial tables in the estate tax regulations. Thus, if the surviving spouse was 74 years of age at the time of her husband's death, the value of the life estate (under table A(2) of regs. sec. 20.2031-10(f)) approximates 40.5 percent of the total value of the *B* Trust. Even though the surviving spouse lived fewer years than anticipated in the IRS tables, 40.5 percent of the value of the life estate would be subject to the credit for property previously transferred, subject to the statutory limitations.

Recognizing these unusual sets of facts and notifying the executors of their rights to the sec. 2013 credit resulted in substantial estate tax savings. The moral is clear: Always be alert to the sec. 2013 credit and don't overlook it when intangible property is involved.

SECTION 2031

Private annuity clauses in wills

The Tax Court decision in *Estate of Lloyd G. Bell,* dealing with private annuities, may be the first step in the determination of the validity of Rev. Rul. 69-74. However, the court bypassed this issue on the ground that the annuity in *Bell* was amply secured while the annuity in the ruling was not. At present, the tax effect of exchanging appreciated property for an annuity remains uncertain, and private annuity transactions may be inhibited.

In any event, one type of private annuity transaction seems to present no problems. This is the situation where the surviving spouse enters into an annuity contract with the trustee of her husband's testamentary trust. Typically, the property she is transferring has a date-of-death tax basis, and thus there is little or no unrealized appreciation to be subject to taxation, the problem with which Rev. Rul. 69-74 and its predecessor, Rev. Rul. 239, are concerned. The widow gets an annuity exclusion and the property is out of her taxable estate. Any actuarial gain goes to the beneficiaries of her husband's trust, usually their children, while any actuarial loss comes out of the trust; this accords with the decedent's intent, which usually is to make sure that his wife has adequate income for life.

However, without advance planning, there will usually be either no private annuity for the widow or there will be valuation problems. Few trustees are eager to enter into annuity transactions, since they fear potential liability to the ultimate beneficiaries of the trust. If they do, they are unlikely to feel comfortable determining the annuity amount under the now low interest rate tables prescribed in the

income and estate tax regulations. Yet those are the tables to be used unless a strong case can be made that they are arbitrary and unreasonable under the circumstances. (See *John C. W. Dix*.)

The solution is to insert language into the will and the trust instrument that directs the sale of a private annuity to be made if requested by the surviving spouse, with the amount of the annuity payment to be determined in accordance with regs. sec. 20.2031-10 or subsequent provisions. On one hand, such language does not bind the surviving spouse to request that a private annuity be sold to her; on the other hand, it does make possible the use of this device if it seems appropriate under the circumstances following the husband's death.

Editors' note: The Tax Court, over five dissents, followed its decision in Bell *as to secured annuities. (See* 212 Corporation.*)*

SECTION 2032

Ready reference table for dividends declared before death

The handling of dividends declared before, but payable after, the date of death of a decedent-stockholder is a matter that requires careful review each time it arises. The following table has been designed to act as a ready reference guide in this matter.

With respect to such dividends, death may occur within the three following time periods:

1. From the declaration date to the day before the stock sells ex-dividend (or before the record date in the case of shares not listed on an exchange);
2. From the ex-dividend date to the day before the record date (not applicable to shares not listed on an exchange); or
3. From the record date to the day before the payment date.

Based upon Rev. Ruls. 54-399, 60-124, and 68-610, and citations therein, the tax treatment to be accorded to each of these three possible time periods may be summarized as follows:

	Dividend falling in time period		
Tax aspect	1	2	3
Includible in gross estate as a separate item (which is "included property" for the purpose of the alternate valuation)	No	No	Yes

Tax aspect	Dividend falling in time period 1	2	3
Not includible in gross estate as a separate item but added to the quoted market in order to determine fair market value	No	Yes	No
Collection gives rise to sec. 691(a) inome	No	No	Yes
Collection gives rise to sec. 691(c) deduction	No	No	Yes
Collection gives rise to income that is not sec. 691(a) income	Yes	Yes	No

Parallel rules apply for determining the fair market value of the shares on the alternate valuation date.

SECTION 2036

Estate planning: sale of a remainder interest for a private annuity . . .

In estate planning, installment or bargain sales of property among family members can be useful tools in removing a family business, closely held stock, etc., from a client's estate. An excellent alternative, however, is the sale of a remainder interest in the property in exchange for a private annuity. Properly executed, this transaction will (1) remove the future appreciation of the property from an estate, (2) remove the present fair value of the property from the estate, and (3) permit the present owner of the property to retain substantial control over, and income from, the property for life.

The sale of a remainder interest in property begins with the division of the value of the whole property between the remainder interest and the retained life estate using regs. sec. 21.2031-10(f), table A. Sec. 2036 provides that the value (at date of death) of all property transferred subject to a retained life estate is part of the transferor's gross estate. An important exception is contained in the parenthetical statement in sec. 2036(a): "(except in case of a bona fide sale for an adequate and full consideration in money or money's worth). . . ." Accordingly, the success of this technique depends upon an accurate determination or appraisal of the value of the property. If based upon such a valuation, the sale of the remainder interest will be outside of sec. 2036.

If the valuation should be upset upon audit, much, but not everything, is lost. Whatever consideration was transferred would be deducted from the gross estate under sec. 2043. (See IRS Letter

Ruling 8041098. Note: An agreement that additional consideration, with interest, would be due on a determination of a greater value—a valuation hedge agreement—may be useful.)

Assume the value of the stock in a family corporation owned by *F* is reasonably appraised at $1,000,000, and *F* is a male, age 68. He desires to continue to exercise some control over this stock until his death, at which point there will be a testamentary disposition of the stock to *S*. Under table A(1), column 4, the remainder interest would be valued at $559,230. If this remainder interest is sold to *S* for $559,230, no part of the value of the stock would be included in *F*'s estate. If the sale is for a private annuity valued at $559,230, the annual annuity payment would be $76,125 (see table A(1), column 2).

By carving out the remainder interest, and selling it for full consideration in money or money's worth, not only is the future appreciation on the property removed from the estate, but the entire property is removed from the estate at a selling price equal to the value of the remainder interest. Of course, if the property owner accumulates any of after-tax cash proceeds from the sale of the remainder interest, he will start rebuilding his estate. Accordingly, he will wish to consider its use in a gift or contribution program.

A sale of the remainder interest for a private annuity instead of, for example, an installment sale, presents some interesting advantages. For instance, the IRS annuity tables are based upon a 6 percent interest factor, whereas at least 9 percent would have to be used on an installment sale to avoid problems inherent in sec. 483, according to new IRS regs. (Note, however, that the payer of the private annuity may not be entitled to deduct the interest element in the annuity. See *John C. Moore Corp.*, and *Dix*.) The unpaid balance of the installment receivable would be an asset includible in the decedent's estate, whereas the annuity would expire upon the death of the annuitant. Finally, the deferred gross profit included in the unpaid balance of the installment receivable at date of death would be income in respect of a decedent under sec. 691.

A determination of the relative merits of sale of a remainder interest for a private annuity compared to other property transfer techniques, such as a gift of some or all of the property or a freezing transaction (corporate recapitalization), requires some calculations and a projection using the facts and circumstances of each case. For example, the obligor's aggregate cash payout will be determined by the actual life span of the seller whereas the annuity payment is based on the average life expectancy implicit in regs. sec. 20.2031-10(f), table A. Also, use of the tables might be challenged if the annuitant's survivability compares poorly to the life expectancy

assumed in the IRS tables. (See, e.g., *Est. of Lion.*) Other considerations are the amount of future appreciation likely to accrue in the value of the property, the cash flow results, and the personal needs of the parties. In particular, one should keep in mind that a private annuity is an unsecured promise to pay, and the low 6 percent earnings rate assumed in table A distorts the values determined from it—either of which could make one of the parties uneasy. (The general rule is that an unsecured promise to pay is not equivalent to cash or, at least, is not susceptible to valuation for income tax purposes. Were a private annuity secured, recognition of taxable income on the transfer of appreciated property could be immediate.)

All things considered, there are cases where the relative tax cost of a sale of a remainder interest for a private annuity is more favorable than other property transfer techniques, and it may accomplish the property owner's personal desires more effectively.

Editors' note: A secured annuity definitely must be avoided. See Estate of Lloyd G. Bell *and* 212 Corporation.

SECTION 2039

Estate tax exclusion and income tax deferral for lump-sum distributions from qualified plans

Sec. 2039(c) provides an estate tax exclusion for certain distributions from a qualified employee plan. Sec. 402(a)(7) allows a surviving spouse to roll over a lump-sum distribution from a qualified plan into an IRA. A combination of these two provisions can provide an estate tax exclusion and an income tax deferral for lump-sum distributions from qualified plans.

Under sec. 2039(c) and regs. sec. 20.2039-2(c)(1), the proceeds from a qualified employee benefit plan that are attributable to employer contributions will not be subject to federal estate taxes if they are not payable to the executor and, if they are payable in a lump sum, the recipient elects not to use 10-year averaging or long-term capital gain treatment. Proposed regs. sec. 20.2039-4(d) provides that the beneficiary must irrevocably elect not to be taxed under the 10-year averaging method by filing a copy of the income tax return with the estate tax return in which the lump sum is not reported under the 10-year averaging method.

Sec. 402(a)(7) provides that, if a surviving spouse receives a lump-sum distribution from a qualified plan on account of the employee's

death, the spouse may transfer all or any portion of the property received to an individual retirement plan. To the extent that the proceeds are transferred, they are not includible in gross income for the taxable year in which they are paid.

Therefore, if there is a lump-sum distribution from a qualified benefit plan because of the death of an employee, and the amount is payable to the employee's spouse, the spouse can elect irrevocably to forgo the 10-year averaging treatment and have the proceeds taxed under sec. 402(a) by election under sec. 402(a)(7) to roll them over into an IRA. This would enable the spouse to secure both the estate tax exclusion under sec. 2039(c) at the death of the employee and an income tax deferral through the use of an IRA.

The choice of whether to roll the proceeds over into an IRA, to have them taxed as a lump sum, or to have them paid out over a period of time can be made by the spouse after the death of the employee. When the beneficiary is given the right to elect an optional method of settlement, the IRS has previously ruled that there is no constructive receipt that would destroy the estate tax exclusion (IRS Letter Ruling 7817021).

