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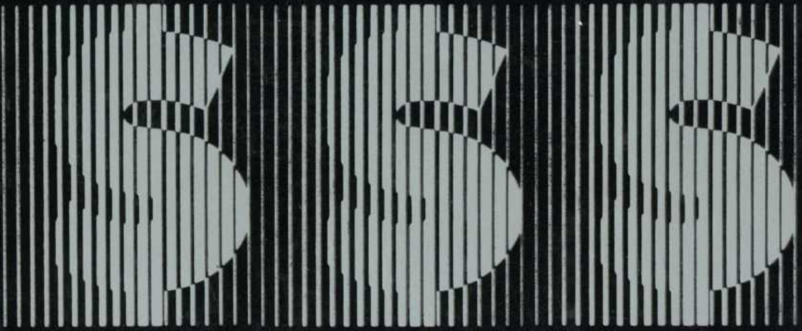
TAX PLANNING TIPS 1981

FROM THE TAX ADVISER



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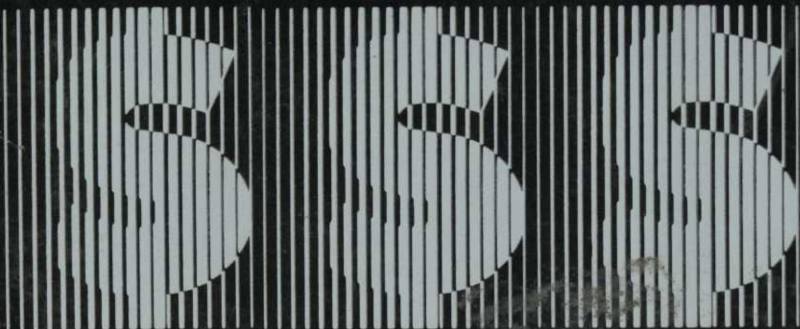

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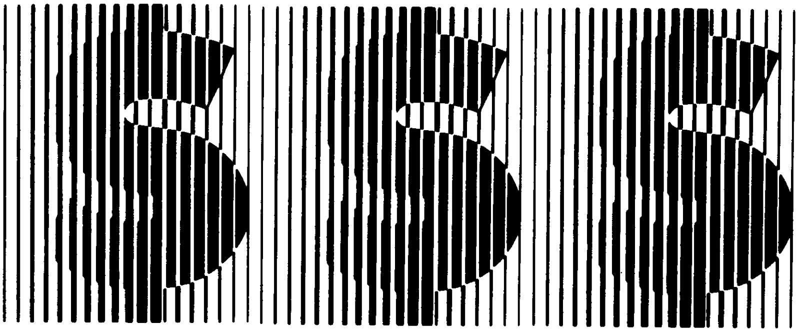

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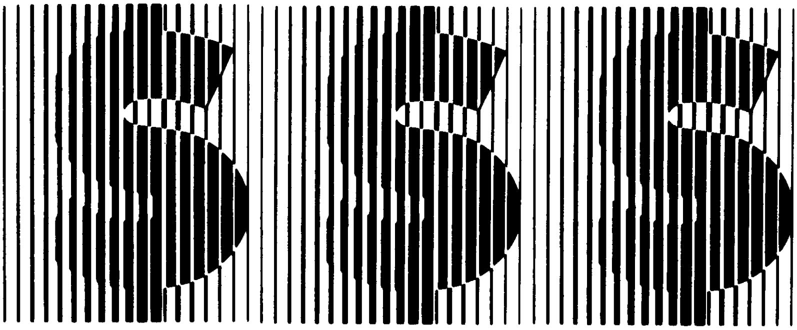

American Institute of Certified Public Accountants

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The material in this book has been written by experienced practitioners and checked to ensure that it is current at the time of publication. It has not, however, been officially reviewed or endorsed by the American Institute of Certified Public Accountants.

Foreword

We are again privileged to have Irvin F. Diamond, CPA, and Mike Walker, CPA, of Rogoff and Youngberg, Albuquerque, New Mexico, as editors of *Tax Planning Tips From The Tax Adviser—1981*.

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 1980 are

Steve Braun, CPA
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We also wish to acknowledge the fine efforts of Jo Proett, CPA, Diana Bode, CPA, and John Howard, CPA, of Rogoff and Youngberg; and David Diness, CPA, 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 Brian Kintish of the Institute's production department.

Kenneth F. Thomas, CPA
Director, Federal Tax Division

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Tax Effects of Written Agreements

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 arms-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

Investment credit—limitation on noncorporate lessors

sec. 46

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 *sec. 46* 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.

Investment credit pass-through by noncorporate lessors

Noncorporate lessors are allowed to claim the investment credit on leased property only if the strict requirements of sec. 46(e)(3) are met. However, when a noncorporate lessor fails to meet those requirements, he may still elect to pass the credit through to the lessee under sec. 48(d)(1). Although regs. sec. 1.48-4(a) requires that leased property be "sec. 38 property" in the hands of the lessor before investment credit can be passed through to the lessee, the restrictions of sec. 46(e)(3) do not affect whether or not the property is sec. 38 property; they merely forbid the lessor from taking the credit. If the leased property is sec. 38 property, then the lessee may take the credit if the lessor properly elects to pass it through. This position is supported by the House committee reports, 1 CB 504 (1972).

Special rules may resurrect "dead" carryovers

Unless a business has had 15 years of uninterrupted profitable operations, there is a good chance it has been involved with the carryback and carryover of investment credit. For most items of loss, deduction, or credit subject to carryback-carryover treatment, there is a "standard" method of application. Generally, the current year's limitation is computed and the deduction taken or the credit claimed, using first the amounts arising in the current year, with the balance, up to the amount of the limitation, coming from the earliest carryover year or years. This method is so standard that a taxpayer could easily be lulled into allowing some good, useable investment credit carryovers to be lost. *sec. 46*

Example. Assume a company started business in 1965 and had the following investment credit history:

	Current credit	Limitation based on tax
1965	$3,500	0
1966-1969	0	0
1970	0	$1,000
1971	0	0
1972	2,000	2,000
1973	0	0
1974	1,000	1,800
1975	300	1,300

Since 1965 was the company's first taxable year, no credit could be carried back. Using the "standard" method, the credit would be carried over for seven years and used to the extent that each year's limitation exceeded the credit arising in that year, as illustrated in the following table.

	Available	Used	Carryover
1965-69	$3,500	0	$3,500 (from 1965)
1970	3,500	$1,000	2,500 (from 1965)
1971	2,500	0	2,500 (from 1965)
1972	4,500	2,000	0
1973	0	0	0
1974	1,000	1,000	0
1975	300	300	0
Total used		4,300	
Total expired		2,500	
Carryover to 1976		0	

However, the repeal of the credit by the Tax Reform Act of 1969, and its restoration by the Revenue Act of 1971, left us with three transitional rules that change this example.

First, for 1969 through 1971, the amount of investment credit carryover that could be used was limited, not only by the tax for those years, but also by a percentage of the carryover itself [sec. 46(b)(5)]. So, in our example, only 20 percent of the carryover, or $700, could have been used in 1970. Thus, our "total used" credit would drop to $4,000, and the "total expired" credit would increase to $2,800.

The other two changes are beneficial to the taxpayer. Carryovers from pre-1971 years that were carried over to 1971 under the seven-year rule may be carried over an additional three years. Thus, investment credits arising in years 1964 through 1970 may be carried over ten years [sec. 46(b)(1)(B)]. This provided some relief, but the change that is most likely sec. 46 to be of benefit, and also most likely to be overlooked, is that credits from pre-1971 years are used *before* credits for the current year [sec. 46(b)(3)], thus significantly reducing the chance that these carryovers will expire before they can be used. Using these special rules, here is our example again.

	Available	Used	Carryover
1965-69	$3,500	0	$3,500 (from 1965)
1970	3,500	$ 700	2,800 (from 1965)
1971	2,800	0	2,800 (from 1965)
1972	4,800	2,000	2,800 ($800 from 1965) ($2,000 from 1972)
1973	2,800	0	2,800 ($800 from 1965) ($2,000 from 1972)
1974	2,800	1,800	2,000 (from 1972)
1975	2,300	1,300	1,000 (from 1972)
Total used			5,800
Total expired			0
Total carryover (available 1976-1979)			$1,000

In 1970, as noted above, the 20 percent limitation resulted in only a $700 credit for that year. In 1972, the carryover is applied first against the $2,000 limit, the remaining $800 from 1965 is still available for three more years, and the entire $2,000 from 1972 is available for seven years. In 1974, the $800 from 1965 is used, then the $1,000 from 1974, with the $2,000 from 1972 still carried over. In 1975, the $300 from 1975 is used, then $1,000 from 1972, and the remaining $1,000 from 1972 is still available for 1976 through 1979. The post-1970 credits may be carried over only the "standard" seven years and are applied against the limitation in the "standard" way by first applying credits arising in the current year.

Any taxpayer that has had investment credit apparently "expire" since 1970 should dust off those old credits—they may be alive and well after all.

Note that beginning in 1976, investment credits are to be used on a first-in, first-out basis, with the oldest carryovers to be used first, then currently earned credits, and finally the oldest carrybacks.

sec. 47 Investment credit: recapture on disposition by former subchapter S corporation

Sec. 48(e) provides that qualifying sec. 38 property is to be allocated among the shareholders of a subchapter S corpora-

sec. 47

tion as of its year end. The shareholders to whom the qualified property is allocated get the benefit of the credit allowed (subject to limitations at the individual level) by including the basis of the property allocated to them, together with any other eligible property that they may acquire individually, on their tax return for the year in which or with which the taxable year of the corporation ends [regs. sec. 1.48-5(a)(1)]. In the case of an early disposition of such sec. 38 property, however, situations can arise that lead to questions as to the correct handling of the recapture required by sec. 47.

The recapture of investment credit upon early disposition of qualified sec. 38 property by a subchapter S corporation will, under normal conditions, fall to the shareholders who originally got the benefit of the credit [regs. sec. 1.47-4(a)(1)].

Suppose, however, that subsequent to a termination of the subchapter S election, the corporation disposes of the qualified property that had been taken into account by the shareholders. The termination of the election does not cause sec. 38 property to cease to be such [regs. sec. 1.47-4(d)]. The recapture applicable to any such early disposition is the responsibility of the shareholders who were treated under sec. 48(e) as the taxpayers with respect to such property. However, no hard and fast rules seem to exist as to *when* the recapture is reportable. If the corporation's year ends with that of the shareholder, it is easy to conclude that the recapture will be reported in that year of the shareholder. But what if the corporation is on a fiscal year ending, for example, on June 30, 1976, and the date of early disposition of the property was December 15, 1975? Does the date of disposition or the corporate year-end of the former subchapter S corporation control the reporting? The amount of tax included will be the same since the disposition date controls the calculation of the amount of recapture, but the problem remains whether the shareholder should report this recapture in his 1975 or 1976 personal income tax return.

This particular problem, although not specifically dealt with in the regulations, can probably be resolved. It would seem at first impression that since the election is not still in effect, the normal flow-through characteristics at year-end are lost and that recapture is reported by the shareholder in his taxable year in which the date of disposition by the corporation occurred. This position seems further warranted by regs. sec. 1.47-3(f)(6), example (2), wherein it is explained that a shareholder in a corporation formed from the transfer of his pro-sec. 47 prietorship is required to recapture the credit necessitated by an early disposition in his taxable year in which the disposition date occurred.

Subchapter S: agreement to avoid investment credit recapture

The fact that the '76 act and '78 act contain a number of liberalizing changes affecting subchapter S corporations may result in a greater interest in the subchapter S election. These amendments eliminated, or at least simplified, problems encountered in the past with changes in ownership.

However, the shareholders of existing corporations who now may be considering the adoption of a subchapter S status should be aware of an agreement that, if not made, would trigger an investment credit recapture.

Sec. 47(a)(1) imposes a recapture tax where certain qualified depreciable property ("sec. 38 property" on which a credit has been allowed) is "disposed of or otherwise ceases to be sec. 38 property" with respect to the taxpayer in a taxable year ending before the expiration of the estimated useful life used in computing the credit.

Regs. sec. 1.47-2(a)(2)(i) provides that, in determining whether a cessation has occurred, an examination must be made of each taxable year subsequent to the credit year. Thus, a determination must be made for each taxable year of whether such property would qualify as sec. 38 property in the hands of the taxpayer if it were placed in service in that particular year.

Sec. 48(e) provides that the qualified investment of a subchapter S corporation for each taxable year shall be apportioned pro rata among the shareholders, and they "shall be treated as the taxpayers with respect to such investment."

Under regs. sec. 1.47-4(b)(1), as a result of a subchapter S election, property ceases to be sec. 38 property with respect to the taxpayer (the corporation) the day before the effective date of the subchapter S election, and at that point the recapture tax applies. Liability for the tax arises in the taxable period immediately preceding the effective date of the election.

However, the regulations permit an electing corporation and its shareholders to avoid the imposition of the tax in that year if they agree to assume liability for any recapture tax that may arise if the corporation's sec. 38 property acquired prior to the election is disposed of or otherwise ceases to be sec. 38 property while the election is effective. Regs. sec. 1.47-4(b)(2), which sets forth the requirements, states that the agreement is to be filed with the district director with whom the corporation files its income tax return, for its taxable year immediately preceding the first taxable year for which the election is effective, and shall be filed on or before the due date (including extensions). For taxpayers who fail to meet this requirement, the regulation allows the district director to permit the agreement to be filed on a later date if "good cause" is shown.

A case in which good cause was shown is *Bell Fibre Products Corp.*, where the taxpayer was not advised by his accountant or attorney, who were familiar with the taxpayer's tax problems, of the requirements of the regulations.

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

sec. 47

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.

Investment credit recapture resulting from basis reduction under section 1017

The present IRS position that investment credit recapture occurs when the basis of sec. 38 property has been reduced under sec. 1017 may represent an invalid extension of the recapture rules of sec. 47(a)(1). Sec. 1017 requires the basis of property to be reduced when an election is made under sec. 108 to exclude from gross income the gain arising from discharge of indebtedness. The basis reduction required is the amount of gain excluded from income. Sec. 47(a)(1) prescribes recapture of investment credit on "early" dispositions of sec. 38 property or when property *ceases to be sec. 38 property* before the end of the useful life that was used in computing the credit. Since there obviously has been no disposition in the situation under consideration, the question is whether a basis reduction under section 1017 constitutes a "cessation," and, if not, whether there is any other support for the IRS's position.

In its first pronouncement on the subject (Rev. Rul. 72-248), the IRS may have reached the right result for the wrong reason. The ruling considers a taxpayer who purchased sec. 38 property with the proceeds of a new issue of bonds. Less than three years after the property was placed in service the taxpayer realized a gain by acquiring the bonds at less than their face value. The gain was excluded from the taxpayer's income under sec. 108 and the basis of the sec. 38 property was correspondingly reduced under sec. 1017. Holding that the investment credit previously computed must be recomputed to reflect the reduction in the basis of the sec. 38 property, the ruling cites in support regs. sec. 1.47-2(c), which provides generally that if the basis of sec. 38 property is reduced, the property shall be *treated as* having ceased to be sec. 38 property to the extent of the basis reduction.

sec. 47

There is no support in the statute for this rationale. Since the property continued to be used by the taxpayer in conducting its trade or business in the United States, the property did not *actually* cease to be sec. 38 property. The deduction for depreciation reduces basis, but, presumably, the commissioner would not contend that this adjustment changes the character of the property. The IRS position, as stated in the ruling and in regs. sec. 1.47-2(c), that sec. 38 property whose basis is reduced shall be *treated as* having ceased to be sec. 38 property would appear to be an unwarranted gloss on sec. 47(a)(1).

The holding in Rev. Rul. 72-248 could have been reached by another line of reasoning: Since the bonds issued to purchase the sec. 38 property were acquired at less than their face value, it would have been reasonable to hold that the original cost of the property was adjusted as a result of the bond acquisition, thereby necessitating a recomputation of the credit originally computed. However, this reasoning would not have applied to the facts present in a later revenue ruling, Rev. Rul. 74-184. There, the proceeds of bonds issued before the enactment of sec. 38 and subsequently acquired at a discount from face value were not used to purchase the sec. 38 property whose basis was adjusted under sec. 1017. Despite this factual difference, the ruling holds that the principle set out in Rev. Rul. 72-248 is equally applicable. In other words, in the view of the IRS, the property's basis adjustment causes it to be treated as having ceased to be sec. 38 property.

In Letter Ruling 7807007, the IRS has carried its view to the extreme. There the taxpayer acquired its bonds at less than face value, and the sec. 1017 adjustment to basis of sec. 38 property was made in a year subsequent to the end of the useful life of the property used in computing the credit originally. According to the ruling, this fact does not make the two revenue rulings previously mentioned inapplicable. Under regs. sec. 1.47-2(c), in recomputing the investment credit under sec. 47(a)(1), the actual useful life of the property treated as having ceased to be sec. 38 property is considered to be less than three years. Thus, the full amount of the investment credit on the portion of the total basis that is treated as having ceased to be sec. 38 property is recaptured, regardless of the length of time the property has been held at the date of the basis reduction. Of course, this is contrary to *sec. 47* the provision of sec. 47(a)(1), which requires that the actual useful life of the property be taken into account in recomputing the allowable investment credit.

It is submitted that the IRS's position as to the effect of basis reduction upon the investment credit has no clear-cut statutory support. If Congress believes that such stringent rules are appropriate, clarifying legislation should be enacted.

sec. 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 reexamine 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, discs, 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. *sec. 48*

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.

sec. 48 Investment credit—leveraging after the '76 act

With the exception of real estate, the '76 act has substantially reduced the availability of nonrecourse financing to generate losses. Under new sec. 465, for all taxpayers other than corporations that are neither subchapter S corporations nor personal holding companies, the loss for a taxable year from certain specified activities is limited to the amount "at risk" for the particular activity at the close of the taxable year.

A similar "at risk" limitation applies to losses that may be claimed from a partnership, regardless of the activity that generated the loss. (See amended sec. 704(d).) This partnership "at risk" limitation does not apply if sec. 465 applies, nor does it apply to a partnership whose principal activity is investing in real property (other than mineral property).

What may be overlooked is that the above provisions do not limit the amount of tax credits that may be leveraged with no-risk capital, since the new provisions only address loss situations, i.e., excess of deductions over income. As a result, it may still be possible to use nonrecourse financing to produce a tàx savings in excess of amounts placed at risk.

Example. Five investors each contribute $1,000 cash and use nonrecourse financing of $95,000 to purchase $100,000 of cattle to be used for breeding purposes. Assuming a seven-year life and that the property otherwise qualifies, each investor may claim a $2,000 investment tax credit (10 percent credit = $10,000) that is in excess of his cash investment. Further, the credit claimed does not reduce the amount at risk for purposes of determining the partners' loss limitation.

As a practical matter, the ability to leverage investment credit with such a large proportion of nonrecourse financing will be limited by economic considerations. However, the principle is sound.

Note that under the '76 act there is an exception to the availability of no-risk capital to generate investment tax credit. In the case of movie and television films, new sec. 48(k) provides that a taxpayer is allowed the credit to the extent of his "ownership interest" in the film or tape. Sec. 48(k)(1)(C) provides that a person's ownership interest shall be determined on the basis of his proportionate share of any loss that may be incurred with respect to the production costs of such film. The Senate Finance Committee report indicates that this is to be interpreted as providing an "at risk" rule similar to that contained in sec. 465.

Investment tax credit: avoiding the used-property limitation . . .

sec. 48

The $100,000 used-property limitation for sec. 38 property provided by sec. 48(c) typically comes into play when a going business is acquired. One planning technique to circumvent the used-property limitation is to claim the investment credit for the used property over more than one year. This will require that the used property be "placed in service" over more than one taxable period. The term "placed in service" is defined in regs. sec. 1.46-3 as the earlier of the year in which—

- Depreciation begins under the taxpayer's normal practice, or
- Property is placed in a condition of readiness and availability for a specifically designed function.

The possibility of having property "placed in service" over two taxable periods will be enhanced if the acquisition takes place just prior to the end of the acquirer's taxable period, so that some assets are placed in service in one year and some in the next. If a new corporation is established to be the acquiring party, it could select its taxable year so that used property may be "placed in service" over its two initial taxable periods. A corporation may also be able to terminate its taxable period around the time of the acquisition if it qualifies for an automatic change of accounting period under regs. sec. 1.442-1(c). The basic requirements for an automatic change are that the corporation must not have changed its annual accounting period within the previous ten years, the short period must not create a net operating loss, and the annualized taxable income for the short period must be at least 80 percent of the taxable income for the immediately preceding full taxable year. Note that investment credit would not enter into the 80 percent test, which is geared to taxable income.

Another possible planning technique for circumventing the $100,000 limitation is to have the shareholders of the acquiring corporation acquire some of the used property. While certain related parties, such as a controlled group of corporations, must apportion a single $100,000 limitation amount, there appears to be no such limitation on shareholders and their controlled corporation. Thus, the used-property limitation may be expanded to $200,000 or more if used property is acquired by both the acquiring corporation and its shareholders.

sec. 48

. . . and qualification of damage payments for the credit

In a recent case, *Mapco, Inc.*, the Court of Claims held that crop and other damage payments by an oil pipeline company to the owners and tenants of the land subject to pipeline right-of-way easements should be regarded as part of the cost of constructing the pipelines, and are thus tangible assets that qualify for the investment credit. This holding is directly contrary to the position of the IRS, which is supported by a decision of the fifth circuit, that such damage payments are attributable to the cost of the easements and thus are intangible assets that do not qualify for the investment credit. (See *Tenneco, Inc.*) Taxpayers who have not claimed investment credit or accelerated depreciation on these costs should consider filing claims for refund.

In the normal sequence of events, a pipeline company purchases a right-of-way easement across a particular parcel of land and then, at a later date, clears and grades the surface of the land within the boundaries of the right-of-way, digs the ditch, and lays the pipeline. The agreement conveying the right-of-way easements generally contains a provision that the utility will pay the owners and tenants for all damages to crops, timber, fences, drain title, or other improvements on the premises that may arise from the exercise of privileges granted.

The service has taken the position that such damages are the cost of intangibles and do not qualify for the investment credit. This position is supported by *Tenneco, Inc.*, wherein the court concluded that the damages were properly attributable to the cost of the easement on the ground that the damages were paid to the landowners for utilization of the contractual easement; they were therefore primarily easement costs, and only secondarily construction costs of a pipeline.

In *Mapco, Inc.*, the Court of Claims concluded that the logic used by the taxpayer in his argument that the damage payments are an integral part of the cost of constructing the pipeline was better than that used by the court in the *Tenneco* decision. The Court of Claims believed that the purchase of the right-of-way easement across a parcel of land was an entirely separate transaction from the construction of the pipeline and the ensuing damage to the land. The requirement for the damage payments occurs only if and when the taxpayer decides to utilize the easement by clearing and grading the land, digging the ditch, and laying the pipeline. It follows logically that such damage payments are as much a part of the cost of constructing the pipeline as is the expense incurred in purchasing the pipe for the pipeline.

The decision in the *Mapco* case is sufficient authority for utilities and others to treat such damage payments as costs qualifying for the investment tax credit and accelerated depreciation. It is also possible that the IRS will seek Supreme Court review of this decision, and the results of such appeal cannot be predicted; thus, taxpayers who have not claimed the investment credit and accelerated depreciation on such costs should be advised to consider filing protective claims for refunds before the relevant statutes of limitations expire.

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, subordi-

sec. 48

nate 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. sec. 48

. . . 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.*

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." sec. 48

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 *sec. 48* 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.

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.

Passthrough 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 *sec. 48* 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.

AMT may affect conventional shelter strategies **sec. 55**

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 *sec. 55* 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 1981, accelerating income into 1980 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 1980 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

sec. 55 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!

'78 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. *sec. 55*

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 sec. 55 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). *sec. 55*

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.

Refunds to financial institutions on prior-year preference tax

sec. 57

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.

Waiving deductions: a new tax planning tool?

Logically, taxpayers would assume that the greater their itemized deductions, the lower their tax liabilities—but illogically, a few would be wrong. The following example illustrates a case in which a taxpayer eliminates a potential tax liability by waiving certain itemized deductions (charitable contributions in this instance).

Example. T filed a joint return for 1977 claiming seven personal exemptions. The allowable itemized deductions include $2,500 for charitable contributions. By waiving the $2,500 deduction, *T*'s tax liability was reduced by $240, computed as follows.

	With contribution deduction	Without contribution deduction
Adjusted gross income (AGI)	$36,800	$36,800
Itemized deductions	(34,000)	(31,500)
Zero-bracket amount	3,200	3,200
Tax table income	6,000	8,500
Income tax	None	None
Minimum tax	240	None
Total tax	240	None
Minimum tax computation		
Itemized deductions	34,000	31,500
Less medical insurance and casualty loss deductions	320	320
	33,680	31,180
AGI of $36,800 × 60%	22,080	22,080
Adjusted itemized deductions	11,600	9,100
Less exclusion	10,000	10,000
Base for minimum tax	1,600	(900)
Tax @ 15%	$ 240	None

T cannot escape the minimum tax under the "tax benefit" rule even though his taxable income is below the zero-liability level provided by the tax rate schedules. Compare sec. 58(h) and regs. sec. 1.57-4(b)(1)(i), which provide for a reduction of the minimum tax base if, and to the extent, tax preferences do not produce an income tax benefit. *sec. 57*

Note also that *T* could not use the general tax credit of $245 (seven personal exemptions × $35) against the minimum tax. (See sec. 42(a).)

No provisions in the code or regulations could be found that require a taxpayer to claim all of his itemized deductions. Therefore, in situations similar to the example here, tax advisers should consider *not* claiming some of the itemized deductions otherwise allowable to a taxpayer-client.

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)].

sec. 57

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)	(2)	(3)	(4)
Item of sec. 1250 property	Declining-balance depr'n	Straight-line depr'n	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)	(2)	(3)	(4)
Item of sec. 1250 property	Declining-balance depr'n	Straight-line depr'n	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.

sec. 72 Annuities—an appealing tax shelter

Many of the new annuity plans being marketed by life insurance companies are substantially similar to interest-bearing deposits in a bank or savings and loan association. However, interest on bank and savings and loan deposits is currently taxable whereas interest credited on annuity deposits is tax deferred.

In general, interest credited on annuity deposits is not taxable to the policyholder until such time as the funds are withdrawn. A partial withdrawal prior to the annuity starting date does not result in taxable income until the total amounts withdrawn exceed the amounts deposited. In many instances, the policyholder will annually withdraw the interest credits. *sec. 72*

The new annuity plans currently being sold have some or all of the following characteristics:

- The annual interest rate credited to annuity deposits is between 7 and 8 percent. Some life insurance companies guarantee the interest rate for a number of years, while others make it dependent on future investment earnings.
- There is usually no (or a nominal) front-end load charge. In other words, the initial cash surrender value of the annuity is equal to the initial deposit (premium).
- There are no (or nominal) interest forfeitures or charges for withdrawals.
- There are very limited, if any, restrictions on partial withdrawals.
- The policyholder, at his option, may use the cash surrender value (premium deposits plus interest credits) to purchase a lifetime annuity. The life insurance company guarantees the premium rate it will charge for such lifetime annuity.

Whether or not interest credits on an annuity qualify for tax deferral may depend on how the life insurance company treats them on its own federal income tax return. Sec. 801(b) defines the term "life insurance reserves." In general, interest credited by a life insurance company on life insurance reserves is not currently taxable to the policyholder [regs. sec. 1.72-2(a)(1)]. However, interest credited by a life insurance company on reserves that do not qualify as life insurance reserves usually is currently taxable to the policyholder. Examples of non-life-insurance reserves where the interest is currently taxable to the policyholder would include (1) interest on advance premiums, (2) interest on dividend accumulations, and (3) interest on supplementary contracts without life contingencies (i.e., a settlement option where a policyholder elects to receive payments without regard to life expectancy).

Even during the accumulation period and prior to the annuity starting date, it is common for both the IRS and life insurance companies to treat reserves held under annuity policies as life insurance reserves if the annuity contract permasec. 72 nently guarantees the premium rate charged for a lifetime annuity.

One final note. It is our understanding that very few, if any, life insurance companies have private rulings from the IRS that indicate that the interest credits on the newer annuity contracts are tax deferred. In fact, we are aware of at least one instance where the IRS refused to issue such a private ruling. Nevertheless, it would appear that interest credits on the newer annuity products are tax deferred if the annuity contract contains permanent guarantees as to the premium rate charged for lifetime annuities.

Editors' note: See Rev. Rul. 80-274, in which the IRS holds that annual interest on savings and loan association certificates is taxable to the policyholder, not to the life insurance company, where the certificates are held as annuity investments.

Interest on annuity deposits: what's an annuity?

In general, interest credited on annuity deposits is not taxable to the policyholder until such time as the funds are withdrawn. Partial withdrawal prior to the annuity starting date does not result in taxable income until the total amounts withdrawn exceed the amounts deposited.

Even though a contract may be labeled an annuity, the interest on annuity deposits will not be tax-deferred unless the contract does in fact constitute an annuity. Sec. 72 and the regulations do not define an annuity. However, the term "annuity" appears in a number of code sections relating to taxation of life insurance companies. For example, sec. 809(c)(1) provides that premium income of a life insurance company includes deposits on annuity contracts. In Rev. Rul. 77-286 and IRS Letter Ruling 7727001, the IRS clarified its position as to what constitutes an annuity contract for purposes of life insurance companies. The published and letter rulings provided that a contract does not constitute an annuity contract unless it contains permanent annuity purchase rate guarantees.

In many instances, a life insurance company will pay less federal income tax if its contracts do not contain permanent annuity purchase rate guarantees. Accordingly, there has been a tendency for some life insurance companies to eliminate these guarantees.

It would appear that if a contract does not constitute an annuity contract to the life insurance company for federal income tax purposes, it does not qualify as an annuity contract to the contract holder under sec. 72. This would not seem to be an important consideration if the contract holder is a tax-exempt organization, a qualified pension or profit-sharing plan, or an IRA. However, if the contract holder is an individual investor and not part of a qualified plan, the absence of permanent annuity purchase rate guarantees could subject interest accumulations to current taxation. *sec. 72*

New 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.

Salary deduction for dividends paid on restricted property

sec. 83

The tax treatment of property that is transferred, in connection with the performance of services, subject to restrictions that can lapse is covered by sec. 83. The general rule, consec. 83 tained in sec. 83(a), is that the employee or independent contractor receiving the restricted property (i.e., property subject to a substantial risk of forfeiture) may delay the reporting of income until the restrictions lapse. In the alternative, he may elect under sec. 83(b) to report any income element, measured at that time, upon receipt. Usually, the election is not made, so that sec. 83(a) applies.