SECTION 2041

Estate tax: grantor's power to change corporate trustees may be fatal

Grantors often establish irrevocable *inter vivos* trusts to remove the trust corpus from their estates. Where the trustee's powers include a discretionary right to distribute income or principal among the beneficiaries without the limit of an ascertainable standard, the grantor's reservation of a power to name himself trustee would normally result in inclusion of the trust corpus in the grantor's estate under secs. 2036 and 2038. Before 1979, it was believed that a corporate trustee could be named to hold the discretionary power and that the grantor could retain a power to freely substitute the corporate trustee with another corporate trustee, without bringing the trust corpus back into the grantor's estate.

However, Rev. Rul. 79-353 held that where a corporate trustee held unlimited discretion to distribute income and principal among the beneficiaries, and the grantor retained a power to substitute the corporate trustee without cause, the retained power would result in inclusion of the corpus in the grantor's estate, even though the grantor could not appoint himself trustee. This ruling has been widely

questioned and its withdrawal has been requested. Although the ruling has not been withdrawn, Rev. Rul. 81-51 holds that Rev. Rul. 79-353 will not apply to a transfer or addition to a trust made before the publication date of the ruling on October 28, 1979.

Some estates may have already included the value of the trust corpus as part of the taxable estate, pursuant to Rev. Rul. 79-353. For those trusts that were irrevocable on October 28, 1979, a refund claim in accordance with Rev. Rul. 81-51 should be considered. For those trusts that became irrevocable, or had additions, after October 28, 1979, and which were included in the taxable estate, a protective refund claim might be advisable.

If a power to freely substitute corporate trustees is found in a post-October 28, 1979 trust which is irrevocable but not yet part of an estate, an initial reaction might be to surrender the power in order to activate the three-year period of sec. 2035. However, this surrender may raise gift tax liability and gift tax valuation problems. In addition, if the courts later invalidate the ruling, a valuable tool for flexibility may have been needlessly wasted. Given the controversy over Rev. Rul. 79-353, a reasonable short-term approach might be to defer remedial action until definitive judicial resolution of this issue occurs. If death should occur before the power is surrendered, or before a three-year period from date of surrender has elapsed, those estates choosing not to follow Rev. Rul. 79-353 should evaluate the interest and settlement or litigation costs which might be incurred. Those estates choosing to follow Rev. Rul. 79-353 should consider filing protective refund claims in the event favorable precedent emerges.

Anyone drafting a new trust, or considering an addition to a pre-October 29, 1979 irrevocable trust, will have to come to terms with the IRS position set forth in Rev. Ruls. 79-353 and 81-51. Unless the judiciary invalidates these rulings, the retained grantor power to freely substitute corporate trustees will probably disappear from current and future irrevocable trusts to avoid pioneering litigation.

Editors' note: Since the Economic Recovery Tax Act substantially eliminated the gift-in-contemplation-of-death inclusion, the surrender of the power may be attractive. See also First National Bank of Denver, *wherein the tenth circuit held that the power to change corporate trustees did not cause inclusion. Rev. Rul. 79-353 was not cited.*

Powers of appointment: implications of Rev. Rul. 79-154

In Rev. Rul. 79-154 the service examined a little discussed estate tax matter regarding general powers of appointment.

In that case, the decedent (*D*) was the donee of a power to appoint the principal of an insurance fund for the health, education, support, and maintenance of her adult children, whom *D* had no legal duty to support. The appointed property was to be paid directly to the children. *D* also had a life estate in the insurance fund. Upon *D*'s death, the remaining principal of the fund was to pass in equal shares to the children. The question presented in the ruling is whether *D* possessed a general power of appointment at the time of her death under sec. 2041(a)(2).

The ruling cites regs. sec. 20.2041-1(c), which provides that a power of appointment exercisable for the purpose of discharging a legal obligation of the decedent is considered a power of appointment exercisable in favor of the decedent or the decedent's creditors. A power exercisable in favor of the decedent or his creditors is a general power of appointment (sec. 2041(b) and regs. sec. 20.2041-1(c)(1)(a)). The ruling holds that because *D*'s power to appoint the fund was limited in its exercise only for the use of her *adult* children whom she had no legal duty to support, the fund was not includible in *D*'s gross estate under sec. 2041(a)(2). The analysis concludes—

> If, however, *D* had a legal obligation to support the children that could have been satisfied by *D*'s appointment of the insurance fund, *D* would be regarded as having possessed a general power of appointment over the fund to the extent that the fund could have satisfied *D*'s obligation.

Although this ruling does not change the service's position regarding powers of appointment, it is a vivid reminder of the potential problems in this area of estate planning. That is, the draftsman must be careful to select as the donee of a special power of appointment one who does not possess an obligation to support the objects of that power.

For example, *H* creates a trust of which *W* is trustee with power to invade principal for the benefit of their minor children. The income tax problems of the holder of a special power that can be used to meet the support obligation are conveniently limited by sec. 678(c), so that only income that is in fact used for support is taxable to the holder of the power. It seems clear in this example that, if at *H*'s death any of the children to whom *W* can appoint principal are under 18, *W* possesses a general power of appointment over the trust fund. Accordingly, if *W* were to die before her youngest child attained age 18, the remaining principal of the trust fund would be includible in her gross estate.

If *W* has a general power while she is responsible for the support of her children, the termination of that support obligation should properly be characterized as the lapse of the general power of

appointment. Thus, when *W*'s youngest child attains age 18, there is a lapse of *W*'s general power of appointment. Sec. 2514(e) provides that the lapse of a general power is considered a taxable release of the power only to the extent that the appointive property exceeds the greater of $5,000 or 5 percent of the trust assets. Thus, the lapse of a general power of appointment is a taxable event; when the youngest child reaches age 18, the trust principal (less the $5,000/5 percent *de minimis* exception) is the subject of a taxable gift from *W* to her children. The effect of this taxable gift is, of course, not only the liability for the payment of a gift tax at the time of the lapse but also that *W*'s estate tax will be pushed into a higher bracket through the application of the unified estate and gift tax rate schedule.

Further problems could arise if *W* were to die within three years of the lapse of the general power. In that case, the property subject to the lapsed power would be brought back into *W*'s gross estate under sec. 2035 at its value as of *W*'s death (which could be substantially higher than its value at the time of the power's lapse, as a result of market fluctuations).

All of these gift and estate tax implications are affected by obligations of support under local law. If local law requires a parent to provide college education for a child or requires support beyond minority for a dependent child who would otherwise be publicly supported, the lapse/release problem can continue well beyond the age of the child's majority and can exacerbate the three-year inclusion problem under sec. 2035.

Obligations of support under local law are rapidly changing according to the theory that both parents have a joint liability for the support of their children. Even in those states where the husband alone has a primary obligation of support, upon his death that support obligation passes automatically to the surviving parent. Support problems can also arise under state laws requiring a child to provide for the care of an elderly parent who might otherwise become a public charge.

These problems are not new, but Rev. Rul. 79-154 requires that estate planners carefully consider the tax implications resulting from the selection of family trustees and the granting of special powers of appointment. Consideration should be given to bootstrap language in wills and trust instruments that expressly prohibits the expenditure of trust principal for expenses that are within the support obligation of the power holder. Alternatively, provision can be made for the appointment of a special independent trustee whose sole responsibility is the exercise of discretion in matters relating to the payment of principal to persons entitled to support from a family trustee.

SECTION 2042

Assignment of group-term life insurance and exclusion from estate

Assignment of employer-paid group-term life insurance policies has long been used as an effective estate planning tool. The transfer is typically to an irrevocable life insurance trust. If the transferor relinquishes all incidents of ownership and the policy is not payable to his estate, the proceeds are excludible from the insured's gross estate under sec. 2042. Although the service once argued that an insured's ability to terminate his employment and, thereby, his insurance coverage, was an incident of ownership absent a policy provision permitting conversion of the group's insurance into permanent life insurance, that position was abandoned in Rev. Rul. 72-307.

The technique is attractive since the term policy is a most inexpensive gift considering the estate tax saving resulting from the exclusion of the policy proceeds from the gross estate. While both the initial policy transfer and subsequent annual premium payments by the employer constitute gifts (see Rev. Rul. 76-490), the IRS has ruled that the subsequent premium payments are eligible for annual exclusions under sec. 2503(b) if the trust contains a *Crummey* provision (i.e., gives beneficiary annual right to withdraw amount of premium to the extent of $3,000). (See IRS Letter Ruling 8006109.)

A more difficult question arises under sec. 2035, which provides that the gross estate includes the value of property transferred within three years of the death of the decedent. Clearly, the initial assignment of the group policy to the trust is a transfer within the meaning of sec. 2035. Does the annual payment of the renewal premium result in continuing transfers of insurance coverage under that section?

In IRS Letter Ruling 8034017, the IRS held that payment of a renewal premium does not make policy proceeds includible under sec. 2035 if the policy itself was assigned more than three years before death. Only the premiums paid within three years of death are included in the estate. The ruling emphasized that the policy had an automatic renewal option, which distinguished the situation from the 1971 fifth circuit opinion in *Bel*.

In Rev. Rul. 79-231, the service held that a group-term policy transferred to the decedent's spouse more than three years prior to the death was includible in the decedent's estate when the decedent's employer, within three years of the decedent's death, changed insurance companies under the master contract, necessitating a new

assignment by the decedent. This ruling has now been revoked by Rev. Rul. 80-289. As the service stated,

> . . . the Service believes that the [new] assignment . . . should not cause the value of the proceeds to be includible in the gross estate of the decedent under Sec. 2035 where the assignment was necessitated by the change of the employer's insurance plan carrier and the new arrangement is identical in all relevant aspects to the previous arrangement. . . .

The common theme running through these rulings is that the IRS will recognize an employee's assignment of all rights in group-term life insurance as excluding the proceeds of the insurance from the employee's gross estate provided two criteria are met: First, the initial transfer of the policy must occur more than three years prior to the employee's death. Second, as the recent rulings emphasize, any subsequent employer actions with regard to the policy must be consistent with the concept that the insurance is a continuing and essentially unaltered package of insurance benefits provided for the employee. The service seems to be trying to apply a consistent rationale by which to judge the effect of employer actions on the estate plans of the employees, but it remains to be seen to what extent it will allow this rationale to govern in fact patterns other than those involved in these recent rulings.

Editors' note: Gifts of life insurance policies continue to be subject to the gift-in-contemplation-of-death rates after the Economic Recovery Tax Act of 1981.

SECTION 2053

Estate tax deduction: interest paid to IRS as administrative expense

Ancillary tax consequences will result from treatment of interest paid on installment estate tax payment plans under secs. 6166 and 6166A as administrative expense deductible in computing the federal estate tax. IRS, at one time, permitted this sec. 2053 deduction only for interest paid to *third-party lenders* on loans obtained to make federal estate tax payments. After the IRS lost the case of *C. A. Bahr*, however, it issued Rev. Rul. 78-125 to accept interest payments to the IRS as a sec. 2053 expense. It then provided details of the interdependent tax factors in IRS Letter Ruling 7912006.

Interest payments to the IRS have always been allowable as a sec. 163 income tax deduction; however, this deduction frequently pro-

duced an excess-investment-interest expense disallowance under sec. 163(d) because of the sparse income during the 10-year estate tax installment period. Now that the IRS has accepted the interest expense as an administrative expense, a full *income tax* deduction should be allowable, since the interest is being deducted under sec. 212 rather than sec. 163, if this sec. 642(g) option is taken. The tax adviser can choose solely according to the respective tax benefits involved.

Treatment of the interest expense as an administrative expense should reinforce Rev. Rul. 76-23, which held that a deceased shareholder's estate that holds stock in a subchapter S corporation solely to facilitate payment of estate tax in installments will continue to be an eligible shareholder under sec. 1371(a) for the period during which the estate complies with sec. 6166.

Editors' note: The service has issued several letter rulings (7940005, 7940009, and 8022023) that pertain to the computation of the deduction and refund procedures.

SECTION 2055

Charitable remainder trusts: unitrust vs. annuity trust

Rev. Rul. 77-374 holds that a charitable remainder annuity trust will not qualify as such for purposes of sec. 2055 if the probability that the noncharitable income beneficiary will survive the exhaustion of the fund exceeds 5 percent. This depends on the amount of the annuity and the age of the life tenant. The ruling uses a 6 percent return regardless of the actual expected return on money.

Recently, a donor wished to provide for a 9 percent payout in a trust for the support of a dependent, with the balance given over to charity at the dependent's death. To avoid Rev. Rul. 77-374, a unitrust was proposed, which provided for a 9 percent annuity of not more than the annual income. The limit of the annuity to the annual income of the trust is permitted by regs. sec. 1.664-3(a)(1)(i)(b) and Rev. Rul. 72-395, sec. 7.01, for a unitrust but not for an annuity trust.

A private ruling was requested that the proposed trust qualified as a charitable remainder unitrust under sec. 664. Since in this case there was no possibility that the principal could be invaded to pay the annuity, the service ruled favorably on the trust.

Editors' note: The service has recently ruled (Rev. Rul. 80-123) that the governing instrument of a testamentary charitable remainder trust must contain mandatory provisions conforming to regs. sec. 1.664-1(a)(s) in order for the charitable interest to qualify for the estate tax deduction: (1) the obligation to pay the unitrust or annuity amount must begin on the date of death; and (2) corrective payments must be provided in the case of an underpayment or overpayment of the annuity or unitrust amount determined to be payable.

SECTION 2513

Split gifts in anticipation of divorce

The gift-splitting rule of sec. 2513 considers half the gift to have been made by the consenting spouse of the donor. Under the unified transfer tax system, the effect of gift-splitting for estate tax purposes is to remove gifts not made within three years of death from the donor's estate and to add 50 percent of the gift to the donor's estate tax computation as a taxable gift under sec. 2001(b)(1)(B). The remaining 50 percent is added to the consenting spouse's estate tax computation as a taxable gift. Since both spouses are entitled to a unified credit, gift-splitting may make it possible to use the unified credit of the spouse with little or no assets whose credit might otherwise be wasted.

Consideration should be given to gift-splitting in anticipation of a divorce. If a divorce is contemplated between a couple where one spouse has the bulk of the assets, one estate-planning technique would be to have that spouse make a large gift to the couple's children and have the other spouse consent to gift-splitting. The gift might be large enough to use the consenting spouse's total credit. No gift tax will normally be due if the donor spouse had at least as much unified credit available. (Keep in mind, however, that pre-1977 gifts affect the gift tax computation under the new law and each spouse may have a different history of gifts.) Split gifts that are large enough to trigger a current gift tax may even be considered in very large estates. The consenting spouse may not object to such a plan since the assets are going to the couple's children.

An individual is considered the spouse of another individual for this purpose if they are married at the time of the gift and they do not remarry during the remainder of the calendar quarter (regs. sec. 25.2513-1(a)). State law would have to be consulted to determine when a person is considered divorced and therefore what would be the last date for making such a gift.

Property settlements between spouses may deplete the estate of the spouse owning the assets while building up the estate of the other spouse to the point that there is no wastage of unified credits. Under sec. 2516, where the spouses enter into a property settlement agreement and divorce occurs within two years, transfers in settlement of marital or property rights, as well as transfers to provide a reasonable allowance for child support during minority, are treated as having been made for full and adequate consideration for gift tax purposes. Thus, the tax adviser should consider both the sec. 2516 property settlement and split-gift approaches in estate planning for taxpayers anticipating divorce. Property settlements that do not satisfy sec. 2516 may be subject to gift tax, although it is understood that the service is currently analyzing the unequal-division-of-property issue in connection with the gift tax. (See Rev. Rul. 77-314.)

Keep in mind that property settlements may be taxable events that subject gains from appreciated property to income tax. (See *Davis*.) Split gifts of appreciated property may be one approach to circumvent or mitigate the Supreme Court's *Davis* doctrine since they entail transfers to third parties.

Editors' note: An additional technique which might be useful in light of the new unlimited marital deduction provided by the Economic Recovery Tax Act of 1981 involves a gift from one spouse to another in anticipation of divorce.

SECTION 2518

Disclaimers require careful planning

Disclaimers can be a useful postmortem estate planning device. Yet, all too often, consideration is given only to disclaiming probate assets. Legislation recently enacted in several states (including New York) enables beneficiaries of estates to disclaim their interests in powers of appointment, Totten trusts, life insurance or annuity contracts, transfers created by joint tenancy or tenancy by the entirety, benefits under employment plans, or other transfers by operation of law. This legislation is relevant to the provisions of proposed regs. sec. 25.2518-1(c), which requires a disclaimer to be effective under local law.

Tax advisers must also take care to comply with sec. 2518(b)(3), which prohibits the beneficiary from accepting the interest or any of its benefits. For example, if the property involved is a couple's personal residence, and the surviving spouse has already enjoyed the use of it (even if during the deceased spouse's lifetime), he or she is

precluded from executing a qualified disclaimer. (See IRS Letter Ruling 7912049.) Some states, New York for example, also provide that a disclaimer may not be made after a renouncing person has accepted the property in question.

Sec. 2518, enacted in 1976, was considered restrictive because of the regulatory requirement that the disclaimer satisfy state law. Although legislation in many states offers expanded opportunities for utilizing disclaimers, remember that the remaining requirements of sec. 2518 must continue to be observed.

Editors' note: Effective with property interests created after December 31, 1981, The Economic Recovery Tax Act of 1981 provides that a timely transfer of property to the person who would have received it under a disclaimer valid under local law is considered an effective disclaimer for federal purposes. Note also that prop. regs. sec. 25.2518-2(d)(3) provides that a disclaimer of joint tenancy property must be made within nine months of the creation *of the tenancy.*

SECTION 2601

Generation-skipping tax on accumulated income

A tax adviser for a so-called grandfather trust, which was irrevocable on June 11, 1976, may believe that the trust is exempt from the complex generation-skipping tax provisions because of the prospective effective dates—as long as corpus additions were not made after June 11, 1976, there seemed to be no cause for concern. Generally, one thinks of a corpus addition as an additional transfer of money or property to the trust by the grantor. However, prop. regs. sec. 26.2601-1(d)(4) expands this concept to cover accumulated income.

If a trustee has discretionary power to distribute income from a grandfather trust, any undistributed income accumulated in taxable years ending after December 31, 1978, may eventually precipitate the generation-skipping tax. This is true even if the trust was irrevocable on June 11, 1976, because the proposed regulations consider the accumulation of income an addition to corpus. Consequently, those trusts that had seemingly escaped potential generation-skipping taxes may be back on the drawing board.

Specifically, prop. regs. sec. 26.2601-1(d)(4) provides that an accumulation of income will subject a proportionate amount of the subsequent transfers from the trust to the generation-skipping tax. The portion of the subsequent transfers to the younger generation

that is subject to the tax is a fraction of the trust's total value. The numerator is the sum of the value of the latest addition to corpus (i.e., current year's accumulated income) and the total value of the trust, which, immediately before the latest addition, is subject to the generation-skipping tax. The denominator is the total value of the trust immediately after the latest addition.

Example. *X* is the trustee of an irrevocable trust in existence on June 11, 1976. The trust agreement provides that *X* has discretionary power to distribute income to *Y*, the grantor's son, during *Y*'s life. Upon *Y*'s death the remaining accumulated income and corpus pass to *Z*, the grantor's grandson, free of trust. *X* also has discretionary power to distribute corpus to *Y* and *Z* during *Y*'s life for their health, education, and support. The trust has a calendar year-end.

During 1979 the trust income was $75,000, and *X* made a discretionary distribution to *Y* of $25,000, leaving accumulated income of $50,000. On December 31, 1979, the total value of the trust, including the 1979 accumulated income, was $500,000. On January 1, 1980, *X* made a discretionary corpus distribution to *Z* of $10,000. This $10,000 distribution to *Z* is subject to generation-skipping tax to the extent of $1,000 (50,000/500,000 × 10,000).

This example is a very simple application of the proposed regulations. It also ignores the effect of the $250,000 "grandchild exclusion" from the generation-skipping tax provided by sec. 2613(b)(6). However, it illustrates the possible need for an annual determination of the fraction representing the portion of the trust tainted by the accumulated income. Furthermore, the fraction could become much more significant in the future, depending on the relevant factors. There also appear to be trusts, other than the typical grandfather trust, that may be within the reach of the proposed regulations.

Editors' note: The regulations were adopted on August 8, 1980; regs. sec. 26.2601-1(e)(1) continues the inclusion of a proportionate amount of accumulated income. Further, pursuant to the Economic Recovery Tax Act of 1981, the transitional rule exempting certain trusts from the generation-skipping tax has been extended to January 1, 1983 pertaining to the death of the decedent.