Under regs. sec. 1.83-1(a), when sec. 83(a) applies to a transfer of restricted property, the transfer is not considered complete. The transferor, or employer, is regarded as the owner of the property until the time when the transfer does become complete. The regulations expressly state, however, that any income from the restricted property constitutes additional compensation to the employee or independent contractor, and regs. sec. 1.83-6(a) states that the employer is allowed a deduction for such compensation paid.

In the rather common situation where stock of an employer is the restricted property, the payment of dividends on the restricted shares held by the employee constitutes compensation rather than dividends. This has the following three practical consequences:

- A deduction is available to the corporate employer;
- The "dividends" constitute wages subject to withholding, etc.; and
- The "dividends" are not eligible for the $100 dividend exclusion under sec. 116.

Special efforts must be made to coordinate the tax consequences of the amount paid on the restricted shares, particularly when the dividends are paid by an independent transfer agent.

Nonqualified fluctuating market stock options vs. qualified options

The Tax Reform Act of 1976 eliminated qualified stock options and the long-term capital gain benefits that they could provide on appreciation in the options stock occurring after the grant date. A new type of nonqualified option may now give the same economic benefits to both the employer and the employee. In this type of option, the exercise price declines in an amount equal to the appreciation in the value of the stock from the date of grant.

Example. An employee is granted a nonqualified fluctuating market stock option to buy 10,000 shares at $25 per share (the market value).

One year later, when the stock has increased in value to $30, he exercises the option and pays $20 per share. (The option price has gone down $5 per share, since the stock price has increased by $5 per share.) The tax consequences of the fluctuating market option compared with the qualified option (exercised at $25 per share) are as follows:

	Fluctuating market	Qualified stock option
Effect on employee:		
Cost to exercise	$200,000	$250,000
Tax on excess of fair market value over cost ($100,000 ordinary income taxed at 50% rate)	50,000	—
Cost to employee	250,000	250,000
Basis to employee	$300,000	$250,000
Effect on corporation:		
Proceeds from exercise	$200,000	$250,000
Benefit from tax deduction ($100,000 at 50% tax rate)	50,000	—
Cash to employer	$250,000	$250,000

Note that the tax effects are similar under both types of plans. The $50,000 saved by the employee as a result of the lowered option price is lost in the payment of $50,000 of income tax. Similarly, the smaller proceeds ($200,000) received by the corporation are augmented by the additional $50,000 of tax savings. The employee, however, has a higher basis for the stock than would be the case under a qualified stock option (see sec. 83(a)) and no tax preference amount equal to the bargain element (see sec. 57(a)(6)).

Whether this type of plan should be offered depends on the circumstances in each case. It does, however, provide a possible alternative to those corporations that previously used qualified stock options.

An unanswered question about this kind of option is whether or not each fluctuation in value will be considered a modification and, as such, a new option, requiring that the differential be included in income under sec. 83.

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 *sec. 83* 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. *sec. 83*

The sec. 57(a)(6) preference item from the exercise ot 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 non-lapse 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 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 ıesignation 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.

sec. 83 274(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 judicially resolved, however, it would be prudent to withhold if it is feasible to do so.

sec. 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.

Industrial development bonds: includible capital expenditures

sec. 103

Interest received by holders of industrial development bonds is taxable unless the bond issue meets one of the statutory exceptions, such as the exemption for a $10 million small issue described in sec. 103(b)(6)(D). This exception exempts the interest income from taxation so long as the issuer, *inter alia*, limits its capital expenditures to $10 million "during the six-year period beginning three years before the date of such issue and ending three years after such date. . . ." Furthermore, the *source* of the capital expenditures *is not limited* to the proceeds of the industrial development bond issue.

What are capital expenditures? Do they reach beyond the tangible brick and mortar items to expenditures normally deducted by tax conscious borrowers? Yes, they do. Under regs. sec. 1.103-10(b)(2)(ii)(e), they include *any* expenditures, which for tax accounting purposes may be capitalized, even if the taxpayer properly deducts them. The following are examples of elective expenditures required to be included for the $10 million small-issue exemption.

Section		Description
Code	Regs.	
169(b)	1.169-4	Pollution control facility
174(a)	1.174-3	Research and experimental
174(a), (b)	1.174-3, 4	Computer software
175	1.175-1, 6	Soil and water conservation
177	1.177-1	Trademarks and trade names
248	1.248	Organization costs
263(c)	1.263(c)-1 and 1.612-4	Intangible drilling
266	1.266-1(c), (b)(1)(ii)(c)	Construction period interest, real estate and sales taxes
617(a)(1)	1.617-1, 2	Mining exploration

In addition, in applying this limit, certain capital expenditures financed other than out of the proceeds of the bond issue are counted toward the allowable amount. Such capital expenditures are those that are made during a six-year period, beginning three years before the date of issue and ending three years after such date. The unwary taxpayer may overlook some "hidden" expenditures that must be counted against the $10 million amount.

For example, when considering the feasibility of financing the construction of rental property, the developer must consider the plans of its major tenants. The IRS has unofficially taken the position that a tenant leasing over 5 percent of the leasable space of the facility will be treated as a principal user of the facility. The capital expenditures of principal users of a facility must be counted against the overall $10 million limit if the facility is constructed with the proceeds of industrial development bonds [regs. sec. 1.103-10(b)(2)].

The includible expenditures for leasehold improvements, furniture, and equipment can be minimized either by leasing equipment or by using equipment that was purchased more than three years before the issuance of the bonds. Inventory and initial working capital should be excluded from the limitation since they are not of a capital nature. Capitalization of items, expensed by a taxpayer and required by the IRS upon examination of a return, also count against the $10 million limitation.

Where the same principal users have facilities in more than one location within the boundaries of an incorporated municipality, or within the same county but not in any incorporated municipality, the expenditures made at each such facility during the six-year period are included against the overall limitation [sec. 103(b)(6)(E)]. Special rules apply to adjacent or unitary facilities that are on both sides of a municipal or county boundary. This aggregation must also occur when the other facility is owned by a person related to the principal user under secs. 267 or 707(b).

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-

sec. 103

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 recently issued 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 *sec. 103* 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.

sec. 105

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

Beginning in 1980, highly compensated individuals will be taxed on medical-expense reimbursements paid under a discriminatory "self-insured" plan. (See sec. 105(h), which was added by the '78 act, and which is effective for taxable years beginning after December 31, 1979.)

Does the December 31, 1979, effective date apply to the plan year or the participant's year? An employer may have a discriminatory 1979-80 fiscal year plan for reimbursement of a calendar year employee's medical expenses. Must the employee include in his 1980 gross income reimbursements for the entire plan year ending in 1980, including any 1979 payments? This would be avoided under the Technical Corrections Act of 1980 (sec. 103(a)(13)(D)), which clarifies the effective date of sec. 105(h): Taxation would be limited to payments received in 1980, and any amount reimbursed before January 1, 1980, would not be taken into account. This is also the position taken in prop. regs. sec. 1.105-7(j), published on February 28, 1980.

One thing is clear—employers must now look for alternatives to self-insured discriminatory medical reimbursement plans, since sec. 105(h) applies only to self-insured plans. 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 issued 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—

sec. 105

- 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.

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 *sec. 105* 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 could 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

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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 employees' financial security in the event of disability.

Avoiding recognition of income on debt cancellation

sec. 108

Whenever a taxpayer has an obligation cancelled, reduced, or discharged in any manner, there is a possibility of income recognition under sec. 61(a)(12). Although case law has carved out a number of exceptions to this general rule, there always exists the possibility of challenge by the IRS. In order to avoid this confrontation and still achieve the desired result of nonrecognition of income, qualified taxpayers should consider the elective provisions of secs. 108 and 1017. The following example may be used to illustrate the practical advantages of the election:

> Corporation *A* purchases 100 percent of the stock of corporation *B* for $1,000,000, evidenced by a note. Subsequent to the sale, *A* learns of several contingent obligations of *B* that were not disclosed prior to purchase. *A* renegotiates with the seller of *B*'s stock, who eventually agrees to reduce *A*'s note by $200,000. Assume further that if none of the contingent liabilities materialize, the fair market value of the assets involved will remain at $1,000,000.

Corporation *A* could contend that its situation does not give rise to income recognition under sec. 61(a)(12) because it is a compromise of a disputed obligation, which was held to be outside the general rule in *Sobel, Inc.* In *Sobel* the taxpayer was persuaded to sign a note for the purchase of bank stock sec. 108 that eventually proved worthless. He then instituted a rescission action, which was settled out of court when he agreed to pay only one-half of the note. Because a bona fide dispute existed in regard to the validity of the note, the court held that the amount of obligation from which the taxpayer was released did not result in income.

Corporation *A* could also contend that there should be no income recognized because of the so-called purchase-price-adjustment doctrine. Under this doctrine, if a debtor reduces the purchase price of assets through negotiations with the creditor, there will be no gain recognized, but merely a corresponding reduction in the basis of the assets in question. See *Kalman Hirsch*. There, the taxpayer was successful in reducing an outstanding mortgage from $15,000 to $8,000 at a time when the underlying building's fair market value was only $8,000. The court invoked the "substance over form" doctrine, stating that taxable income is not created if "nothing of exchangeable value comes to or is received by the taxpayer."

The problem with either of these positions is the possibility of challenge from the IRS. Just as there are exceptions to the general rule that discharge of indebtedness results in taxable income, there are limitations to the exceptions. Of particular importance in this regard is the market-value test, which nullifies any exception if the fair market value of the property equals or exceeds the amount of the obligation before reduction (*Coddon & Bros., Inc.*). Thus, the service might contend that the undisclosed potential liabilities were so contingent that they had no effect on the fair market value of the assets sold. This being the case, the reduction in liabilities from $1,000,000 to $800,000 at a time when the assets were worth $1,000,000 would result in $200,000 of gain recognition to *A* in the year of debt reduction (see *J.E. Montgomery*).

Corporation *A* can easily avoid any potential conflict with the service if it elects to use secs. 108 and 1017. These provisions would require *A* to realize gain of $200,000 in the year of cancellation. None of this gain is recognized, however, because sec. 1017 provides for the reduction in basis of assets in a specified order to the extent of the income realized. Basically, the first assets reduced are those that gave rise to the obligation (other than inventory or trade receivables). Next to be reduced is the property against which the obligation was a lien (other than inventory or receivables), then other assets (other than inventory and receivables), and finally inventory and receivables. These adjustments are considered to be made on the first day of the taxable year, unless the taxpayer did not own the property on the first day, in which case it begins on the day ownership began [regs. sec. 1.1017-1(b)(4)].

The advantages of an election under secs. 108 and 1017 are readily apparent when compared to the nonrecognition-of-income position. Under the nonrecognition position, the taxpayer reduces the basis of assets of his own choosing and then hopes that his action goes unchallenged. Should his position be successfully contested, the taxpayer will suffer immediate recognition of income to the extent of cancelled debt. Alternatively, the taxpayer could have avoided the possibility of income recognition by simply making the election. Although he does lose the flexibility of determining which assets are adjusted downward in basis, in many cases there would be little or no variation between the method prescribed in regs. sec. 1.1017-1 and a method of the taxpayer's choosing. Finally, in addition to the reduced risks afforded by the election, a taxpayer electing secs. 108 and 1017 is not subject thereby to any type of ordinary income recapture upon disposition of the assets; thus there is the possibility of converting ordinary income into capital gain. An election under secs. 108 and 1017, therefore, has the advantage of nonrecognition of income without the risk of IRS challenge.

Congress is also cognizant of the advantages available to eligible taxpayers who elect the provisions of secs. 108 and 1017. In 1979, Congress attempted without success to pass H.R. 5043 as a companion bill to the Bankruptcy Reform Act, which became effective on October 1, 1979. If passed, H.R. 5043 would have severely curtailed the present tax advantages available to electing taxpayers. Under this bill, income from the discharge of indebtedness would first be used to reduce net operating losses and carryovers, then investment and income tax credits and carryovers, and then capital losses and carryovers. Any cancellation of indebtedness income remaining after these reductions would be used to decrease the basis of specified assets. Because it is uncertain what will be included in future legislation, a taxpayer should make the secs. 108 and 1017 elections as soon as the cancellation-of-indebtedness issue arises.

Editors' note: H.R. 5043 has been passed by the House and is presently being considered by the Senate Finance Committee.

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Gain from repayment of foreign currency loan—does sec. 108 apply?

When a gain is realized upon repayment of a loan in a devalued foreign currency, the question arises as to whether it qualifies as "income from discharge of indebtedness" within the meaning of sec. 61(a)(12). If the income is so characterized, a taxpayer may elect, under sec. 108, to defer taxation of the gain by reducing the tax bases of its business properties by a corresponding sum, in the manner prescribed by the regulations under sec. 1017. In Rev. Rul. 78-281, the IRS recently avoided the opportunity to specifically deal with this question. The facts of the ruling, somewhat simplified, are as follows:

> *X*, a U.S. corporation, is engaged in the equipment rental business in foreign country *F*. On January 10, 1974, *X* borrowed 1,000 units of *F* currency from a bank in country *F* to purchase a machine for rental abroad. The loan was repayable in five annual installments of 200 units each.
>
> On the loan date, the value of one *F* unit and one U.S. dollar were equal. On January 16, after delivery of the machine to a lessee, *F* devalued its currency by 10 percent. Thus, one *F* unit was worth only 90 percent in U.S. currency.

The IRS ruled as follows:

- *X*'s tax basis for the machine is U.S. $1,000—i.e., the U.S. dollar equivalent of the cost of the machine in *F*'s currency on the date of purchase (January 10).
- The $1,000 tax basis will not be affected by the January 16 or any subsequent fluctuation in the value of the *F* currency.
- *X* will realize "ordinary gain or loss" on installment payments of the bank loan equal to the difference, if any, between its original U.S. dollar value and the U.S. dollar value of the *F* currency used to make such payments.

In other words, if the value of the *F* currency remains at 90 percent of the U.S. dollar for five years, *X* will realize "ordinary income" of $20 (10 percent of $200) on each installment payment, or a total of $100. Note that the IRS broadly characterizes the gain as "ordinary," but otherwise fails to specify its character. Thus, the ruling avoids the question as to whether the gain qualifies as income from discharge of indebtedness for sec. 108 purposes.

There is ample support for applying sec. 108 to the facts in the ruling. The regulations under sec. 61(a)(12) provide that a taxpayer may realize income from discharge of indebtedness

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"by the payment or purchase of his obligations at less than their face value" [regs. sec. 1.61-12(a)]. This rule has been applied in at least two cases not cited in Rev. Rul. 78-281 to characterize a gain realized on repayment of a debt in devalued foreign currency as "income from the discharge of indebtedness" under sec. 61(a)(12). In *Kentucky and Indiana R.R. Co.*, the taxpayer purchased its pound sterling bonds in the open market and retired them, realizing a gain of $105,000. Of such gain, $85,000 was due to the devaluation of the pound sterling between the date of the issuance of the bonds and the date of their retirement; $20,000 was simply due to the repurchase of the bonds below their face value. The taxpayer contended that the entire gain was excludible pursuant to the election it had made under sec. 108 (actually, its 1939 code predecessor). The IRS asserted that sec. 108 applied to only $20,000 of the gain and that the remaining $85,000 did not qualify because it was derived from "speculation in foreign exchange."

The sixth circuit upheld the taxpayer's position on the ground that taxing any part of the $105,000 gain would defeat the underlying purpose of sec. 108 to offer relief to the taxpayer. The court stated, "Neither the language of the statute nor its legislative history indicate a Congressional intent to exclude from the benefits of the statute any of the income attributable to the discharge of taxpayer's indebtedness, for any reason whatsoever."

Similarly, in *John A. Gillin;* the Court of Claims held that the taxpayer realized income from the discharge of indebtedness when he repaid his Canadian dollar obligation at an exchange profit. In finding that the gain was "income from the discharge of indebtedness," the court analogized the transaction to the issuance of a bond and its subsequent repurchase for less than face value. The applicability of sec. 108 was not an issue in *Gillin*; but, as already indicated, it follows that if sec. 61(a)(12) applies to tax a gain, sec. 108 can be invoked to defer the taxation of such gain.

In Rev. Rul. 78-281, the IRS was clearly not focusing on what type of ordinary income was involved. The IRS may attempt to further refine its definition of the character of the income on repayment of the debt at a later time. Nevertheless, it would appear that the rationale of the *Kentucky* and *Gillin* cases is not vitiated by the revenue ruling. Insofar as the ruling held that no adjustment should be made to the tax basis of the machine because of foreign exchange fluctuations, *sec. 108* it is doubtful whether the IRS was addressing the sec. 108 question. Rather, presumably, the IRS was merely restating the well-settled rule that the purchase and the loan transactions ordinarily constitute separate and independent transactions for tax purposes. It is submitted that the ruling does not prevent a taxpayer in *X*'s position from deferring recognition of income on the repayment of a foreign debt by using the property basis adjustment of secs. 108 and 1017.

sec. 111 Unusual, if limited, opportunity from excess state income tax payments

Last year, the IRS issued Rev. Rul. 79-15, which 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 services 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 without 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

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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

Sec. 117: private educational foundation

sec. 117

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 sec. 117 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.

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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 percentage 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.

Reasonable compensation and dividend policy

sec. 162

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 recently 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.*, sec. 162 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

Recently, 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 that 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 aftertax 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 *sec. 162* 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,

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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.

"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 sec. 162 *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 *(Madison Gas & Electric Co.)*

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

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

sec. 162

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 sec. 162 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.

sec. 162

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.

sec. 162 *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."*

sec. 163 Investment interest—the five-year lease election

The '76 act amended sec. 163(d) by generally decreasing the annual limitation on the amount of deductible interest on investment indebtedness from $25,000 to $10,000 (plus the amount of the net investment income). This increases the importance of a little-known but beneficial election available to certain taxpayers, and the importance of the obscure regulations providing the procedure for making such election.

Sec. 163(d) was added to the code by the '69 act and was applicable for years beginning after December 31, 1971. For 1970 and 1971, the excess investment interest was one of the tax preference items listed in sec. 57.

Investment interest is interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment. Property subject to a lease is treated as property held for investment, and not as property used in a trade or business for a taxable year, if either the 15 percent test or the guarantee test contained in sec. 163(d)(4)(A) cannot be passed. The 15 percent test provides that for a specific property, the sum of deductions allowable solely by sec. 162 must equal or exceed 15 percent of rental income from such property in order for the property to escape the "investment taint."

Although the '76 act has changed the deduction limitation amount, the same sec. 163(d) rules still apply in determining the treatment of certain property as investment property.

One of these rules is the five-year election. Sec. 163(d)(6)(B) provides that if a taxpayer has used real property for more than five years, such property may at the election of the taxpayer be excluded from the 15 percent test. The election is to be made in such manner as prescribed by regulations; however, such regulations were never proposed or adopted under sec. 163.

A similar election is allowed for years prior to 1972 by sec. 57(c)(3). Temporary regs. sec. 12.8 was issued April 11, 1973, and was positioned in the regulations where one would expect to find regulations under sec. 57. This temporary regulation contains the procedure for making the annual election for purposes of secs. 57(c)(3) and 163(d)(6)(B).

Where a taxpayer owns rental property and the net investment income and other offsets allowed by sec. 163(d)(1) do not exceed the interest expense on such property, and the 15 percent test is not satisfied, the five-year rule will prevent limiting the deduction of the interest on that property, assuming the taxpayer-lessor is not guaranteed a specific return or is not guaranteed, in whole or in part, against loss of income.

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 *sec. 163* 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].

sec. 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 home owner 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 home owner 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 home owner, or by purchasing all materials and supplies in the contractor's name, with the contractor turning over all bills to the home owner 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 home owner 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 home owner with a contract that separately states the amount of sales tax paid, the home owner 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 *sec. 164* 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.

sec. 165 Indirect taxation of life insurance proceeds

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

sec. 165

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 recently 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 sec. 165 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. *sec. 165*

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*

sec. 165

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.*

Disaster losses under sec. 165(h) amending subchapter S returns

Sec. 165(h) provides that any loss attributable to a disaster occurring in an area subsequently determined by the President to warrant assistance by the federal government under the Disaster Relief Act of 1974 may, at the election of the taxpayer, be deducted for the tax year immediately preceding the taxable year in which the disaster occurred. The purpose of this provision is to provide immediate tax relief for those who have suffered as a result of a major disaster.

In the case of an individual taxpayer, the amendment of the prior year's return to account for a disaster loss will generally mean an immediate refund of taxes paid for the prior year, as well as a decrease or elimination of estimated tax payments scheduled for the remainder of the current year, assuming the current year's estimates are based on 100 percent of the prior year's tax. In the case of a corporation, other than a subchapter S corporation, the result is much the same—a portion of the prior year's taxes will be refunded, and the current year's estimates may be revised to lower amounts.

What, however, is the result if a subchapter S corporation suffers a disaster loss and its shareholders attempt to avail themselves of sec. 165(h) relief by amending the prior year's return? A shareholder might assume that an amendment of the prior year's subchapter S return would provide a benefit in the form of lower tax liability because his share of subchapter S earnings would be reduced as a result of the amendment. However, this assumption may be in error. For example, assume the following situation:

> A subchapter S corporation with undistributed taxable income for the year ended April 30, 1977, of $80,000 has no previously taxed income and $125,000 of accumulated earnings and profits. On July 10, 1977,

> all of the April 30, 1977, earnings ($80,000) are distributed in cash to its shareholders. The corporation suffers a $75,000 disaster loss in August 1977. Assume further that the corporation will have earnings for the year ending April 30, 1978, of $40,000, not including the disaster loss. Further, the shareholders decide to amend the fiscal 1977 subchapter S return for the loss pursuant to sec. 165(h), assuming that the result will be a reduced tax liability on their individual returns for 1977. However, that is not the case.

A distribution of cash made during the first 2½ months of the current taxable year is considered to be a distribution of the undistributed taxable income of the immediately preceding year to the extent thereof [sec. 1375(f)]. If there is only one distribution and it exceeds that undistributed taxable income of the immediately preceding year, the remainder of the distribution is considered to have come from current earnings and profits to the extent thereof. Once current earnings and profits are exhausted, previously taxed income is the source of distribution. After previously taxed income, accumulated earnings and profits are the designated source. If actual cash distributions exceed all the previously mentioned sources, then the remaining unclassified portion of the distribution is classified as a return of capital.

What, then, would be the reduction of the shareholders' taxable income in 1977 if they amend the fiscal 1977 subchapter S return? Answer: none. The amendment of the fiscal 1977 return for the $75,000 loss would reduce subchapter S income for that period to $5,000. If no cash distribution had been made, this amendment would have accomplished the shareholders' objective of a lower taxable income on their 1977 returns. However, since the original $80,000 in income has been distributed to the shareholders, the subchapter S rules for sources of distributions will change the source of this distribution from $80,000 of undistributed taxable income to the following: $5,000 undistributed taxable income, $40,000 current earnings and profits, no previously taxed income (none available), and $35,000 from accumulated earnings and profits. This reshuffling provides no tax benefit to the shareholders since distributions from all of these sources are considered taxable distributions. The shareholders would only get a tax benefit when the distribution exceeds accumulated earnings and profits and can be classified as a return of capital.

Sec. 165(h), then, may work well to provide relief for individuals and regular corporations, but not always for subchapter S shareholders.

sec. 165 Participant's ordinary loss on plan termination or withdrawal of voluntary contributions

An ordinary loss was approved on a recent 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.

IRS strikes commodity straddles—strips tax benefits

The IRS, in Rev. Rul. 77-185, has ruled that a taxpayer who entered into the simultaneous purchase and sale of silver futures transactions was not entitled to—

- The short-term capital loss on the closing of one leg of the straddle, and
- A deduction for the related out-of-pocket expenses incurred in connection with creating the loss.

sec. 165

The ruling describes a situation in which a taxpayer with a short-term capital gain from an unrelated real estate transaction entered into a silver futures contract straddle, established a short-term loss of $128 after only a few days, immediately reestablished the straddle, and ultimately liquidated the position with the realization of a net long-term gain of $119 in the next year. The net tax effect would have been to roll over income (short-term gain) from the early year into the next year and to convert it into long-term gain.

The rationale of the IRS position is that a loss, to be allowable as a deduction, (1) must be evidenced by a closed and completed transaction, fixed by identifiable events, and actually sustained during the taxable year, and (2) must be bona fide and the taxpayer must have a reasonable expectation of deriving an economic profit from the transaction.

The IRS position on the first issue is questionable. Sec. 1233(e)(2)(B) says that, for short-sale purposes, commodity futures contracts with different delivery months are not substantially identical. While that rule is not specifically related to sec. 165, applicable in the ruling, it is very persuasive, and it is believed the government will be hard-pressed to sustain its position in court.

The second issue is more substantial, i.e., whether the taxpayer had a reasonable expectancy of deriving an economic profit. Has the IRS the right to apply this standard in a normal commercial transaction? Commodity straddling is a long-standing economic practice with a proved economic basis, and this should be pointed out in court if the matter is litigated. The potential for gain or loss on transactions comprising a straddle, regardless of offsetting gain or loss from other events, is always present. This fact is demonstrated in the ruling itself. In any event, the profit motive test is a factual one to be applied on a case-by-case basis, both as to past and future transactions.

The IRS should also explain why it is attempting to retroactively change a long-standing and well-known tax practice. If the service wants to reopen the issue, it should do so only prospectively and preferably by legislation. In fact, Congress had the opportunity to consider this matter when it enacted the '76 act. Not only did Congress not make a change, but it retained the "more than six month" holding period *sec. 165* required for long-term capital gain for any commodity futures transaction subject to the rules of a board of trade or commodity exchange. (See sec. 1222, last sentence.)

Rev. Rul. 77-185 is certain to be the focus of litigation, and it is by no means clear that the IRS should or will prevail. Nevertheless, taxpayers who have entered into transactions similar to those in the ruling should anticipate that their tax treatment of such transactions in open years will be challenged on audit and that resolution of this issue is unlikely until the courts have an opportunity to make a final determination.

The background of this ruling is also quite interesting. It resulted from a request for technical advice, and the national office, in its original decision, held for the taxpayer. It was only after reconsideration that the IRS changed its position to the one approximating Rev. Rul. 77-185. Most of the arguments that a taxpayer can make are fully discussed in the original Treasury position and are quite persuasive. If the matter is eventually litigated, it should be interesting to hear the Treasury's attempt to rebut, point by point and issue by issue, its original position, well-reasoned and supported as it is by the applicable code sections, regulations, case law, and rulings.

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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
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 deducti-

ble 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. *Note that the first taxable year ended after March 11, 1979, includes the year ended March 31, 1979.* *sec. 166*

***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.

sec. 166 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.

Flexible tax planning available for bad debt charge-off

With respect to specific business debts, sec. 166(a)(2) allows a taxpayer to deduct a partially worthless obligation for the year during which it is "charged off" on the books and records of the taxpayer. The only requirement is that the taxpayer establish that the portion of the debt written off is clearly worthless as of the end of the taxable year of write-off. It doesn't matter whether the portion of the debt being written off actually became worthless in the current or in a prior taxable year.

This provision allows a taxpayer the opportunity of claiming a deduction for a partially worthless debt when it will provide the greatest tax benefit. This is important where there are expiring NOLs or investment credit carryovers, or where a change in tax brackets in future years is anticipated.

A critical question involved in this situation is what constitutes a "charge-off" of a debt. More specifically, a question might arise whether the creation of a bad debt reserve is a "charge-off" that would fix the year of the deduction.

The courts have addressed themselves to this problem in *Capital National Bank of Sacramento, Commercial Bank of Dawson,* and *International Proprietaries, Inc.* In each of these cases, the taxpayer claimed a partial bad-debt deduction that was disallowed on the ground that the taxpayer, by creating a reserve against certain loans or accounts receivable, had not effected a proper charge-off permitting the deduction of a partial bad debt. In *Capital National Bank,* the court said that all that was done by the taxpayer was to set up a valuation reserve for depreciation of bonds, and the amount at which the asset was carried was not affected by the establishment of such a reserve. Therefore, no specific charge-off of any part of the bonds was made in that year. But compare *O.S. Stapley Co., Inc.,* and *Brandtjen & Kluge, Inc.*

The IRS has acquiesced in the *Capital National Bank* decision, and, therefore, it appears that the mere creation of a reserve or allowance for noncollectibility of a debt by a taxpayer (not authorized to use the reserve method for tax purposes) does not constitute a charge-off of the debt. *sec. 166*

This would imply that a taxpayer may be able to create an allowance against a worthless receivable in the year in which it becomes worthless for financial purposes, but "charge it off" in a subsequent year for tax purposes to obtain the maximum flexibility and usefulness of the deduction.

Amortization of CATV intangibles **sec. 167**

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 to have 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

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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.

sec. 167 Depreciation of realty after the '76 act—to accelerate or not to accelerate

In light of the '76 act, all individual taxpayers (including partnerships with individuals as partners and fiduciaries) must reconsider the tax consequences of electing or continuing accelerated depreciation of real property. This decision, as will be seen, requires a crystal ball. The major '76 act changes that have contributed to the complexities of this matter are as follows:

- The depreciation recapture rules have been changed for residential property depending on whether the property qualifies as low-income property.
- The minimum tax has been increased to 15 percent of tax preferences with substantial reduction of the previous exclusions.
- There is now a dollar-for-dollar reduction in personal service income qualifying for the 50 percent maximum tax rate for all tax preferences.
- There is a phase-out of the old stepped-up basis for property acquired from a decedent dying after December 31, 1976, together with the resulting new carryover of the sec. 1250 "taint" problem.

Relevant factors. The following are some of the factors to consider in deciding whether or not to elect accelerated depreciation:

- The age and health of the taxpayer. A younger person with growing taxable income may not wish to accelerate depreciation now when his tax bracket is low and risk possible recapture at a much higher tax bracket in the future. (Note that even the capital gains, apart from the recapture, could greatly exceed the current bracket since the capital gain tax with related effect on maximum and minimum tax could reach 49.125 percent.)
- Projected tax brackets and tax preferences of the taxpayer and his heirs. Possibly, tainted property can be left to low-bracket beneficiaries.
- Estimated holding period and selling price of the property (and its components). If any property is held for a long enough period, ordinary income recapture can be minimized.
- Anticipated after-tax earnings on use of the tax dollars deferred. The ability of a taxpayer to invest funds at a high after-tax yield can significantly affect the decision to

claim accelerated depreciation where the current tax savings is at less than the 70 percent bracket. *sec. 167*

- The proper weight to attribute to a potential tax-free exchange or possible refinancing as an alternative to a future sale.
- The possibility of future incorporation of the business with recapture occurring at lower corporate tax rates. The many other tax complexities of incorporating and owning real estate in corporate form must also be considered.