SECTION 2613

Generation-skipping transfers: planning for the $250,000 exclusion

During 1976 year-end gift-planning sessions, many tax advisers noted the uncertainty created by limitation of the generation-skipping trust

exemption under sec. 2613(a)(4) and (b)(6) to $250,000 as applied to the value of the trust fund at the date of the deemed transferor's death. Thus, a donor might have given $250,000 in trust, with income payable to his son during the son's lifetime, and the remainder payable to his grandchildren upon death of the son. If the trust fund value is $300,000 at the date of the son's death, $50,000 will be taxed as a generation-skipping transfer.

This $50,000 will be taxed at the highest rate applicable to the son's estate, including other property owned by him. However, if a principal distribution is made from the trust to the grandchildren more than three years prior to the son's death, the generation-skipping tax will be computed under sec. 2602 at the applicable federal gift tax rate for the son. (See sec. 2602(a) and HR Rep. No. 94-1380, 94th Cong., 2d Sess., 56, fn. 13 (1976).) Furthermore, this imputed gift will not constitute an adjusted taxable gift retaxable in the son's estate.

Although the 1976 year-end planning season is gone forever under present law, there is still the opportunity, in a testamentary generation-skipping trust, to provide for discretionary distribution to the remaindermen during the lifetime of the income beneficiary in order to obtain the benefit of the lower imputed gift tax rates applicable to the income beneficiary as a deemed transferor. The following paragraph has been suggested as suitable for this purpose, and it also takes advantage of the reach back provision of sec. 663(b):

> In the event the value of the principal of the Trust and any accumulated income shall, within sixty-five days of the close of any fiscal year of the said Trust exceed $250,000, the Trustees (except the said [son]), may pay or apply to the use of any issue of the said Beneficiary in such amounts and in such proportions all or so much of said principal and accumulated income which exceeds the value of $250,000 as they (except the said [son]) deem advisable and in the best interests of the said issue of the Beneficiary.

Employment taxes

SECTION 3121

Avoiding employment taxes on nonresident aliens working for nonresident employers

The IRS recently notified several nonresident foreign corporations that compensation paid to their employees for services rendered in the United States may be subject to employment (social security and unemployment) taxes. In the notification letters, the IRS stresses that a foreign employer need not have a permanent place of business in the United States for these taxes to be incurred. The letters say that the 183-day exclusion in most United States treaties applies only to the income tax and not the employment taxes. The letters also point out that compensation paid to the employees of the foreign employer is subject to employment tax even if the employees are in the U.S. for brief business trips. The IRS is asking for the payment of any taxes due for all delinquent periods.

Literally, the tax statutes support the IRS position. They provide that compensation for services rendered by an employee for an employer are taxable "irrespective of the citizenship or residence of either" the employee or the employer (secs. 3121(b) and 3306(c)). There is an included and excluded service rule which provides that none of the compensation paid to an employee for a payroll period (not exceeding 31 consecutive days) is subject to employment taxes if the services performed during less than one-half of such period constitute employment (secs. 3121(c) and 3306(d)). Although this rule may seem to exempt compensation paid to a nonresident alien for services rendered in the United States during less than 50 percent of his payroll period, the courts and the IRS have held otherwise. (See *Inter-City Truck Lines, Ltd.*)

Assuming that the statutes do require the taxation of compensation for services rendered in the United States by employees of nonresident employers, the question arises as to whether the United States has

the jurisdictional authority to impose and enforce collection of a tax on a foreign corporation that has no permanent establishment in the United States, is not engaged in a United States trade or business, and whose only connection with the United States is irregular, brief business visits of its employees to the United States.

It should be noted that a foreign employer, or its employees, may not be subject to one or both of the employment taxes for several reasons, including the following:

- An employer is not subject to the unemployment tax (FUTA) unless, within the current or preceding calendar year, it either (1) paid at least $1,500 in wages during a calendar quarter for services rendered in the United States or (2) employed in the United States at least one individual in each of 20 separate weeks. (See sec. 3306(a)(1).)
- If a nonresident foreign corporation with related U.S. entities participates in an exchange program (e.g., a program to train the employees of the foreign employer in U.S. marketing techniques), it may secure an exemption from employment taxes for compensation paid to those employees who visit the United States on a J visa for a purpose prescribed therein (sec. 3121(b)(19) and sec. 3306(c)(18)).
- Employment taxes specifically do not apply to employees of an international organization, a foreign government, or an instrumentality wholly owned by a foreign government (sec. 3121(b)(11), (12) and (15), and sec. 3306(c)(11), (12) and (16)).
- If paid by the employer, the employee's share of the social security tax is not itself subject to the social security tax (sec. 3121(a)(6)). (However, such payment would be included in the employee's taxable income from U.S. sources.)
- If the United States has a social security totalization agreement with the home country of the employee, the foreign employee is not required to pay such tax to both countries on U.S.-source compensation. (Totalization agreements do not apply to unemployment taxes.) A totalization agreement is in effect with Italy, and an agreement is expected to come into effect shortly with West Germany. Under these agreements, the employee can elect, with respect to his U.S.-source compensation, to retain coverage in his home country or to be covered under the U.S. social security system.
- The U.S. "Technical Explanation of the Proposed U.S.–U.K. Tax Treaty" states that an employee's share of the social security tax is a tax on income and is covered under the treaty. This means that a U.K. employer should not be required to withhold

United States social security taxes from compensation paid to its British resident employees who work in the United States if the employee satisfies the 183-day rule under the treaty. IRS representatives have suggested informally that this exemption should apply under the existing U.S.–U.K. treaty as well. However, reliance should not be placed on this interpretation in construing other U.S. treaties. Note that the treaty exemption applies only to the employee's share of the social security tax; the U.K. employer remains liable for its share of the tax.

Overpaid FICA taxes—refund requirements

There has been a good deal of commentary and confusion about the requirements that the law imposes on an employer claiming a refund of overpaid FICA taxes. Recent court decisions suggest that FICA tax overpayments fall into the following three distinct categories:

- Employer overpayments;
- Overpayments made on behalf of employees who are still employed by the firm at the time the error is discovered; and
- Overpayments made on behalf of employees who are no longer employed by the employer at the time the error is discovered.

An employer is always entitled to a refund of its own portion of the overpaid FICA taxes. However, in *Atlantic Department Stores*, the court of appeals made it clear that an employer will not be eligible for its refund until proper adjustments are made with respect to employees who are in its employ at the time the error was ascertained.

Until recently, the courts had not considered the circumstances under which an employer may claim a refund of its share of overpayments as to employees no longer in its employ when an error is discovered. However, in *Entenmann's Bakery, Inc.*, the court held that before an employer can claim a refund of its share of the overpaid FICA taxes an employer must make a "reasonable effort within the applicable period to adjust the overcollection and overpayment of the employee's share." The court indicated that "at a minimum this meant mailing an appropriate letter to an employee's last known address and asking for the return of an appropriate form."

At the present time, in view of these two cases, taxpayers should expect the service to take the firm position that an employer may not receive a refund of its overpaid FICA taxes until appropriate adjustments are made for employees whom it can contact with reasonable effort and until a reasonable effort is made to contact *all* former employees of the refund years.

Employment taxes: common paymaster can save employers' social security taxes

Prior to 1977 if an employee worked for more than one corporation in an affiliated group of corporations, social security taxes for that employee had to be paid by each such corporation for which he worked.

For example, in 1976 an individual formed 10 separate corporations for his 10 restaurants, and he performed services for each corporation. One corporation handled the administration for all 10; and the owner's $100,000 salary was allocated ratably, $10,000 per corporation, although the entire amount was paid from the one corporation's bank account. The IRS took the position in such a case that, whether or not the salary was allocated to each corporation, each corporation must withhold and pay over social security taxes on the full salary that it was deemed to have paid.

This would not affect the employee's tax position, since any excess withholding would be refunded to him when he filed his tax returns. The employer's excess portion of the tax ($5,104) could never be recovered from the IRS.

Because this problem was widespread, Congress acted in 1977 to resolve it. In that year's social security amendments, it was provided that if an employee works for more than one related corporation and that individual is compensated by a common paymaster, the social security liability of the corporations will be determined as if there were only one employer. (See sec. 3121(s).) In the example above, the social security tax would be reduced by $5,104.

A common paymaster must be a corporation that is a member of a group of related corporations and for which the common employee performs services. Also, corporations will be considered related corporations for an entire calendar quarter if they satisfy any one of the following four tests at any time during the calendar quarter:

- The corporations are members of a "controlled group of corporations," as defined in sec. 1563.
- In the case of a corporation that does not issue stock, the holders of more than 50 percent of the voting power to select the members of the board of directors of one corporation are concurrently the holders of more than 50 percent of that power with respect to the other corporation.
- 50 percent or more of one corporation's officers are concurrently officers of the other corporation.
- 30 percent or more of one corporation's employees are concurrently employees of the other corporation. (See prop. regs. sec. 31-3121(s)-1.)

Since these provisions were not a part of the Tax Reduction and Simplification Act of 1977, but rather part of the social security amendments for that year, this provision has not received much attention.

If an employee works for more than one corporation in a controlled group and the above conditions are met, substantial savings can be achieved by structuring the compensation arrangements so that there will be a common paymaster.

Tax saving on meals furnished to employees

IRS regulations require that employers pay social security taxes on employee meals. These regulations have been questioned in a recent court case, *Hotel Conquistador, Inc.* The implications of this case are far reaching; in addition to hotels, motels, and restaurants, which were specifically covered by the case, it may affect any employers who provide meals to their employees, including hospitals, retail stores, and airlines.

The Court of Claims held that the meals were not remuneration and, therefore, not wages. The court referred to *Central Illinois Public Service Co.*, which differentiated between income and wages. In that case the Supreme Court concluded that although reimbursements made to employees may be income to the employees they may not necessarily be wages for employment tax purposes. In *Conquistador* meals were furnished free to hotel employees in a windowless basement that was off limits to the general public. Many of the employees were in uniform. It was the hotel's policy not to allow uniformed employees to eat in the public restaurants on the premises, and the employees could not leave the premises in uniform. The meal period was 30 to 45 minutes. If meals were not furnished, it would have been one hour to an hour and fifteen minutes because additional time would have been needed to change in and out of uniforms. Finally, no services were performed by the employees during the meal period.