The above list is not exhaustive, but merely indicates the complexity of a decision based on the above tax considerations. Some taxpayers will decide to claim the additional depreciation simply because they need the money now and choose to ignore any recapture considerations.

The entire problem is even more complex if the property is owned in a limited partnership where the possibility of all the partners reaching agreement on the depreciation method is remote. This puts the general partner in a most difficult position. However, it would appear appropriate for the general partner to notify his investors of the problem so as to invite them to seek tax advice and to notify him of their preference.

Depreciation: segregating residential from commercial property in combined development

Under the Tax Reform Act of 1969, the use of certain accelerated depreciation methods is limited in the case of real property to new residential rental property. New commercial real property is limited to the 150 percent declining-balance method, while new residential real property may be depreciated by the use of either the 200 percent declining-balance or sum-of-the-years-digits methods. The purpose of this distinction is to provide tax incentives for residential housing.

For purposes of distinguishing between residential and commercial property, sec. 167(j)(2)(B) defines residential rental property as property from which at least 80 percent of gross rental income is derived from dwelling units. Therefore, if a taxpayer rents out a portion of a building for commercial use and the rental proceeds from this use exceed 20 percent of the gross rental proceeds from the entire building, the taxpayer will be denied some accelerated depreciation benefits.

Typically, this situation might occur where the lower floors of a building are used for stores or offices, and the upper floors for apartments. However, a question arises about how to apply this 80 percent test in the case where a development has been built that consists of more than one structure. If one of the structures is commercial, but on a combined basis all of the structures meet the 80 percent test, then it may be possible to provide the benefits of a residential classification to even the commercial structure. However, it may be that on a combined basis the rental proceeds would not meet the 80 percent test. In that case, the desirable treatment would be to at least provide the benefits of the residential classification to this structure rather than deny the benefits to all the structures.

In a recent situation, a taxpayer had constructed a 19-story apartment building with the lower two floors used for commercial offices. There was also a 2-story shopping mall joined to the lower floors by a corridor. Access between this mall and the 19-story tower was limited to tenants only. On a combined basis, the mall and the apartment building did not meet the 80 percent gross rental test to qualify as residential housing.

The taxpayer sought a ruling that would allow the option of treating the two structures as separate units. Regs. sec. 1.167(j)-3(b)(1)(ii) states:

> In any case where two or more buildings or structures on a single tract or parcel (or contiguous tracts or parcels) of land are operated as an integrated unit (as evidenced by their actual operation, management, financing, and accounting), they may be treated as a single building for purposes of this paragraph.

The language of the regulation does not say that the units operated as an integrated unit *must* be combined, but only that they *may* be. There was concern that the option to treat more than one structure as a single or separate structure was at the option of the government rather than the taxpayer.

In its response to the ruling request, the service held in favor of the taxpayer and agreed that the language of the regulations did not require the consolidation of the structures; rather, it was at the taxpayer's option.

This distinction between residential and commercial property with respect to the availability of depreciation methods continues to be important under the '76 act. The act adds another reason to distinguish between residential and commercial property in that construction period interest and real estate taxes on commercial property must be capitalized beginning in 1976. However, these expenses on residential property need not be capitalized until 1978. The act again uses the 80 percent test found in sec. 167(j)(2)(B) to define residential property. *sec. 167*

ADR depreciation: SYD and the first-year convention

The computation of depreciation on the Class Life (ADR) system for an asset using the sum-of-the-years-digits method (SYD) in the first and subsequent years can produce various results depending upon which first-year convention (i.e., the modified half-year or the half-year) is elected.

Regs. sec. 1.167(a)-11(c)(1)(iii)(f), examples (3) and (4), illustrate that regardless of the first-year convention elected, the numerator of the depreciation fraction for the second and all subsequent years shall be determined as if the taxpayer had been allowed one-half year's depreciation in the first year. Therefore, the second year's fraction would be set up to provide half of the first full year's depreciation and half of the second full year's depreciation.

This leads to some rather interesting conclusions, as follows (also see example below):

1. Where the modified half-year convention is elected and a full year's depreciation is taken in the first year, an asset with a five-year life is fully depreciated after four years. This yields a more rapid recapture of capital investment than depreciation of an asset under the usual "optimum" method of double-declining balance depreciation with a switch to SYD in the third year. Of course, there is a trade-off between higher depreciation deductions in the first year under the "optimum" method and a more rapid total depreciation with SYD.
2. Where the modified half-year convention is elected with no depreciation in the first year, it is more advantageous to switch to straight-line in the fourth year (of a five-year asset) than to continue with SYD.
3. If the modified half-year convention is elected with no depreciation in the first year and SYD is used throughout, there will be a remaining undepreciated basis with no remaining fraction to apply against the basis.

Example. ADR depreciation using SYD

Assumptions: An asset costing $1,000 with a five-year life.

Column 1: Modified half-year convention using SYD and a full year's depreciation in the first year.

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Column 2: Modified half-year convention using DDB with a switch to SYD (12-month depreciation in the first year).

Column 3: Modified half-year convention using SYD with no depreciation in the first year and a switch to straight-line at the optimum point.

Column 4: Modified half-year convention with no depreciation in the first year and using SYD.

Column 5: Half-year convention using SYD.

Year	Rate	Col. 1	Col. 2	Col. 3	Col. 4	Col. 5
1	5/15	$333				
1	.4		$400			
1	2.5/15					$167
2	4.5/15	300		$300	$300	300
2	.4		240			
3	3.5/15	233		233	233	233
3	3.5/8		158[1]			
4	2.5/15	134[2]			167	167
4	1/2.5			187[3]		
4	2.5/8		113			
5	1.5/15				100	100
5	1/2.5			187		
5	1.5/8		68			
6	.5/15				33	33
6	.5/2.5			93		
6	.5/8		21			
Total		$1,000	$1,000	$1,000	$833[4]	$1,000

[1] Switch to SYD

[2] Limited to remaining basis

[3] Switch to straight-line

[4] Undepreciated basis of $167

Taxpayers fail to use a new ADR benefit regarding "service assets"

The asset depreciation range (ADR) regulations [regs. sec. 1.167(a)-11] provide an elective method that enables a business to group a number of eligible assets into categories known as guideline classes and depreciate all the assets in each class over a prescribed period of time.

Three years ago, the service, in Rev. Proc. 74-31, adopted a special guideline class covering the depreciation of such "service assets" as silverware, china, glassware, and linen. Businesses in the lodging, restaurant, and health-care industries ordinarily have a substantial investment in this type of asset.

To illustrate the operation of ADR prior to Rev. Proc. 74-31, take the case of a typical restaurant. During the course of a year, it might purchase tables, chairs, refrigerators, silverware, and table linen. Under the old ADR rules, those

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assets were lumped together in one class and allowed a depreciation range of between eight and twelve years.

The problem with this approach was that linen, china, silverware, and glassware have a much shorter useful life—due to unusual wear and tear, theft, and breakage—than the minimum eight-year life that had been specified for the restaurant industry. Accordingly, as indicated, after considerable study, the IRS adopted Rev. Proc. 74-31, which provided a service asset guideline class for such assets with a range of between two and three years.

However, the service has recently suggested that because this guideline class has not been used sufficiently by the various industries grouped together in the guideline class, it is thinking of dropping it.

Taxpayers in the industries covered by that guideline class should compare the amount of their depreciation deductions without the use of ADR with the amount of depreciation deductions using ADR and the service asset guideline class. Any taxpayer who does choose to elect ADR and use the service asset guideline class might consider advising the national office of IRS of the election.

Editors' note: Rev. Proc. 74-31 has been superseded by Rev. Proc. 77-10, which continues to provide a two- to three-year range.

Simplified reporting requirements for ADR years

The IRS has recently 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. Further-sec. 167 more, 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-year 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.

Component depreciation for a used building: pros and cons

As early as 1959, the Tax Court held in *Herbert Shainberg* that the components of an entire building may be segregated for purposes of computing separate depreciation lives with *sec. 167* respect to new property. In Rev. Rul. 66-111, however, the service ruled that component depreciation may not be used by the purchasers of a used building because of the difficulty of allocating purchase price to the components. In the ruling, the taxpayer's basis in the building was apparently allocated in proportion to the relative construction cost of the components as determined by the original owner.

Harsh Investment Corp. upheld as a matter of law the use of component depreciation for a used building where the total cost of the building was broken down into its components by independent appraisers. In Rev. Rul. 73-410, finally conceding, the service held that component depreciation may be utilized with respect to used real property, provided—

- The cost of the acquisition is properly allocated to the various components based on their value as determined by qualified appraisers, and
- Useful lives are assigned to the component accounts based on the condition of such components at the time of acquisition.

Pros. Component depreciation affords investors in real estate an opportunity to maximize tax write-offs in the early years of operation. Larger depreciations will be allowed because the integral parts of a building (i.e., wiring, plumbing, roofing, heating, paving, ceiling, air conditioning, elevators) will have shorter useful lives than the building as a whole.

In addition to the use of shorter lives, component depreciation will permit the personal (sec. 1245) property components to be depreciated under an accelerated method. For example, after 1969 a used office building may be depreciated only under the straight-line method, while elevators in such buildings can be depreciated under the 150 percent declining-balance method. In addition, if such segregated sec. 1245 property is not subject to a net lease, the result could be a reduction in the amount subject to the minimum tax on tax preferences.

Cons. However, there is a negative side to component depreciation. The sec. 1245 property components are subject to more stringent recapture rules than real (sec. 1250) property is. Note also that while the useful lives of the personal property elements are shorter than the building's composite life, the building shell will generally have a useful life that is longer than the building's composite life. Moreover, the utilization of the component method of depreciation precludes the adoption of the ADR depreciation system with respect to such property.

Conclusion. The change in position by the service relative to component depreciation of used property will certainly result in revitalized interest in this method of depreciation. Tax professionals should be alert to the cons as well as the pros of this vehicle—its tax detriments as well as its tax benefits.

Depreciation: "excess" rehabilitation for low-income housing

Sec. 167(k) provides rapid depreciation (60 months, straight-line) for rehabilitation expenditures of qualified low-income housing. The limitation on the amount subject to the rapid rate is $20,000 per dwelling unit. The '78 act extended this provision from December 31, 1978, to December 31, 1981. In today's inflationary economy, this ceiling frequently is exceeded when an apartment building is completely rehabilitated. The obvious question is the treatment of the "excess" expenditures.

Accelerated methods of depreciation (DDB or SYD) of real estate only apply to new residential rental property. In order to use either of these methods, the "original use of" the property must commence "with the taxpayer" [sec. 167(j)(2)(A)(ii)]. Accordingly, it appears that if one elects to use rapid depreciation for rehabilitation expenses, any excess expenditures would not qualify as new property, since the original use of the property did not commence with the taxpayer. As used property, the maximum rate of depreciation available would be 125 percent declining balance, provided a useful life of at least 20 years is assigned to the asset [sec. 167(j)(5)(B)].

However, it was learned through the IRS national office that, by using the component method of depreciation, taxpayers can get the best of both worlds. Presumably, by componentizing assets during construction or reconstruction, taxpayers are deemed to be creating new separate assets and may treat them as such for tax purposes. This interpretation by the service, in an unpublished private ruling, is in line with the computation of excess depreciation for minimum tax purposes when component depreciation of a building is utilized.

The ability to use either DDB or SYD to depreciate any excess rehabilitation expenditures can be beneficial, since the only economic advantage in this type of venture is generally *sec. 167* the tax benefits. Obviously, by receiving the benefits sooner, taxpayers are getting a better return on their investment.

sec. 170

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 a recent private ruling (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.

Planning for corporate charitable contributions of inventory

The Tax Reform Act of 1969 amended sec. 170 to limit the deduction for charitable contributions of inventory to the taxpayer's cost or adjusted basis. This limitation was eased somewhat by the '76 act, which amended the limitations with respect to contributions of certain types of inventory for specified charitable uses to permit deductions of up to twice the basis of such inventory. (See sec. 170(e)(3).) In any event, charitable contributions are limited to 5 percent of taxable income for corporations. (See sec. 170(b)(2).)

sec. 170

Interestingly enough, the existing regulations under sec. 170 (pre-'76 act) provide different results depending on *when* the contributed inventory is acquired. Regs. sec. 1.170A-1(c)(4) provides that costs and expenses pertaining to the contributed inventory, incurred by the taxpayer in the year of contribution and normally reflected in cost of goods sold for the year, are to be treated as part of the cost of goods sold [examples (2) and (4)]. On the other hand, where the contributed property is included in inventory at the beginning of the year, such inventory is excluded from both beginning inventory and cost of goods sold [examples (1) and (3)]. The distinction becomes important because in the case of inventory *produced* (or acquired) during the year the basis of the property for purposes of sec. 170(a)(1) and regs. sec. 1.170-4(a)(1) is zero; whereas in the case of inventory on hand at the beginning of the year, the basis is cost.

The result, in effect, is that inventory produced during the year can be contributed *without regard* to the 5 percent limitation. Thus, corporations that otherwise might not obtain a benefit, because of the 5 percent limitation or the existence of a net operating loss, can obtain a current deduction (cost of goods sold) by contributing inventory produced or acquired during the taxable year.

Although, as explained above, the current regulations offer some planning opportunities, they may well pose a problem for corporations making a contribution of appreciated inventory eligible for the increased deduction under sec. 170(e)(3). Application of the regulations to contributions eligible for the increased deduction produces a result probably not intended by Congress. That is, appreciated inventory produced or acquired during the year would have a zero basis for purposes of sec. 170(e). In determining the deduction for such appreciated inventory, taxpayers are limited to one half of the profit that would have been realized, but in no event can such deduction exceed twice the cost or adjusted basis of the inventory; accordingly, inventory manufactured or acquired during the year is not eligible for the increased deduction.

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 contribu-

sec. 170 tion 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 ten 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.

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 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.

sec. 170

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 limitasec. 170 tion 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 recently 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 plant 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.

sec. 170 *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. The IRS has stated in its *Statement* *of Some Principles of Tax Administration*, Rev. Proc. 64-22— sec. 170

> The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax policy for raising revenues is determined by Congress.
>
> . . . At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Service charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision *and not to adopt a strained construction* in the belief that he is "protecting the revenue." [Emphasis added]

NOLs of individuals—relinquishment of carryback period after the '78 act

sec. 172

Sec. 172(b)(3)(C) allows a taxpayer entitled to carryback 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).

sec. 172 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.

NOLs: application of ten-year carryback rules to affiliated group

Sec. 172(b)(1)(F) provides that "[i]n the case of a financial institution to which Section 585, 586, or 593 applies, a net operating loss for any taxable year beginning after December 31, 1975, shall be a net operating loss carryback to each of the ten taxable years preceding the taxable year of such loss and shall be a net operating loss carryover to each of the five taxable years following the taxable year of such loss."

Regs. sec. 1.1502-21(a) and (b)(1) defines the "consolidated net operating loss deduction" as an amount equal to the aggregate of the consolidated NOL carryovers and carrybacks to the taxable year that consists of any consolidated NOLs of the group, plus any NOLs sustained by members of the group in separate return years that can be carried over or back to the taxable year, with the exception of amounts apportioned to a member because of certain special consolidated return rules.

The application of the new ten-year carryback rule to an affiliated group that includes one or more qualifying financial institution members creates a number of interesting problems.