Conquistador, like all decisions of the Court of Claims, may only be appealed to the U.S. Supreme Court. The IRS petitioned for a rehearing of the case by the full court, but its petition was denied. The same issue has been raised in several pending district court cases. Thus, there could be a judicial conflict for the Supreme Court to resolve. In the meantime, the Court of Claims is the best forum for taxpayers contesting this issue.

Perhaps the best approach for employers who believe *Conquistador* applies to them is to consider paying the taxes and immediately filing refund claims. When refund claims are made for FICA taxes, the

regulations require the employer to protect the rights of employees who also paid excess taxes. This was another significant area that was covered by the *Conquistador* case. In order to file such claims, the employer must notify the employee of these rights and determine whether the employee will file his own claim or have it filed by the employer.

It may also be worthwhile to determine if protective claims should be filed for prior years. In filing such claims, the taxpayer should consider whether the reduction in FICA and FUTA expense is worthwhile in light of increased potential for tax examination and reduction of jobs tax credit.

If it is ultimately determined that claims should be filed, sec. 6513(c) deems such returns filed by April 15 of the succeeding year, even though FICA taxes are filed and paid on a quarterly basis.

The saving (where a significant number of meals are being furnished to employees) could be substantial. If it appears that *Conquistador* might be applicable, it should be determined whether the scope of *Conquistador* is broad enough to cover the particular facts and whether refund claims and other procedures are advisable.

Editors' note: In Rowan Companies, Inc., *the U.S. Supreme Court decided that the value of meals and lodging furnished for the convenience of the employer is not wages for purposes of FICA and FUTA taxes. The IRS concedes that the value of such meals and lodging is not wages for income tax purposes. The decision is consistent with its earlier opinion in* Central Illinois Public Service Co., *in which the court held that cash reimbursements for lunch expenses on nonovernight trips were not subject to income tax withholding despite the fact that they might be income to the employee. (See* R. J. Kowalski.*)*

As a result of the decision, affected employers may wish to consider filing claims for refund of these taxes for years not barred by the statute of limitations.

SECTION 3402

Withholding allowances and investment interest expense

Investments in limited partnerships that hold real property for lease on a net rental basis can be attractive for an executive paying tax at the maximum 50 percent rate on personal service income. Frequently,

the property is leased to a tenant with a national credit rating, and the economic results are therefore reasonably assured. The combined deduction of interest and depreciation from the rental income produces a rental loss deductible on the executive's individual return.

However, this loss, to the extent it is attributable to interest expense (unless there is a net loss without regard to the interest deduction—see sec. 163(d)(1)(B)), constitutes excess investment interest expense under sec. 163(d) that will be subject to disallowance and rolling carryover, unless covered by the exemption of $10,000 plus investment income, including rental profit on other net lease property. (See Form 4952.) Such excess investment interest expense must be separately reported to the partners on their schedule K-1 information forms.

This interest expense, however, should qualify as an itemized deduction for purposes of sec. 3402(m), which permits an additional withholding allowance for each $1,000 or major fraction by which the itemized deductions exceed the zero bracket amount. Specifically, the sec. 163 definition of net rental property as producing *investment* income or loss should prevent the interest expense deduction from being treated as an above the line deduction for purposes of sec. 62(5). This interpretation is supported by the K-1 reporting structure, which relegates the interest expense to itemized deductions. (See Form 4952.) Furthermore, the interest expense should be considered fungible under sec. 265(2) concepts.

Consideration should, of course, be given to the new rule under regs. sec. 31.3402(f)(2)-1(g), which requires the employer to submit, with its employer tax return, a copy of any W-4 withholding allowance certificate which claims more than nine allowances, effective for certificates received after March 31, 1980.

Tougher wage withholding reporting rules affect corporation executives

Recently adopted regulations and greater attention by examining revenue agents reflect the increasing IRS emphasis on the adequacy of wage withholdings. Highly compensated corporate executives, particularly those with tax shelters, and their employers should be made aware of the possible problems when withholding is less than the required amount.

Minimum income tax withholdings are required to be based on (and only on) IRS prescribed tables. These tables consider an employee's salary level and his withholding exemptions as reflected on Form W-4 filed with the employer. Employers must adhere to

this procedure even if the employee's tax liability for the year may be less than the required withholding amount (e.g., because of tax shelter losses, etc.).

Important points to remember with respect to the employer and employee withholding rules are:

- Employers must withhold income taxes based on Forms W-4 filed by employees.
- An employee must disregard most tax shelter losses in determining allowable withholding exemptions for Form W-4.
- Although there is no specific authority, it could be argued in certain cases, particularly as to employees investing in partnerships with only passive investments, that under the conduit theory the partnership entity should be ignored and certain partnership items (e.g., interest, property taxes, etc.) should be treated as itemized deductions for Form W-4 computations.
- There are a number of potential civil and criminal penalties imposed on employers (including responsible corporate officers) and employees for violation of the withholding rules and Form W-4 procedures. (See, e.g., sec. 6682.)
- The new regulations requiring employers to file with the IRS copies of Forms W-4 with abuse potential are effective for those forms received after March 31, 1980. (See regs. sec. 31.3402(f)(2)-1(g).)

Employers must now file certain W-4 forms with the IRS

Effective April 1, 1980, regs. sec. 31.3402(f)(2)-1(g)(1) requires employers to submit quarterly a copy of any withholding exemption certificate (Form W-4) received from certain employees during the reporting period. These new rules are intended to impose stricter withholding requirements for more effective administration and collection of income taxes. The new regulations require that such forms be submitted each quarter for employees who claim more than nine withholding exemptions or who claim a status *exempting* the employee from withholding.

With respect to the second classification of employees, regs. sec. 31.3402(f)(2)-1(g)(2) provides an exemption from the rules if the employer reasonably expects, at the time the certificate is received, that the employee's wages will not usually exceed $200 per week.

The first submission of W-4 forms for certificates received for the calendar quarter beginning April 1, 1980, was required to be

submitted with Form 941, 941E, or 941-M, whichever is applicable by July 31, 1980.

If the service finds a certificate materially incorrect, regs. sec. 31.3402(f)(2)-1(g)(5) states that the employer will be notified and required to withhold amounts from the employee as if the employee were a single person claiming no exemptions until a new certificate is filed.

Withholding on deferred compensation of retired executive

Rev. Rul. 77-25 was published in an attempt to clarify the rules with respect to the withholding requirements for deferred compensation to a retired executive. The ruling provides that a company's payments to its executives after retirement under a deferred compensation plan providing for payments upon termination of employment are excludible from wages under FICA and FUTA but are wages for purposes of income tax withholding. In order for the FICA/FUTA exclusion to apply, the following tests must be met:

- The payments must be pursuant to a deferred compensation plan.
- They must be payable upon or after termination of an employee's employment relationship because of death, retirement for disability, or retirement after reaching a specified age.
- The retirement age must be specified in the deferred compensation plan or a separate pension plan under which the employee is covered.
- The plan must make provisions for employees generally or a class or classes of employees (or for such employees and their dependents).

The service has not elaborated on the issues of what constitutes a plan or a class of employees. For example, it might be argued that chief executive officer constitutes a class of employees. It is anticipated, however, that the delineation of a class of one would be seriously questioned by the service. Classes such as "officers" or "salaried employees" should be considered reasonable classifications.

A more recent ruling, Rev. Rul. 78-263, elaborated on the requirement that the retirement age must be specified in a plan. It held that payments made by a company under its deferred compensation plan, which does not specify a retirement age, to an officer who retired at age 60 and who was also covered by a qualified pension plan allowing retirement at age 65 are not excepted from FICA and FUTA even though the company had a separate qualified pension plan for

nonsalaried employees allowing retirement at age 60. The officer failed to meet the requirement of being covered by a plan that specified a retirement age consistent with the age at which he actually retired.

The tax practitioner should carefully review all deferred compensation agreements providing for payments upon death or retirement in order to avoid the additional burden of FICA and FUTA taxes.

Miscellaneous excise taxes

SECTION 4975

Noncash contributions to qualified plans may be prohibited transactions

Sec. 4975(c)(1)(A) provides that direct and indirect sales or exchanges of any property between a qualified plan and a disqualified person are prohibited transactions. Sec. 4975(e)(2) defines the term "disqualified person" to include an employer any of whose employees are covered by the plan. (ERISA section 406 contains a parallel prohibited transaction provision.)

Informal discussions with representatives of the Labor Department (which has primary administrative responsibility for most prohibited transaction provisions) suggest that, in their view, noncash contributions by an employer to a pension plan are prohibited transactions. Apparently, the government's rationale is that pension contributions are mandatory pursuant to the provisions of the plan itself as well as the minimum funding standards (sec. 412 and ERISA section 302), and, as a result, the employer has a fixed and determinable liability to the plan. Satisfaction of that liability by a transfer of property other than cash, concludes the government, is a constructive sale of property and is, therefore, a prohibited transaction.

This rationale breaks down somewhat when applied to profit sharing and stock bonus plans since employer contributions to these plans are usually discretionary. Often, these plans provide that annual contributions, if any, are determined by the employer's board of directors, and, of course, the minimum funding standards do not apply to these plans. Nevertheless, because final policy decisions have not yet been made, the Labor Department is currently unwilling to concede that profit sharing or stock bonus plans are immune to the constructive sale theory.

Certain contributions of qualifying employer securities or real property may be statutorily exempt from the prohibited transaction

rules pursuant to ERISA section 408(e). Also, employers that fund contributions with customer notes may be able to avail themselves of prohibited transaction class exemption 79-9. However, employers wishing to fund retirement plan contributions with any other noncash assets should request a Labor Department exemption in advance. (See Rev. Proc. 75-26, as modified.) Employers who have made noncash contributions in prior years may request exemptions on a retroactive basis. (Several retroactive exemptions have already been granted for other type transactions.) Of course, a retroactive exemption request entails some risk since there is no guarantee that the Labor Department will grant it.

ERISA update: investment in customer notes

Small employers that had previously borrowed from their employee retirement plan trusts, then changed to other financing sources, should consider use of the temporary class exemption issued by the Department of Labor on March 23, 1979 (Prohibited Transaction Exemption 79-9). The exemption permits the trust to purchase from the employer secured customer notes taken by the employer in the ordinary course of its business. Although the exemption expires June 30, 1984, the department will allow trusts to retain beyond that date notes already purchased in accordance with the exemption.

Up to 50 percent of the trust's assets may be invested in these customer notes, provided that no more than 10 percent of the trust fund is involved in notes of any one customer. If the note is secured by heavy equipment, the maturity or term cannot exceed 60 months. In similar fashion, the term must be 48 months or shorter if the note is secured by vehicles, and 36 months if secured by other tangible personal property.

The employer must notify the department within seven months after the end of the trust plan year that the customer note investment has been made. Furthermore, the employer must repurchase any note that has been in arrears for more than 60 days.

Another financing technique may be useful if significant balances in the trust fund are held for the accounts of stockholder-employees. These participants can borrow, under uniform arrangements, part or all of their vested account balances, then relend the proceeds to the corporate employer. Reliance on this participant loan exemption in sec. 4975(d)(1) will require that the participant have the ultimate decision regarding whether he makes his own loan to the employer.

An employer that sponsors a retirement plan that does not provide for distributions to disabled participants should consider adding

disability benefits to the plan in order to make available the sec. 105 long-term disability exclusion for periodic payments or the sec. 104 exclusion for lump-sum distributions incident to disability from injuries or sickness. Specifically, the plan should take advantage of the *J. A. Wood* case, which allowed an exclusion for a lump-sum distribution that would otherwise have been taxable as a capital gain; i.e., the court considered dual retirement and health and accident plans to be involved.

Procedure and administration

SECTION 6013

Notification to the field of IRS national office adverse decisions

Section 11 of Rev. Proc. 72-3 provides that when a taxpayer requests a ruling or determination letter from the IRS, it can be withdrawn at any time prior to the signing of the letter of reply. However, when a request is withdrawn, the procedure states that the national office may advise the district director whose office will have audit jurisdiction over the taxpayer's return. Generally the same policy exists with respect to applications for changes in accounting methods.

This policy clearly has serious implications since ruling requests and applications for changes in accounting methods are normally withdrawn as soon as adverse IRS conclusions are indicated. In the past, the national office has generally not exercised its prerogative to notify district directors of withdrawals of ruling requests or applications for method changes. In the last several months, however, we have received reports of IRS field agents being aware of ruling requests withdrawn by the taxpayer or administratively closed by the service.

Upon informal inquiry, it was pointed out that the IRS has not recently changed its policy regarding the notification to district directors or field offices of actions on taxpayer ruling requests. We were informed that the national office policy continues to be as follows:

- When an adverse ruling is issued or a change of accounting method is denied, the district director is always notified at the same time as the taxpayer.
- When a request or application is either withdrawn by the taxpayer or closed out by the IRS because required information is not submitted, the district director is generally not notified.
- When a district director or field office has been in contact with

the national office with respect to a request or application, the national office will probably notify them of the withdrawal or other significant action (i.e., closing out of case because information had not been received within allotted time).

- When the national office has strong reason to believe that a taxpayer will proceed with a method change or transaction that was the subject of a withdrawn application or ruling request, the national office may exercise its prerogative to notify the district director.

Clearly, the above policy suggests that district directors are not automatically notified of withdrawn requests and applications. However, it is impossible to determine how often such notifications are made. A taxpayer with an extremely sensitive issue should be aware of the implications of this policy when considering the submission of a request for a ruling or an application for change of accounting method.

SECTION 6039

Clarification of corporate reporting requirements for exercised stock options

P.L. 96-167, enacted December 29, 1979, changed the corporate reporting requirements for certain stock options exercised after 1979. Amending sec. 6039, the law provides that for calendar years beginning after 1979 a corporation is no longer required to furnish the IRS with information concerning the exercise of certain qualified and restricted stock options. A corporation is still required to furnish such information to those persons exercising the options specified in sec. 6039.

In Announcement 80-30, 1980-9 IRB 21, the service has clarified the statute's effective date. It provides that corporations must file Forms 3921 and 3922 with the IRS in 1980 for option transactions that occurred during 1979; thereafter, Forms 3921 and 3922 become obsolete. For stock options exercised in years after 1979, the IRS will not publish any required form for the purpose of transmitting information to persons exercising options (as is still required by statute). Therefore, corporations are free to select their own form of written statements in fulfilling their reporting responsibilities to their employees.

SECTION 6081

Automatic extensions for foreign sojourners: avoiding interest and penalties

Most travelers abroad are aware of the automatic 60-day individual return filing extension provided in regs. sec. 1.6081-2(a)(5) to a U.S. citizen (apparently not to a resident alien) who is residing or traveling outside the United States or Puerto Rico on the regular due date for the return. This extension includes persons in military or naval service on duty outside the country. If this regulation applies, the taxpayer also enjoys a like extension of time for paying the tax balance due, under regs. sec. 1.6081-1(a). Furthermore, regs. sec. 1.6073-4(b) automatically allows a two-month extension for filing the taxpayer's declaration of estimated tax.

Interest, of course, accrues from the original due date 3½ months after the end of the individual's taxable year, and regs. sec. 1.6073-4(c) confirms that the underestimation penalty is also determined without regard to the extension. In view of the 12 percent interest and underestimation penalty rates which became effective February 1, 1980, it would appear desirable for the sojourner who files an application for an automatic extension for the prior year on Form 4868 to make an approximate estimated tax payment on his current year paying the approximate balance due.

SECTION 6152

Misuse of Form 7004 is costly

The use of Form 7004 requesting an automatic three-month extension of time to file a federal corporate income tax return pursuant to sec. 6081(b) is common practice. However, careless use of Form 7004 can cost the taxpayer interest if the actual return reflects a tax liability greater than that shown on Form 7004.

Regs. sec. 1.6081-3(a)(2) permits a corporation, upon the timely filing of Form 7004, to *elect* to pay the tax due, as shown on Form 7004, in two equal installments. The installment privilege is limited to the amount of tax shown on line 3(a) of Form 7004 (regs. sec. 1.6081-3(a)(2) and regs. sec. 1.6152-1(a)(2)(ii)).

The election to pay the tax in installments can be made if the corporation files its income tax return on or before the date prescribed

for filing thereof (determined without regard to any extensions of time) and pays 50 percent of the unpaid amount of the tax at such time, or if it files an application on Form 7004 for an automatic extension of time to file its tax return, as provided in regs. sec. 1.6081-3, and pays 50 percent of the unpaid amount of the tax at such time (regs. sec. 1.6152-1(a)(2)(i) and (ii)).

In addition, regs. sec. 301.6601-1(a) provides for payment of interest on any unpaid amount of tax from the last date prescribed for payment of the tax (without regard to any extension of time for payment) to the date on which payment is received. If the tax shown on a *return* is payable in installments, the interest will run on any tax not shown on the return from the last date prescribed for payment of the first installment (Form 7004, instruction F). It is settled that Form 7004 is considered a return. (See *Hayden Publishing Co., Inc.*, and *P. Lorillard Co.*)

Under sec. 6601(b)(2)(B), the last date prescribed for payment of the first installment shall be deemed the last date prescribed for payment of any portion of the tax not shown on the return. Therefore, this is the point at which interest commences on the unpaid portion of the tax.

The application of these rules in instances where the tentative tax on line 3(a) of Form 7004 is understated (as compared with the actual liability as shown on the corporate income tax return) will subject the taxpayer to an interest charge. The interest is calculated on the portion of the final liability representing one-half the excess of the installment that should have been paid over the amount actually paid. To illustrate, if the amount of tax shown on line 3(c) of Form 7004 is $10,000, the first installment required to be paid by the original due date of the return is $5,000. If, however, the final liability as shown on Form 1120 is $20,000, the payment required by the extended due date is $15,000. Since the installments are limited to 50 percent of the amount of tax shown on Form 7004, interest accrues on any unpaid tax not shown on Form 7004 at the time it was filed (or $10,000) from the original due date of the return until the date the balance of the tax is paid. Therefore, a preparer should be as accurate as possible in computing the tentative tax to be shown on Form 7004 to avoid imposition of interest in such circumstances. Where uncertainty exists, the anticipated tax should generally be made high enough to reflect the operation of these rules.

Editors' note: See Rev. Rul. 68-258, as amplified by Rev. Rul. 75-465, and also Rev. Rul. 78-329.

SECTION 6164

Estimated loss for 1981 may be recovered from unpaid 1980 corporate tax

Generally, the tax benefit of a net operating loss (NOL) does not become available until—

- The amount of the loss is calculated *after* the end of the loss year;
- A claim for refund of taxes paid for a prior year is filed and processed by the IRS; and
- A refund check is received from the IRS.

However, under sec. 6164, if it is estimated that a loss will occur in 1981 (or any current year), an immediate cash flow benefit can be obtained by postponing some or all of 1980 taxes otherwise payable during 1981. This includes income, accumulated earnings, and personal holding company taxes. Further, the postponed amount may never have to be paid if the estimate of the 1981 loss turns out to be accurate.

This provision can only be used if all or part of a previous year's corporate tax remains unpaid. Taking a June 30 fiscal year corporation, for example, if it becomes apparent before September 15, 1981 (the due date for filing the fiscal 1981 return) that fiscal 1982 will be a loss year, the expected 1982 NOL can be used to postpone part or all of the required September 15 payment of 50 percent of the remaining 1981 tax liability. Likewise, the 1982 outlook should be reassessed early in December to determine whether the December 15 installment can be similarly reduced.

It is essential to note that this procedure cannot be used for any 1981 taxes that have been paid or are past due. In that case, the corporation will not get a refund until after its fiscal 1982 return is filed. Thus a determination should be made before the due date for filing the corporate return as to whether this provision can be used to reduce the payment of any remaining taxes that need to be paid.

To use this provision, a statement (Form 1138) is filed with the IRS at any time during the tax year of the expected NOL. The statement should include:

- The estimated amount of the expected NOL.
- The reasons for the expected loss.
- The amount of the expected reduction in taxes attributable to the carryback of the current year's expected NOL.
- A declaration that the statement is made under penalty of perjury.

In general, the amount that can be recovered from the unpaid tax liability under this special provision is limited to the amount of refund that could be claimed by a carryback of the estimated loss for the following year under the normal procedures. Interest is due on the postponed taxes from the date payments would have been due if there had been no extension.

If, after filing Form 1138, it appears that the expected loss will be greater or smaller than originally estimated, a revised statement should be filed. However, taxes that have already been paid may not be recovered by filing a revised statement showing a greater estimated loss.