Allocation rules for the loss year. Although there are no published rulings or regulations implementing sec. 172(b)(1)(F), the IRS will likely take the position that the ten-year carryback provision will only apply to the portion of a consolidated NOL for the year that is attributable to a qualifying financial institution member. This would be similar to the rules applicable to a trade expansion loss incurred by a member of the consolidated return group.

Sec. 172(b)(1)(A)(ii) generally provides for a five-year carryback for NOLs of a taxpayer for which a certification has been issued under section 317 of the Trade Expansion Act of 1962. Other than the ten-year carryback rules of sec. 172(b)(1)(F) and (G), this is the only provision allowing a carryback period in excess of the general three-year rule of sec. 172(b)(1)(A)(i). Regs. sec. 1.1502-21(b)(2)(ii) provides that "[i]n the case of a carryback of a consolidated net operating loss from a taxable year for which a member of the group has been issued a certification under section 317 of the Trade Expansion Act of 1962 and with respect to which the requirements of Section 172(b)(3)(A) have been met, Section 172(b)(1)(A)(ii) shall apply only to the portion of such consolidated net operating loss attributable to such member."

Allocation rules for the carryback year. The amount apportioned to a financial institution member of a consolidated return group will first be carried back to that member's tenth preceding year and, to the extent not utilized in its tenth through fourth preceding years, will be available as part of the consolidated NOL to be applied against the consolidated taxable income of the third preceding year of the group if a consolidated return was filed for such year. In each case where the tenth through fourth preceding year is a separate return year, then the apportioned loss may be applied against the separate return income for such year. But if the carryback year is a consolidated return year, a question arises whether the allocated loss may be applied to the entire consolidated taxable income for the carryback year or only the portion of the consolidated taxable income allocable to the financial institution member.

It is noted that there is no special allocation procedure for the taxable year in which the loss is applied in the case of the following:

- A carryback of a trade expansion loss of a member [regs. sec. 1.1502-21(b)(2)(ii)];
- A carryover of a NOL of a regulated transportation corporation attributable to a member [regs. sec. 1.1502-21(b)(2)(i)]; and

- A carryover of a foreign expropriation loss of a member [regs. sec. 1.1502-21(b)(2)(iii)]. *sec. 172*

By analogy to these rules, affected financial institutions probably should take the position that no special allocation is necessary for the ten-year carryback of a NOL in the carryback year.

Incorporation of proprietorship may preserve expiring NOL carryovers

It may be possible to extend a personal net operating loss (NOL) carryover past the seven-year limitation period by incorporating the proprietorship. Consider the following situation.

A, an individual, operated his business for a number of years as a proprietorship. During past years he incurred operating losses. A NOL carryover existed, a portion of which was scheduled to expire in the current year if not utilized. *A* expected his business to become profitable in the near future.

Under these circumstances, *A* incorporated the proprietorship, and the corporation paid him a salary for services and rent for the use of certain property. The salary and rent were absorbed by the NOL carryover in *A*'s individual return. Simultaneously, the rent and salary expenses increased the current-year operating loss of the corporation.

Accordingly, it can be seen that *A*'s expiring individual NOL carryover has been *transformed*, at least in part, into a corporate NOL carryover, and *A* has gained an extension of seven years. Of course, the amounts paid as compensation and rent must be able to meet the test of reasonableness.

Accounting methods: change for R&E costs

sec. 174

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 modified 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

sec. 174

> $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.

Changed IRS position on election to amortize R&E

The IRS announced in Rev. Rul. 76-324 that it will not permit taxpayers to amortize research and experimental expenditures (R&E) unless the taxpayer makes a formal written election to capitalize and defer such expenditures in his return for the year in which the project expenditures are incurred. The three tax methods of accounting for R&E are as follows:

- Deduct such expenditures in the year incurred.
- Capitalize such expenditures and amortize them over a period of not less than 60 months commencing with the month in which benefits are first realized from the expenditures.
- Permanently capitalize such expenses.

Formerly, Rev. Rul. 71-136 held that failure to make the formal amortization election required by regs. sec. 1.174-4(b)(1) was not fatal, since the taxpayer was considered to have made a de facto election by deducting in the year of capitalization one fifth of the amount expended for R&E. This lenient position resulted from the service's broad interpretation of *Kentucky Utilities Co.*, in which the taxpayer was denied the right to deduct payroll taxes on construction work in an amended return since it had previously capitalized such amounts as if it had so elected under the predecessor of sec. 266. Since the taxpayer had identified in its return the items being capitalized, it did provide sufficient information constituting a de facto election under the less stringent requirement of regs. sec. 1.266-1(c)(3), which governs capitalized payroll taxes paid or accrued during construction.

Upon reconsideration, the IRS has adopted a more narrow view of what constitutes a valid election to defer and amortize

R&E on the grounds, *inter alia,* that regs. sec. 1.174-4(b)(1) requires more formality than regs. sec. 1.266-1(c)(3). The mere capitalization of an item followed by an amortization deduction is not sufficient, in the IRS's view, to constitute a valid election to support the amortization deduction. Rev. Rul. 71-136 was revoked. *sec. 174*

Since the new interpretation is effective with respect to taxable years ending after August 29, 1976, it is essential for amortization deductions to be supported by timely filed elections, spelling out in detail all the information required by regs. sec. 1.174-4(b)(1).

Planning for realty-construction-period interest and taxes

sec. 189

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 acsec. 189 tually 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.

sec. 191 Tax benefits for certified historic structures

Sec. 191 of the code allows the owner of a qualified structure to amortize, over a 60-month period, expenditures for rehabilitation of the structure. Sec. 167(o) allows accelerated "first user" depreciation for substantially rehabilitated historic property, even though the owner initially acquired the structure as used property.

A literal reading of these two provisions suggests the possibility of sec. 191 amortization for the qualified rehabilitation expenditures (e.g., $500,000), and sec. 167(o) 150 percent declining-balance (accelerated) depreciation on the original used-building cost (e.g., $250,000), based upon the cross-reference in sec. 191(e) to sec. 167 depreciation. (This example relates to a structure located in a registered historic district, etc., purchased as a used building and rehabilitated into an office building for lease by the investor to various occupants.)

These provisions were added by a Senate amendment, and

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consequently, no discussion appears in the House Ways and Means Committee and Finance Committee reports. However, page 505 of the conference report explains that the Senate amendment allows taxpayers the amortization deduction election in lieu of claiming depreciation deductions "otherwise allowable." If "otherwise allowable" refers to the sec. 167(o) accelerated depreciation, then apparently election of the sec. 191 amortization on the $500,000 rehabilitation cost will prevent use of the accelerated depreciation on the original $250,000 cost of the structure; that is, straight-line depreciation is required.

Temporary regs. sec. 7.191-1(a)(1)(v) permits an amortization election before the structure has been certified, provided a request has been made to the Secretary of the Interior for certification. Temporary regs. sec. 7.0 provides for the sec. 167(o) election, makes no reference to any actual certification requirement, and presumably permits a sec. 167(o) election on the strength of a request for certification.

Although no specific mention is made in the Conference Report, apparently only the taxpayer incurring the rehabilitation expenditures is entitled to the amortization or first user accelerated depreciation election. An analogy to regs. sec. 1.167(c)-1(a)(4) and (5) suggests that a sec. 381, or consolidated-return-affiliate, transferee will be entitled to continue accelerated depreciation or amortization deductions elected by the transferor.

Notwithstanding the full "depreciation recapture" provision in sec. 1245(a)(3)(D), a certified historic structure should be an attractive investment for a "tax shelter partnership." No accelerated depreciation or amortization election will be available, of course, for a structure used by the investor for personal purposes. (See sec. 191(d)(1).)

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

sec. 243

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 deduction, or if the sec. 243 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.

100 percent dividend-received deductions— an automatic election?

Despite the termination of multiple surtax exemptions, etc., at the end of 1974, there are still a significant number of parent-subsidiary affiliated groups in existence. Many of these

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affiliated groups have not elected to file a consolidated federal income tax return. Under these circumstances, any dividend paid by a subsidiary company may create a potential tax liability. In general, to the extent that dividends are paid out of earnings and profits of years beginning after December 31, 1974, they are eligible for the 100 percent dividend-received deduction provided by sec. 243(a)(3) and (b) since multiple surtax exemptions are not available for such years. See sec. 243(b)(2), which denies the deduction if a sec. 1562 election is in effect. This would completely eliminate any tax.

There is one further requirement: under sec. 243(b)(1)(A), an election must be in effect to claim the 100 percent dividend-received deduction. With the repeal of sec. 1562, there is now only one adverse consequence of the election: The members of the group must handle in a uniform manner the treatment of foreign income taxes as a credit or as a deduction. (See sec. 243(b)(3)(B).) The desire to treat such taxes differently would be rather unusual.

A special benefit exists for dividends received from a subsidiary company with respect to which an election of new sec. 936 is in effect for the year of payment. All dividends by a sec. 936 corporation are eligible for the 100 percent dividend-received deduction, provided that the general 100 percent dividend-received deduction election is in effect [sec. 243(b)(1)(C)]. There is no requirement that the sec. 936 subsidiary accumulate the earnings and profits represented by the dividend in any particular taxable year or years, or indeed, that the earnings and profits be accumulated in years to which sec. 936 (or its "predecessor," sec. 931) applies.

It therefore seems clear that the election of the 100 percent dividend-received deduction should become almost automatic among eligible affiliated groups since there are essentially no adverse tax consequences. Such an election could even eliminate the risk of a constructive dividend arising from a sec. 482 allocation made between members of the group. (See Rev. Rul. 69-630.)

IRS obstacles to drilling farm-outs

sec. 263

Two recent interpretations by the IRS pose serious income tax problems for oil and gas farm-out transactions. These sharing arrangements typically involve a transfer by an oil and gas leaseholder (working interest holder), the "farmor" of operatsec. 263 ing rights, to a "farmee," who will drill, then, if successful, complete and equip an oil or gas well for production.

The farmee typically is entitled to the entire production from the well until his costs have been recouped, then the farmor and farmee share all further revenue and expenditures in an agreed-upon ratio; that is, the farmee, or "carrying party," continues to hold all the operating rights until full recoupment, then the farmor, or "carried party," reverts to a fractional working-interest ownership.

As an inducement to enter this sharing arrangement, the farmor typically agrees that the farmee will "earn" a fractional working-interest ownership in the remainder of the property involved in the sharing arrangement; that is, the farmee will become a 50 percent holder of the entire acreage covered by the working interest, rather than merely the immediate drill site.

Until recently, formation of this sharing arrangement has never been interpreted as a sale of property by the farmor to the farmee, nor has it involved any compensation income to the farmee for services rendered. These sharing arrangements have been governed by GCM 22730 (1941), which treats the arrangement as a pooling of capital and services among investors to lessen the risks and burdens attending development of an oil and gas property.

The IRS announcement of Rev. Rul. 77-176 in effect largely supersedes GCM 22730 for property transfers made after April 26, 1977, unless made pursuant to a binding contract entered into before April 27. The ruling treats the value of all property transferred to the farmee, other than the immediate drill site, as constructive sale proceeds to the farmor and compensation income to the farmee.

This treatment discourages the farmor from entering the sharing transaction because of the capital gain tax payable upon appreciation in the property involved. The farmee is discouraged because his intangible drilling costs deductible for the initial well are reduced by the value ascribed to the remainder of the property included in the sharing arrangement.

In more recent years, a partnership has frequently been used for farm-out or carried-interest transactions, sometimes to avoid the uncertainty of treatment arising from conflicting court decisions, and sometimes to provide a full intangible deduction to a farmee for a "part carry." The latter involved a transaction where the farmee did not pay for all of the well development cost, or did not have full recoupment rights during the entire well cost pay-out period. These arrangements were approved in Rev. Ruls. 54-84, 68-139, and other authorities, including numerous IRS letter rulings. *sec. 263*

In late July 1977, however, the IRS issued a technical advice memorandum that retroactively upset a limited-partnership carried-interest arrangement formed in the 1960s to accomplish a part-carry sharing arrangement. The partnership agreement provided for an acceleration of the payout period, and reversion of the carried party's fractional working interest upon payment by the carried party to the carrying party of the latter's recoupment costs.

The memorandum treats the partners as if there were no carried interest whatever, that is, as if the carried party and carrying party held the ultimate fractional working interests throughout the term of the partnership, and, accordingly, upsets the special allocation of the drilling cost deduction to the carrying party; that is, it partly reallocates the drilling cost deduction to the carried party.

The memorandum also treats the carried party's fractional interest as a purchased interest, subject to the *Crane* doctrine, reasoning that the optional acceleration payment constitutes a purchase money debt. Although not provided in the memorandum, a possible inference from this interpretation is that the drilling cost expenditures of the carrying party, not otherwise reallocated as carried party deductions, should be treated as purchase costs for the carrying party's ultimate fractional interest in the partnership.

The recoupment-period-acceleration-payment provision may not be commonly found in contract-sharing arrangements or partnership-carried interests. However, the reasoning in the memorandum suggests a possible reversion by the IRS to the *J.S. Abercrombie Co.* interpretation of the carried interest, which most practitioners felt was discredited and finally laid to rest by *W.H. Cocke*. The resulting uncertainties are not calculated to encourage an investor to become a carrying party under a partnership arrangement.

Unless the IRS can be persuaded that its April and July 1977 actions should be rescinded, in order to follow its previous pronouncements and to accommodate a national policy of encouraging oil and gas development activities, consideration should be given to contract-sharing arrangements designed to produce factual patterns that can be distinguished from the ruling and the memorandum. These include the following.

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- Separate purchase by the farmee from the farmor of the fractional interest in the untested acreage not included within the immediate drill site—with the price determined by the value at the time the sharing arrangement is formed—and the title on the same date.
- Transfer by the farmor to the farmee of the entire property, with the farmee allowed to select his own drill site.
- Purchase by the farmee from the farmor of a "rolling option" entitling the farmee to select drill sites and related acreage for development.
- A continuous drilling program, with "non-consent" well provisions for the initial wells and transfer of the entire property to the farmee upon formation of the sharing arrangement.
- Payment by the farmee of a premium to acquire an option from the farmor to purchase the portion of the property not included within the immediate drill site, with the option price based on the untested property value and an arm's length premium paid for the option.
- Sale by the farmor to the farmee of the fractional interest of the property not included within the immediate drill site, with the proceeds used by the farmor to defray his share of drilling, completing, and equipping the initial well or wells.
- Immediate transfer by the farmor to the farmee of the farmee's fractional interest in the entire property, with a subsequent condition requiring the farmee to reconvey his fractional interest in the property in the event the farmee breaches his test well obligation.
- Immediate transfer by the farmor to the farmee of the working interest in the entire property subject to a reserved overriding royalty convertible by the farmor into the agreed fractional working interest after completion of the test well or payout of the test well costs.
- Use of a carried-interest partnership, with no provision for a pay-out period acceleration payment by the farmor or carried party.

The objectives of these alternatives are (1) assurance of a full deduction for the farmee's drilling cost outlays and (2) measurement of any "property sale" transaction by property value at the time the sharing arrangement is formed and not at the time the test well or wells are completed. Except for the partnership approach, none of these solutions may be effective and some may change the economics of the sharing arrangement.

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

sec. 265

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.