If the postponement procedure is used, Form 1139, "Corporation Application for Tentative Refund," covering the loss year, should be filed by the end of the month in which the return for the loss year is filed. The IRS will apply the NOL to the postponed tax liability and will refund any remaining taxes overpaid.

SECTION 6654

Avoiding estimated tax payments with additional withholding

As a general rule, tax advisers devote a good deal of personal attention to planning appropriate estimated income tax payments for their individual clients. When those clients have substantial wages as well as other forms of income, one common way of satisfying those prepayment requirements is to eliminate or reduce quarterly estimated tax filings in favor of setting up the required level of payments through the employer's payroll tax withholding system. There are a number of benefits in using this approach, not the least of which is the assumption in sec. 6654(e) that amounts withheld will be deemed to have been withheld ratably during the year unless the taxpayer undertakes to establish otherwise.

While the tailoring of an executive's withholdings is often beneficial, there is a frequently overlooked danger where those targeted withholdings will be less than the amount that would normally be required to be withheld by the employer. This would be the case where safe harbor payment levels are used to avoid underpayment penalties on unusual compensation increases (bonuses, stock option exercises, etc.) or where the actual tax bill will be low because of above the line deductions such as partnership or schedule C losses. In this kind of case the tax adviser has succeeded in protecting the individual

taxpayer from underpayment penalties, but he may be inadvertently exposing the employer, and possibly the executive himself as an officer of the employer, to penalties for failure to withhold. The reason is that, under current law, the employer must withhold based on the exemptions claimed on Form W-4. Although the calculation of the allowable number of exemptions allows for anticipated itemized deductions, it does not allow adjustment for either above the line deductions or for safe harbors such as last year's tax liability. A further complication is the employer's potential exposure to either fraud or negligence penalties with respect to the use of W-4s where the number of exemptions needed to accomplish the objective may be unreasonable on its face, or worse, where the employer actually knows that the claim is erroneous.

Although there are presently no clear cut solutions to these problems, there should, at least, be awareness that they exist and are likely to receive increasing attention by the IRS. Legislation to resolve the problem with respect to above the line deductions was introduced in June 1981, by three members of the House Ways and Means Committee. H.R. 3967, sponsored by Reps. Matsui, Stark, and Brodhead, would permit such deductions to be taken into account for withholding purposes by deleting from sec. 3402(m)(2)(A) the language ". . . and other than the deductions required to be taken into account in determining adjusted gross income under section 62 (other than paragraph (13) thereof). . . ." If enacted, the amendment would apply to wages paid after December 31, 1981.

Estimated tax penalty: effect of credits not used against AMT

Sec. 6654(d)(1) allows estimated taxes to be based on the preceding year's tax, while sec. 6654(d)(4) allows estimates based on the preceding year's facts.

Consider the following 1979 facts and tax:

Regular tax	$150,000
Investment credit	80,000
Balance	70,000
Alternative minimum tax	$120,000

Of course, $120,000 is the actual liability, and a $50,000 investment credit carryback or carryover is available. The question is, how much should be paid during 1980 in order to have a safe estimate?

Sec. 6654(f) states that the tax (for the purposes of exception 1) is the tax imposed (except for the minimum tax or alternative

minimum tax) less the credits allowed. Regs. sec. 1.6654-2(b)(2)(i) provides that the credits allowed are those "shown on the return for the preceding taxable year." A literal reading of this regulation would allow a reduced 1980 estimated tax (in the amount of $70,000) even though the investment credit was not wholly used in 1979 but was carried back or forward.

The regulations have not been amended to reflect the alternative minimum tax and may ultimately be amended to contain a different interpretation.

SECTION 6655

Estimated tax payments and investment credit recapture

According to Rev. Rul. 78-257, investment tax credit recapture is a tax for purposes of computing whether the exception to an underpayment of estimated tax provided in sec. 6655(d)(2) is satisfied. This is despite the fact that sec. 6154(c)(1) and sec. 6655(e)(1) define, in general, the estimated tax due as the tax imposed by sec. 11 or sec. 1201(a) (minus certain credits), and neither of those sections encompasses investment tax credit recapture. (Cf. sec. 47(a).) Although this ruling appears technically incorrect, the service has made no move to revoke it.

Therefore, a potentially large penalty for failure to pay estimated tax can arise merely because of failure to pay an estimate equal to the recaptured investment tax credit. For example, a taxpayer having no regular tax liability in the taxable year prior to that for which an estimate is required, either because of available credits or use of a net operating loss, can nevertheless be held liable for substantial under-estimation penalties even if the ITC recapture is relatively insignificant, e.g., $1,000. If the $1,000 is not paid in timely quarterly installments of $250, the taxpayer will be liable for an underpayment penalty based on the entire tax liability, even if it is $1 million or more, for the taxable year for which the estimated payments should have been made. Even if the $1,000 is paid late, a penalty is due for the quarterly payments that are not timely made.

Estimated tax following termination of subchapter S election

A corporation is required to make quarterly payments of estimated tax for any taxable year in which its estimated tax can be reasonably

expected to exceed $40 or more (sec. 6154(a)). The estimated tax must be paid in installments if the requirements are met at any time before the twelfth month of the taxable year (sec. 6154(b)). Penalties are provided for failure to pay estimated taxes and they are nondeductible on the corporation's tax return. (See secs. 6655, 275.)

The requirements of quarterly estimated tax payments should not be overlooked when a subchapter S election is terminated. Because the election is considered terminated retroactive to the beginning of the year (sec. 1372(e)), the corporation also subjects itself to the quarterly payment requirements as of the beginning of the year. Were it not for the fact that the IRS issued two rulings with respect to terminated subchapter S elections, the application of the underpayment penalties to a corporation terminating its subchapter S election and not making quarterly estimated tax payments could cause considerable nondeductible penalties. These two rulings can minimize this potential penalty or eliminate it completely.

In Rev. Rul. 72-388, the service ruled that a corporation would not be subject to penalty in the year of termination if it estimated its tax by applying the tax rates applicable to nonelecting corporations to the taxable income shown on its Form 1120-S for the previous year. Thus, a terminated subchapter S corporation that has greatly increased its income over the prior year can use its prior year's taxable income in computing a safe estimate under exception 2 (sec. 6655(d)(2)).

In Rev. Rul. 73-25, the service held that no penalty will be applied for a year if the election is not terminated until the final month of that year, since the requirement to pay estimated tax is not applicable to this taxpayer before the first day of the twelfth month of the taxable year as required by sec. 6154(b). Therefore, if a planned termination (rather than an involuntary one) is being considered, it should definitely be timed for the last month of the year so that underpayment penalties may be completely avoided.

Tax payments for pre-consolidated-return short periods

It is seldom that the taxpayer gets a free ride from the Internal Revenue Code. This has been demonstrated in recent years as requirements for corporate estimated payments have become more stringent. But consider the following situation:

> Corporation *J*, a calendar-year corporation, has no income for the first five months of 1979. *J* pays no estimates in April or June and is protected from penalty under sec. 6655(d)(3)(A)(i) and (ii). June, July, and August are profitable, and *J* pays a protective estimate pursuant to sec. 6655(d)(3)(A)(iii) on September 15, 1979.

> On September 30, 1979, *J* is acquired by corporation *R*, which has a March 31 year-end. *R* files a consolidated return on June 15, 1980, for the year ended March 31, 1980. Consequently, *J* has a short-period return for the nine months ended September 30, 1979. Regs. sec. 1.1502-76(c)(2) provides that this short-period return is due on the due date (including extensions) of *J*'s full-year return. Therefore, in this situation, the short-period return is due on March 15, 1980 (the due date for *J*'s calendar year 1979 full-year return).

Although there is no underpayment penalty for the third quarter under the rules applicable to full-year returns, in the short-period situation regs. sec. 1.6154-2(b) accelerates the due date for the estimated tax payment otherwise due on December 15. Under the regulations, any estimated tax payable in installments that has not been paid prior to the fifteenth day of the last month of the short period is due on that date (in this case September 15). Even though *J* could not have known with certainty on September 15 that the acquisition would occur, it is subject to penalties for failing to make the balance of the estimates due by that date.

On the other hand, it would seem that the penalty for underpayment would continue to accrue until the tax is paid, but sec. 6655(c) specifies that the penalty for underpayment will be computed from the due date of the estimate payment until the earlier of the date of tax payment or the fifteenth day of the third month following the close of the taxable year. Therefore, in this case, the penalty will run from September 15 to December 15, even if part or all of the required tax is paid after December 15.

This may not seem that beneficial, since it appears that at least half the balance of tax due on the short-period return should be paid by December 15 or penalties and interest under secs. 6651 and 6601 would begin to run. However, *J* may elect, under sec. 6152, to pay the unpaid amount of its tax in two installments. Sec. 6152(b)(2) calls for payment of the first of the two installments "on the date prescribed for payment of the tax." According to regs. sec. 1.6151-1(a), "The tax shown on any income tax return shall . . . be paid . . . at the time fixed for filing the return (determined without regard to any extension). . . ."

In our case, *J* must pay half the balance due on the due date of the return, which is March 15, 1980, not December 15, 1979 (regs. sec. 1.1502-76(c)(2)). The net result is that sec. 6655(a) penalties stop on December 15, 1979, and no payment is due until March 15, 1980. *J* has the use of its entire unpaid tax for three months and one-half the unpaid balance for six months.

IRS eases estimated tax requirements for seasonal taxpayers

Recent IRS published and private rulings permit taxpayers earning most of their income late in the year to reduce their quarterly estimated tax payments by more than most people realized. The cash-flow benefits from deferring these tax payments can be substantial. For example, corporations that earn all their taxable income in the second half of the year need make no more than *one* estimated tax payment—in the fourth quarter—equal to just 20 percent of their total tax liability for the entire year; corporations that operate at a break-even or loss in the first quarter need make no more than two 20 percent estimated tax payments—in the third and fourth quarters of the year.

Secs. 6015 and 6154 require many taxpayers to make installment payments of estimated taxes during the course of the year. In general, corporate and individual taxpayers must prepay 80 percent of their annual tax liabilities in order to avoid the imposition of IRS penalties. However, secs. 6654 and 6655 provide certain exceptions to this general rule. One exception permits both corporations and individuals to base their quarterly payments on annualized interim-period income. This exception is particularly beneficial for taxpayers earning the bulk of their income in the latter part of the year.