Sec. 267 may apply to divorce settlements

sec. 267

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.)

sec. 267

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

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. (Note that P.L. 95-628 added sec. 267(e) to the code, effective for payments made after November 10, 1978. Under this provision, where the 2½-month period of sec. 267(a) ends on a Saturday, Sunday, or legal holiday, it is extended to the succeeding day that is not a Saturday, Sunday, or legal holiday.) 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. *sec. 267*

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).)

Loss on sale between estate and beneficiaries

The principal assets of a decedent's estate consisted of stock in a publicly traded company that has a basis of $10 per share and stock in a closely held family corporation that has a basis of $100 per share. For purposes of this example, it is unimportant whether the basis is determined under the '76 act or prior law.

The estate is in need of cash to repay bank loans, to pay estate taxes, etc. The market value of the stock in the publicly traded company has increased and the market value of the closely held stock has decreased. It was suggested that the stock in the publicly traded company be sold on the market at a substantial gain. It also was suggested that the closely held stock be sold to create a loss to offset the gain on the publicly traded stock. However, the family of the decedent decided that the stock of the family business should not be sold to outsiders. Hence, it was suggested that the stock of the family corporation be sold to the surviving members of the family who were also beneficiaries of the estate. The question is whether the loss on the sale to the beneficiaries of the estate is not allowable by reason of sec. 267 (losses between related parties).

In Rev. Rul. 56-270, a marital trust fund was provided in a fixed and definite "dollar amount." It was ruled that upon the satisfaction of the obligation to the marital trust with depreciated property, losses measured by the difference between the basis of the property in the hands of the executor and the value at the date of disposition to the trust may be offset against other gains realized.

In Rev. Rul. 60-87, a marital trust fund was also declared to have been provided for in a fixed and definite "dollar *sec. 267* amount." Here again, it was held that the gain or loss realized by the estate is to be measured by the difference between the fair market value of the property at the date of the distribution and the value as finally determined for estate tax purposes.

These rulings indicate that even though there is a family relationship between the decedent and the beneficiaries of the trust, losses may be recognized and sec. 267 is not applicable.

A more refined analysis appears in *Est. of Ruth Hanna.* Here the court had to determine whether the redemption of stock owned by the estate, with the balance of the stock of the corporation owned by the decedent's sisters, who were also beneficiaries, was a sale between related parties as defined in sec. 267. The specific question was whether sec. 267(b)(2) (sales between an individual and a corporation that is owned directly or indirectly by such individuals) applied. (See sec. 267(c)(1).) The court held that the sale by an "individual" does not include a sale by an estate. Hence, the loss was recognized.

Sec. 267(b)(1) relates to sales between members of a family. It is difficult to see how the sale by an estate would fall within that category. Thus, a loss on the sale of stock to the beneficiaries of an estate should be allowed to offset the gain on other sales in the example set forth above.

Editors' note: The IRS has issued Rev. Rul. 77-439 holding that a sale between an estate and its executor, who was also a child of the decedent, was not one between related parties. Thus sec. 267 did not disallow the loss.

sec. 274

Unreasonable compensation—effect of agreement between corporation and employee-shareholder

In order to neutralize a one-sided adjustment made by the IRS when disallowing a compensation deduction, the technique has often been employed to provide that if any portion of the employee-shareholder's salary is disallowed, the employee shall repay the amount of the disallowance to the corporation. Since the repayment is presumed to be deductible by the employee-shareholder, the device places the corporation and its shareholders in the same position as they would have been had the excessive salaries not been paid.

Although agreements of this type appear to have everything to gain and nothing to lose, the question arises whether taxpayers are always well advised to enter into them. Certainly, the agreement serves no useful purpose if the corporation, after receiving repayment from the employee-shareholders of the excessive portion of the salaries, is required to pay dividends in the same amount because of the employee-shareholders' financial requirements. Where there is a possibility that salaries sufficient to satisfy the personal needs of the employee-shareholders will be disallowed in part as unreasonable, it may be advisable for taxpayers, in view of what appears to be a developing attitude in the courts, to avoid salary repayment arrangements. By contemplating the possibility of disallowance, such agreements tend to create an inference that the compensation is unreasonable since the employer-corporation and its shareholder executives are in a better position than anyone else to judge what is reasonable. In the most recent case in point, *Castle Ford, Inc.*, the Tax Court considered a salary repayment agreement between a corporation and its principal shareholder as evidence that the salary paid to the shareholder was unreasonable. Similarly, evidentiary weight was given to such agreements in *Charles Schneider & Co., Inc.*, and *Saia Electric, Inc.* Although the facts of these cases indicate that they would have been decided against the taxpayers anyway, the existence of the agreements obviously did not help. Therefore, since the question will arise after the salaries have been repaid as to how they can be distributed to the shareholder in a way that is not treated as a dividend distribution by the corporation, the value of salary repayment agreements is open to question.

Another drawback of such agreements is that although both the IRS and the courts agree that the repayment is allowed as a deduction to the employee-shareholder for the taxable year in which he makes the repayment [Rev. Rul. 69-115 and *Vincent E. Oswald*], without the agreement no deduction for the repayment is allowed [*Ernest H. Berger*]. The IRS has ruled, however, that in computing the tax liability for the year in which the salary is repaid, sec. 1341 is inapplicable. Under that section, the tax computation results in a benefit to the taxpayer for the year in which the salary is repaid at least equal to the tax paid on the salary in the year it was received. Since under the IRS's interpretation (which probably is correct) the taxpayer is entitled only to a deduction in the year of repayment, he will not be made whole if he was in a higher tax bracket in the year in which he received the salary.

sec. 274 Of course, some tax benefit is better than none. Nevertheless, where it is likely that the salary repayment will have to be followed quickly with a dividend payment because of the shareholder's financial requirements, a salary repayment agreement may be inadvisable because the agreement itself potentially jeopardizes the corporation's salary deduction.

Editors' note: The adviser must also consider whether the shareholder is agreeable to repaying the amount. Even though such repayment arrangements occur most frequently in the closely held corporation setting, often the employee-shareholder involved is reluctant to repay, especially in a situation where there are adverse minority shareholders or an eventual sale is possible.

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 '78 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 busi-

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ness 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).)

Sec. 280A planning for renting personal residence

sec. 280A

As part of the '76 act, new rules were enacted to limit deductions with respect to "vacation homes." However, a careful reading of the statute makes it clear that these new limitations apply not only to vacation homes but to the principal personal residence of a taxpayer as well.

In general, whenever a taxpayer uses a dwelling unit for personal purposes during a taxable year for the greater of 14 days or 10 percent of the number of days the property is rented at a fair rental during the year, the unit will be treated as his residence and the rules of sec. 280A will apply.

Thus, the title of sec. 280A, "Disallowance of certain expenses in connection with . . . rental of vacation homes . . ." is somewhat misleading. Its rules could apply when an individual takes a month's vacation and rents out his permanent residence to visitors from out of town during that period. They could also apply where an individual moves out of his residence and, since he cannot sell it immediately, rents it out until such time as he can.

Under sec. 280A, the deductions connected with the rental of such a residence are limited to the excess of the rental income over the expenses allocable to rental use that are allowable whether or not the property is rented (i.e., interest and property taxes).

The application of these rules can be illustrated by the following example.

> A cash-basis taxpayer moves out of his house on July 1, 1977, and rents it at a fair rental for the remainder of the year, collecting a total of $4,000 in rent. The expenses for 1977 are as follows: interest, $4,000; property taxes, $2,000; maintenance (after July 1 only), $1,000; and depreciation (after July 1 only), $1,000.
>
> One half of the interest and property taxes (for the half-year period before July 1) are deductible as itemized deductions. In addition, the rental activity yields the following result:

Rental income	$ 4,000
Less allocable one half of expenses otherwise allowable (interest and property taxes)	(3,000)
Excess	1,000
Less maintenance	(1,000)
Net taxable income	$ 0

> No deduction may be claimed for depreciation since it exceeds the limitation.

Although it might be argued that this result does not appear *sec. 280A* to have been intended, the language of sec. 280A seems clear. Taxpayers should be aware of these limitations and, if possible, plan to avoid them. For example, in the above situation the taxpayer could attempt to delay $1,000 of his payments (preferably a portion of the interest and property taxes) until after December 31. If he is able to do so, the depreciation deduction of $1,000 would be allowable in full.

sec. 280C

Jobs credit: intended to be elective but . . .

Under the 1977 Tax Reduction and Simplification Act, the jobs credit was mandatory and required a reduction in the wages deduction. However, the conference report on section 321 of the '78 act states that this credit shall be *elective* for taxable years beginning after December 31, 1976. Where a taxpayer could not use the jobs credit in 1977 or 1978, he may wish to file an amended return to elect not to claim the credit.

For example, because of the sec. 53(b) limitation, a subchapter S corporation shareholder, a partner, or a beneficiary of an estate or trust could not use the jobs credit for any year in which the respective subchapter S corporation, partnership, or estate or trust incurred a loss. (Of course, any unused credit may be carried back three years and forward seven years.) By amending the entity's return to retroactively elect not to claim the credit, the wage deduction would be increased and provide an additional loss to be passed through to the shareholder, partner, or beneficiary (via their own amended return).

Although the legislative history evidences congressional intent to make the jobs credit elective retroactively, such a provision was not included in the '78 act itself. It appears that the joint committee staff is aware of this problem, which is considered as a mere drafting oversight and will *probably* be remedied in the contemplated 1979 Technical Corrections Act. See also, general explanation of the '78 act prepared by the joint committee staff.

In preparing 1978 returns that elect not to claim the general jobs credit, appropriate disclosure should be considered to avoid penalties for negligent or intentional disregard of existing rules and regulations. For instance, the following statement might suffice:

> Pursuant to the conference report on sec. 321 of the '78 act, the taxpayer elects not to claim the credit otherwise allowable under sec.

44B. Consequently, wages have not been reduced in accordance with sec. 280C.

sec. 280C

On the other hand, it should be noted that sec. 53(b) has been repealed for taxable years beginning after December 31, 1978, as part of the '78 act provisions creating the new targeted jobs credit. However, the effect of this repeal on carryovers of the old jobs credit to post-1978 years is currently uncertain.

In view of the contemplated corrective legislation regarding the election and the uncertainty surrounding the repeal of the sec. 53(b) limitation, it appears advisable to postpone filing 1977 refund claims or amended returns until both of these matters are further clarified.

Corporate distributions and adjustments

Bootstrap acquisitions require careful planning

sec. 301

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

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$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.*)*

More on bootstrapping an acquisition

The fifth circuit decision in *J.E. Casner* is another example of the need for increased care in planning a "bootstrap" acquisition of stock of a corporation by individual purchasers.

The facts of *Casner* indicate that immediately prior to sales of stock in two corporations by certain shareholders ("selling shareholders") to other shareholders ("purchasing shareholders") and outside parties, the two corporations made pro rata distributions of all their earnings and profits to reduce the book value of the stock. The purchasing shareholders and the outside purchasers both paid the same price per share for the stock. The selling shareholders treated the distributions as part of the sales price for the stock that they sold, while the purchasers did not report any income on the transaction. The Tax Court held the pro rata distributions were taxable as dividends to the selling shareholders and the purchasing shareholders.

On appeal, the fifth circuit held the pro rata distributions to be taxable—

- As to the selling shareholders—not as a dividend but rather as part of the proceeds of sale of their stock; and
- As to the purchasing shareholders—as a direct dividend in the amount distributed to them and a constructive dividend in the amount distributed to the selling shareholders.

The latter holding was based on the view that the purchasing shareholders received the economic benefit from the distributions of the sellers. The court based its decision on *Steel Improvement and Forge Co.* and *Waterman Steamship Corp.* But note: The Tax Court continues to rule in favor of the taxpayer [*Jay Walker*].

The conclusions reached in *Casner* appear consistent with the rationale of *Steel Improvement* and *Waterman,* to the extent that the three decisions all held that the dividend distribution and the sale of stock were part of a preconceived multistep plan for the sale of stock and that the economic substance of the plan required the two steps to be treated as one transaction for tax purposes. In both *Steel Improvement* and *Waterman,* only the selling shareholders received the purported "dividend" distributions, and both courts were silent as to any possible dividend consequences to the unrelated purchasers who were not parties in either case.

Also see Rev. Rul. 75-360 and Rev. Rul. 75-447, where the service applies the *preconceived multistep plan* concept to determine whether a substantially disproportionate redemption has occurred.

In *Casner,* the entire distribution to the selling shareholders was taxed to the purchasing shareholders as a constructive dividend even though both they and the outside purchasers paid the same price per share for the stock. Since both the *sec. 301* purchasing shareholders and the outside purchasers received the same economic benefit from the distribution to the selling shareholders, it is submitted that the economic benefit allocable to the outside purchasers should not have been considered as a dividend to the purchasing shareholders.

It would seem that purchasing shareholders can avoid having the entire distribution taxed to them as a dividend, as in *Casner*, by purchasing part of the stock of the selling shareholders followed by the corporation's redeeming the balance of their shares, resulting in a complete termination of their interests. This view is supported by the decisions in *Zenz* and *Enoch*.

Editors' note: IRS will not follow Casner *and has ruled in Rev. Rul. 75-493 that the distribution to the selling shareholder will be a dividend. Where the selling shareholder is a corporation, however, the IRS follows* Zenz *and disallows the dividends-received deduction of sec. 243. (See Rev. Rul. 77-226.)*

sec. 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*

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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.

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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.

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

sec. 302

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 could have been avoided if the transaction had been 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.].

Nondividend and substantially disproportionate redemptions

It appears that the IRS is relaxing a rigid stand that made it dangerous to try to qualify a stock redemption as "not essentially equivalent to a dividend" under sec. 302(b)(1), as opposed to the mechanical tests of sec. 302(b)(2). (See Rev. Ruls. 75-502 and 75-512.)

Rev. Rul. 76-385 held that the redemption of stock of a publicly held corporation, owned by the subsidiary of a family holding company, was not essentially equivalent to a dividend, even though the subsidiary's ownership of the public corporation after the redemption was still 96.7 percent of what it had been before because of attribution from the parent. The redemption was made pursuant to an offer by the public corporation which the subsidiary accepted but which the parent did not.

The need for the ruling is somewhat difficult to comprehend since, even though there was no "meaningful reduction" in the percentage interest of the subsidiary, the actual percentage interest of the subsidiary was only .0001118 percent before the redemption and .0001081 percent afterwards. It is hard to believe that such a small interest would create the circumstances offering an opportunity for tax avoidance (absent a pro rata redemption), which Congress had in mind when it enacted sec. 302 and its predecessor. Therefore, coupled with Rev. Ruls. 75-502 and 75-512, there is encouragement that favorable private rulings may be obtained in some situations where there may not be a meaningful reduction in the shareholder's interest and the mechanical test of sec. 302(b)(2) (substantially disproportionate redemptions) is not met.

Incidentally, the following formula may be useful for determining the number of shares to be redeemed to qualify a stock redemption as substantially disproportionate under sec. 302(b)(2), in the usual case of a single class of voting stock.

Let A = total outstanding shares
B = shares owned by redeeming shareholder
X = shares to be redeemed

Formula

$$B - X = \left(.8\,\frac{B}{A}\right)(A - X)$$

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Example

$$A = 100 \qquad B = 60$$

$$60 - X = \left(.8\frac{60}{100}\right)(100 - X)$$

$$\left(\frac{48}{100}\right)(100 - X)$$

$$\begin{aligned} 60 - X &= 48 - .48X \\ .52X &= 12 \\ X &= 23+ \end{aligned}$$

This formula gives exactly 80 percent. Since the statute calls for *less than* 80 percent, the answer should be rounded up. In this example, 24 shares should be redeemed. In addition, the redemption must reduce the interest below 50 percent of the voting power of all the outstanding stock. The formula result will be less than the redemption required whenever *B* divided by *A* is 62.5 percent or more and, therefore, should not be used in such situations.