A calendar-year corporation relying on the annualization exception of sec. 6655(d)(3) would calculate its estimated tax installments as follows:

Quarterly due date	Payment is based on 80% of the tax on annualized income for the
April 15	First 3 months of the year
June 15	First 3 or 5 months of the year
September 15	First 6 or 8 months of the year
December 15	First 9 or 11 months of the year

Similar, but not identical, relief provisions apply to individual taxpayers under secs. 6654(d)(2) and (3).

When the annualization exception had been relied upon early in the year, many taxpayers believed that installment payments later in the year would have to be increased correspondingly. However, in Rev. Rul. 76-563, the Internal Revenue Service held that catch up payments are not necessarily required. This conclusion has been reaffirmed by the IRS in some very recent private rulings. (See IRS Letter Rulings 7801005 and 7812040.) The following example illustrates the effect of these rulings:

Corporation *A* reports on a calendar-year basis and it estimates it will have a $1,000,000 federal tax liability for the entire year 1978. Due to the seasonal nature of its business, it operates at a break-even or small loss through June 30. All of its income tax liability accrues in the second half of the year. It is required by sec. 6154 of the code to make installment payments of estimated tax on April 17, June 15, September 15, and December 15 of 1978. However, as most tax practitioners are already aware, Corporation *A* may rely on the annualization exception of sec. 6655(d)(3) to avoid making any quarterly payments of estimated tax whatsoever for the first *three* quarters.

And, as the recent IRS rulings now make clear, it need only make a payment of $200,000 ($1,000,000 × 25% × 80%) on December 15, 1978, to avoid underpayment penalties for the fourth quarter. In effect, the fourth quarter payment is determined under the general 20% "quarter by quarter" rule in lieu of the annualization exception for that quarter. Payment of the remaining 1978 tax liability of $800,000 may be delayed until March 15 and June 15 of 1979. Prior to the publication of the IRS rulings, many taxpayers would have thought it necessary to make a payment of as much as $800,000 in the fourth quarter of 1978 so as to avoid IRS penalties (unless some other underpayment exception applied).

It is very important that careful calculations and projections be made in order for this tactic to be effective. A small error can nullify this relief and cause a large underpayment penalty. It is also important that the 20 percent minimum payment be made in and for the proper quarter; payments made earlier in the year generally cannot be counted toward the current 20 percent payment that is necessary under the quarter-by-quarter rule. It must also be remembered that even if a company is operating at a loss in the first part of the year, the annualization exception may still require the payment of sufficient estimated taxes in the early quarters to cover such items as investment credit recapture and WIN credit recapture for those periods.

The benefits of the annualization rules are not limited to loss or break-even situations. Taxpayers operating at profitable levels early in the year may also benefit if profits are relatively higher later in the year.

SECTION 6676

Penalties—failure to include taxpayer's identifying number on information returns

Undoubtedly, tax practitioners have noticed a substantial increase in IRS notices in connection with a taxpayer's failure to include interest

or dividend income on his personal income tax return. This follows from the long-established and published IRS policy to match information returns with tax returns.

In addition to notices being received by individual taxpayers, corporations are now receiving notices with respect to their failure to include shareholders' identifying numbers on information returns. The IRS letters point out that a penalty with respect to the tax year in question is not being assessed, but for the succeeding tax year a penalty in the amount of $5 for each missing taxpayer identifying number will be assessed. This letter is being sent to publicly held companies that may have thousands of shareholders receiving dividends.

Generally, in the case of publicly held corporations, the company's transfer agent handles the mechanics with respect to the information return filings. However, the penalty is assessed against the corporation and not against the transfer agent.

The penalty referred to is authorized by sec. 6676. Regs. sec. 301.6109-1(c) requires a payer to request the identifying number of the payee. Regs. sec. 301.6676-1(a) provides in pertinent part, "If, after such a request has been made, the payee does not furnish the payer with his identifying number, the penalty will not be assessed against the payer." Accordingly, if the payer can prove that the transfer agent has made a request for the payee identifying number, the penalty will not be assessed, or if assessed, will be abated.

It is suggested that the taxpayer have clear documentary proof that the transfer agent has requested the identifying number. In some cases, it may be worthwhile to have the transfer agent run a program to request all identifying numbers, even if this had been done in the past. The cost may be insignificant compared to the potential penalty liability or the effort required to convince the government that the request had been made.

Note that regs. sec. 301.6676-1(c) provides that the penalty can be abated for reasonable cause. However, reliance on an abatement for reasonable cause will, of course, require the taxpayer to establish, to the satisfaction of the district director (or the director of the regional service center), that reasonable cause did, in fact, exist. This can be far more difficult and time consuming than establishing that the identifying number was requested.

While sec. 6676 and the regulations thereunder are not new, the substantial number of proposed penalty letters being sent by the IRS is a recent development. Practitioners have found that some IRS local offices and service centers are not familiar with the relief provisions of the regulations.

SECTION 9100

IRS position on extensions of time for elections

Regs. sec. 1.9100-1 is one of the few income tax regulations without an underlying code section. This regulation gives the IRS discretion to grant extensions of time for making tax elections if the time for making the election is not specified by statute but is delegated to the regulations.

The predecessor of regs. sec. 1.9100-1 goes back many years to the days when taxpayers regularly went to their Congressmen for special relief bills when they had failed to make timely elections. To eliminate the necessity of advising the President on individual special interest bills, the Treasury prevailed on the service to issue the predecessor of regs. sec. 1.9100-1. Over the years, however, the IRS national office built up resistance to acting under this regulation, and many applications for relief have been pending for years.

The Service issued Rev. Proc. 79-63, setting forth the information that must be furnished by taxpayers requesting relief under regs. sec. 1.9100-1 and the factors that will be considered in determining whether or not to grant such relief. The factors that will be considered are—

- Due diligence of the taxpayer.
- Prompt action by the taxpayer.
- Intent of the taxpayer, including whether the failure to file on time was due to inadvertence or significant intervening circumstances and whether the taxpayer's subsequent actions were consistent with this intent.
- Prejudice to the interests of the government.
- Consistency with the objectives of the statute and the regulations.

At the same time that Rev. Proc. 79-63 was issued, the service issued five rulings applying regs. sec. 1.9100-1. The five rulings comprise three in which relief was granted and two in which it was not. The three favorable rulings are as follows:

- Rev. Rul. 79-415 dealt with an extension of time to permit a lessor to pass through an investment credit to his lessee. The failure resulted from oversight, and the lessor did not claim the credit on his own return and acted consistently with an intent to pass the credit through to the lessee.
- Rev. Rul. 79-416 concerned the failure of an attorney to file a timely DISC election. All taxpayer actions were consistent with the intent to adopt DISC status, including preparation and signature of the election. The attorney erroneously filed the signed election in his desk instead of with the service.

- Rev. Rul. 79-417 concerned failure to file a timely application to change the method of accounting from the cash to the accrual basis when the corporation's treasurer died. The corporation acted promptly and diligently to rectify the situation.

The two rulings in which relief was not granted are as follows:

- Rev. Rul. 79-414 concerned a failure by a noncorporate lessor to file a timely election to pass through investment credit to a lessee. The lessor claimed the credit on his own return because of his accountant's bad advice and filed for relief when the credit was disallowed.
- Rev. Rul. 79-418 dealt with a failure to include Form 970 or equivalent data in a tax return to elect lifo. The extension was denied because the taxpayer had not demonstrated due diligence by making a significant effort to comply with the lifo regulations.

In a subsequent release, IRS Letter Ruling 8004116, an extension was granted to a partnership to step up the basis of its assets to reflect the higher value of a deceased partner's partnership interest. A timely election was not made because of the '76 act carryover basis provisions. The '78 act retroactively postponed carryover basis for pre-1980 decedents. When the books and records were examined in early January 1979, the accountant recommended the secs. 743 and 754 election, and an extension was requested.

Each of these rulings deals with a specific situation and cannot be extended by implication to others. Further, the existence of regs. sec. 1.9100-1 and Rev. Proc. 79-63 should not cause relaxation of control procedures, since relief will not be granted without a showing of due diligence.

Regs. sec. 1.9100 relief for reliance on advice of tax adviser

The IRS has recently released a somewhat rare private ruling (IRS Letter Ruling 7911046) granting administrative relief under regs. sec. 1.9100 to a partnership requesting an extension of time to make a delinquent election under sec. 754 to adjust the basis of partnership property. Tax practitioners should be aware of this relief provision, which is available for various types of delinquent elections. Although not routinely or casually granted by the IRS, it is available in a number of situations where good cause and clean hands can be demonstrated.

Regs. sec. 1.9100-1(a) provides, in part, that—

> The Commissioner in his discretion may, upon good cause shown, grant a reasonable extension of the time fixed by the regulations . . . for the making of an election or application for relief . . . provided—

> (1) The time for making such election or application is not expressly prescribed by law;
>
> (2) Request for the extension is filed with the Commissioner before the time fixed by the regulations . . . or within such time thereafter as the Commissioner may consider reasonable under the circumstances; and
>
> (3) It is shown to the satisfaction of the Commissioner that the granting of the extension will not jeopardize the interests of the Government.

Under the facts of the letter ruling, the managing partner asked the partnership's accountant about the availability of a basis adjustment to the partnership. The accountant advised the managing partner that nothing could be done. Having relied on this advice, the managing partner filed the partnership return without making a sec. 754 election. Upon subsequent review of the return, an attorney for the partnership brought the failure to make such an election to the attention of the managing partner and then proceeded to request an extension of time, under regs. sec. 1.9100, to file the sec. 754 election.

The IRS concluded that regs. sec. 1.9100 relief should be granted after taking into account the following factors:

- The accountant, the attorney, and the managing partner corroborated the facts by affidavit.
- The managing partner had relied on the advice of an experienced and competent tax adviser in failing to make the timely election.
- The managing partner had focused the attention of the accountant on the specific issue and had disclosed all relevant facts to him.
- The time for making the sec. 754 election is not expressly prescribed by law, only by regulation.
- The regs. sec. 1.9100 request was filed as soon as the managing partner was informed of the election by the attorney.
- The interests of the government were not jeopardized by granting the extension, since the partnership would obtain no hindsight benefit.

It is understood that the commissioner is presently considering the disposition of two to three dozen other requests for regs. sec. 1.9100 relief that have been pending for up to three years. We further understand that these cases involve determinations of good cause not only for reliance on the advice of counsel but also for inadvertence, mistake, incapacitation of the tax adviser, supervening events, and the delegation of filing responsibilities, among others.

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