Editors' note: The service ruled in Rev. Rul. 78-401 that a meaningful reduction in interest was not accomplished by a redemption that reduced a stockholder's ownership from 90 percent to 60 percent of one class of common stock.

sec. 304

Using sec. 304 to advantage by corporate seller of stock

The sale of all the stock of one corporation by another corporation will generally give rise to capital gain treatment if the sale is to an unrelated party. However, by reason of the dividends-received deduction of sec. 243, it is generally better for a corporation to receive a dividend. Dividend treatment can be produced if the sale is to a related party within the meaning of sec. 304.

By use of the "back attribution rule" of sec. 318(a)(3)(C), a corporation owns the stock of its 50 percent shareholder. Sec. 304(c)(2) drops the 50 percent limitation for purposes of sec. 304. Thus, a corporation owns the stock its shareholder owns whether the shareholder owns 100 percent, 50 percent, or one share of the corporation. (See Rev. Rul. 77-427.)

If Corporation *A* sells all of the stock of Corporation *B* to unrelated Corporation *C*, which is owned by one shareholder or a small number of shareholders, it is possible to structure the sale to produce a dividend. Prior to the sale, the shareholders of *C* should each buy a small amount of stock of *A*;

even as little as one share each will apparently do. *A* will then own 100 percent of the stock of *B* and *C* beforehand, thus triggering the application of sec. 304(a)(1). Sec. 304(b)(1) drops the 50 percent rule of sec. 318(a)(3)(C) for purposes of measuring the percent of reduction of *A*'s stock in *B* after the transaction. Thus, *A* will own 100 percent of *B*'s stock before the transaction and, by use of the attribution rules, 100 percent after the transaction. Therefore, the sec. 304 redemption will produce dividend treatment under sec. 302(d).

The fact that the *C* shareholders purchase stock in *A* for purposes of qualifying the transaction under sec. 304 is probably immaterial. See Rev. Rul. 69-407, where the distributing corporation acquired control by a recapitalization prior to a spinoff. See also Rev. Rul. 76-223, where voting rights were given to nonvoting preferred stock concurrent with the acquisition of voting stock so as to qualify a transaction as a "B" reorganization.

If the purchasing corporation is a new corporation, it will be necessary for it to generate earnings and profits by year end so that the selling corporation will have a dividend. (See sec. 304(b)(2)(A).) Earnings and profits may be created by (1) liquidating *B* (if sec. 334(b)(1) is applicable), (2) filing a consolidated return with *B*, or (3) making a deemed dividend election under regs. sec. 1.1502-33 after filing a consolidated return.

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

sec. 304

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.)

Sec. 305: effect of changing conversion ratio

sec. 305

The parties to a statutory merger agreed that cumulative convertible preferred stock would be issued in exchange for the stock of one of the merged companies. Under the terms of the preferred, the number of shares of preferred to be turned in to acquire one share of common of the surviving company became progressively greater over a five-year period. In the first year, 1½ shares of preferred could be exchanged for 1 share of common; in the fifth year the ratio was 2½ to 1. Thus, in effect, as time passed, the preferred shareholders relinquished part of their equity.

The first question is whether the change in the conversion rate causes a distribution that is subject to tax under sec. 301 rather than a tax-free distribution under sec. 305. Regs. sec. 1.305-1(c) states that sec. 305 does not apply if an increase or decrease in the conversion ratio represents an adjustment of the price to be paid by the acquiring company. The example given in the regulations is interpreted as being an adjustment in price.

However, in the case above, it is difficult to say that the changing conversion ratio was an adjustment to price. If it was an adjustment to price, those shareholders who converted in the first year would receive a greater price for their shares than those who converted in the later years.

The IRS will not rule on any transaction that is not clearly within the example in the regulation, but if a ruling is issued with respect to the merger, it will contain a caveat to the effect that the determination of whether sec. 305 applies is not being ruled upon.

A second question is raised by the change in the conversion ratio; that is, whether the common shareholders of the acquired company could be held to have received an ordinary deemed dividend under sec. 305. This is based upon the theory that the common shareholders are better off because they have a larger share of the equity as a result of an increasing conversion ratio. Although there is no safe answer, it would appear that the voluntary delay by one shareholder in acting on the conversion should not cause dividend income to be attributed to another shareholder.

Editors' note: Regs. sec. 1.305-7(a) could be interpreted as requiring taxation under sec. 301, absent application of an antidilution provision.

sec. 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

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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.

Sec. 306 stock and sec. 302(b)

In cases where the management of a closely held corporation decides to "pass the baton" to the younger generation, an effective approach has been the implementation of a so-called "Hartzell-Dean" recapitalization. Such a transaction generally contemplates that the retiring shareholders exchange all or a portion of their common for a newly minted issue of nonvoting preferred. In this manner, the active management group has been "bootstrapped" into a position of control, and the inactive contingent is provided with a fixed-income security that has the effect of "freezing" the value of its interest in the corporation for estate-planning purposes.

Where such shareholders retained a portion of their common, it was generally conceded that the preferred would constitute sec. 306 stock. (See Rev. Ruls. 59-84 and 66-332.) The "306 taint," however, was not a serious impediment since the operation of sec. 1014(a) served to "sanitize" the stock upon the shareholder's death.

Tax planning for a recapitalization of this type should also consider the definition requirements of sec. 306(c)(1)(B), with a view to avoiding sec. 306 characterization for the stock received in the exchange. The operative language in this regard is the requirement that the recapitalization transaction "not have the effect of the receipt of a stock dividend." Although avoidance of the proscribed effect was generally thought to be impossible where there was a retention of *any* portion of an exchanging shareholder's common, the recent IRS employment of principles developed under sec. 302 in testing for the existence of the prohibited effect may serve to mitigate this harsh rule.

The service's employment of a "sec. 302 approach" to this area was foreshadowed by a ruling dealing with the receipt of boot in a reorganization. In Rev. Rul. 75-83, the service formally eschewed its "automatic dividend" rule and held that the determination of whether a reorganization exchange has the "effect of a dividend" for purposes of sec. 356(a)(2) would be made by constructing a hypothetical redemption and then testing such redemption under sec. 302(b). A similar approach has now been adopted, for advance ruling purposes, for determining whether the receipt of preferred has the effect of a stock dividend. Accordingly, the retention of common in a recapitalization in which preferred is received may pass muster under sec. 306(c)(1)(B), where a hypothetical redemption would have qualified for exchange treatment under sec. 302(b). In making this determination, the service has followed the approach used in *William F. Wright*, by declining to enforce the attribution rules.

The results of this approach were dramatically depicted in IRS Letter Ruling 7748016. There, sec. 306 classification was avoided by each exchanging shareholder whose common stock interest was reduced subsequent to the exchange. Further, the ruling, although detailing the close relationship of the participants, specifically focuses only on *actual* stock ownership for purposes of evaluating the extent of the ownership adjustments attributable to the exchange.

The implementation of this surprisingly liberal ruling policy will have a salutary effect in facilitating the recapitalizations described above. Clearly, the surrender of common stock in an amount sufficient to qualify under the "safe harbor" provided by sec. 302(b)(2) or under the rapidly developing principles promulgated under sec. 302(b)(1) will be sufficient to avoid the taint of sec. 306.

See also Rev. Rul. 77-455, which suggests that preferred stock received by a retiring shareholder in such a recapitalization may avoid sec. 306(a) treatment by the application of the exception in sec. 306(b)(4)(B) (no tax avoidance).

sec. 311

Liquidations: conflict between secs. 331 and 311?

Corporations frequently join with third parties to form new corporations to carry on joint business enterprises. The existing corporation (*X*) may consider capitalizing the new corporation (*Y*) in part by transferring marketable capital stock of *X* to *Y* in exchange for capital stock of *Y*. The purpose is to give *Y* sufficient capital to attract lenders, suppliers, and customers. The exchange itself will ordinarily be tax free under both sec. 1032 and sec. 351. Unfortunately, though, when a new corporation is formed, the focus is generally on its immediate operation and little thought is given to the possibility that it may be desirable to liquidate the new corporation at some future time.

If our hypothetical *X* owns less than 80 percent of the stock of *Y*, a liquidation of *Y* would not qualify as tax free under sec. 332, but would be governed by sec. 331. Under sec. 331(a)(1), the taxable gain to the shareholder in a complete liquidation is measured by the excess of the fair market value of the property received by the shareholder over the shareholder's basis in the stock of the liquidating corporation. Since *X* would be receiving in part its own stock in liquidation of *Y*, the measure of gain is the excess of the fair market value of the *X* stock and other property received over the basis of the *Y* stock surrendered. And in this kind of case, the IRS has held that *X*'s basis in its *Y* stock is zero under sec. 362(a) [sec. 358(a) is inapplicable]. (See Rev. Rul. 74-503.) Consequently, *X* will have to recognize taxable gain equal to the full fair market value of the *X* stock and other property distributed by *Y*, unless some other provision of the code should override the complete liquidation provisions of sec. 331.

In addition to being characterized as a complete liquidation of *Y*, the proposed transaction might also be characterized in part as a distribution by *X* of *Y* stock in redemption by *X* of its own stock. (See sec. 317(b).) Generally, a corporation such as *X*, which distributes appreciated property (such as stock of *Y*) in redemption of its own stock, recognizes gain on the redemption unless certain exceptions apply [sec. 311(d)]. If one of the exceptions of sec. 311(d)(2) is applicable, the redemption is governed by the general rule of sec. 311(a), which provides that no gain or loss shall be recognized to a corporation on the distribution of property with respect to its own stock.

Thus, it appears there may be a direct unresolved conflict between these two sections of the code. Assuming that sec. 311 would produce no gain, *X* might argue that sec. 311(a) should govern since sec. 331 appears to merely define the transaction as an exchange, whereas sec. 311(a) expressly specifies that any gain or loss from the transaction is not to be recognized. On the other hand, if the *Y* liquidation qualified under sec. 332, and sec. 311 produced a gain, *X* would want the former to govern. *sec. 311*

Editors' note: The service ruled in Rev. Rul. 80-101 that the receipt of a corporation's own stock in a liquidation is nontaxable pursuant to sec. 311, but the receipt of other property is taxable under sec. 331.

Future tax-free dividends through treasury stock acquisitions

sec. 312

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

sec. 312

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. sec. 312

How far can the tax benefit rule go in expense recoveries? sec. 331

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.

sec. 333

Sec. 333 liquidations: installment notes as "securities"

The gain of a qualified electing noncorporate shareholder in a sec. 333 liquidation is basically recognized to the extent of the greater of—

1. His pro rata share of earnings and profits (E&P) accumulated after February 28, 1913, or
2. Money and post-1953-acquired stock or securities (valued at fair market value) received by such shareholder.

Accordingly, money and the fair market value of post-1953-acquired stock or securities in excess of the shareholder's pro rata share of E&P will increase the gain he must recognize under sec. 333. The shareholder is treated as receiving a dividend to the extent of his ratable share of E&P and is generally entitled to capital gain treatment (long- or short-term, as the case may be) for the balance of the gain [sec. 333(e)].

If the liquidating corporation has been reporting gain under an installment election, the liquidation would apparently be treated as a disposition of the installment note causing the deferred gain to be taxed to the liquidating corporation [sec. 453(d)(4)]. Commentary concerning installment notes in a sec. 333 context generally points out the increase in E&P resulting from the disposition, which could, in turn, increase the shareholder's gain recognized under sec. 333.

An issue not generally emphasized is whether the installment note could also be considered a "security" under sec. 333. If so, the full fair market value of the note, as well as the deferred gain element, could enter into the computation of the gain recognized. It has been learned that the IRS national office apparently believes installment notes can constitute "securities" under sec. 333. Even though their disposition will increase E&P (and thus one aspect of the gain), this apparently does not preclude installment notes from simultaneously being considered "securities."

When an installment note, or other debt instrument, might be considered a "security" under sec. 333 is somewhat uncertain, and this aspect of the problem is beyond the scope of this discussion. However, installment notes are not uncommon in a sec. 333 context, and overlooking the "security" possibility could cause the anticipated sec. 333 gain to be materially underestimated.

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

sec. 333

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 Company* 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 *sec. 333* 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.)

Cutting sec. 333 shareholder taxes by collecting receivables

If the assets of an accrual-basis corporation have appreciated in value and the shareholders are planning to liquidate under sec. 333, the corporation would be well advised to sell the receivables or otherwise accelerate their collection prior to distribution. By so doing, the shareholders may save considerable taxes because the basis of the receivables distributed in liquidation will decrease in relation to assets that have appreciated in value. Thus, any amounts collected after liquidation in excess of the recomputed basis will be considered ordinary income to the distributee-shareholder. (See *Ralph R. Garrow*.)

sec. 333

Recognized gain in a one-month liquidation under sec. 333 is the greater of earnings and profits (E&P) after 1913, or the sum of the money received and the fair market value of stock and securities (acquired after December 31, 1953) received. Any gain to noncorporate taxpayers is taxable as dividends to the extent of E&P and any remainder is taxable as capital gain. The basis of the assets distributed in liquidation is the same as the basis of the stock, decreased by the amount of money received and increased by the amount of gain recognized and liabilities assumed. The total basis is then allocated to the distributed assets according to their net fair market value [Regs. sec. 1.334-2].

A problem arises when the FMVs of the assets have appreciated and the value of the receivables remains at or below book value, as is normally the case.

Example. Assume a corporation has the following on its books immediately prior to liquidation:

	Net book value
Cash	$300,000
Accounts receivable	200,000
Fixed assets	500,000
E&P (after 1913)	200,000

The FMV of the fixed assets is $1,800,000; the basis of the stock is $800,000. Upon liquidation, the shareholders will recognize a gain of $300,000, representing the amount of money received. This gain consists of $200,000 of dividends and $100,000 of capital gains. The basis of the assets to the shareholders will be computed as follows:

Basis of stock	$800,000
Less money received	(300,000)
Add gain	300,000
Total basis	$800,000

The basis of the distributed assets is allocated as follows:

Accounts receivable ($800,000 × 200,000/2,000,000)	$ 80,000
Fixed assets ($800,000 × 1,800,000/2,000,000)	720,000
	$800,000

When the $200,000 of receivables is collected by the shareholders, ordinary income of $120,000 will be taxable to them. (See *Osenbach*.)

Although the sale of the receivables close to the liquidation month may increase the recognized gain to the shareholders, it will be capital gain. Alternatively, the cash received on the sale can be used to decrease liabilities.

sec. 333

Liquidation—month of distribution incorrectly designated

Sec. 333 limits the gain that is taxable to a "qualified electing shareholder" upon complete liquidation of a corporation occurring within one calendar month. To obtain the benefits of the section, the taxpayer must file a written election within 30 days after the adoption of the plan of liquidation with the Internal Revenue Service center where the final income tax return of the corporation will be filed. The statute prescribes that the election must be made and filed in a manner "not in contravention of regulations prescribed by the Secretary" [sec. 333(d)].

The regulations require the election to be made on Form 964 "in accordance with the instructions printed thereon" [regs. sec. 1.333-3]. A box on the first page of the form requests the specification of the month in which all of the property of the corporation will be transferred to its shareholders. It sometimes happens that, because of administrative difficulties or delays in executing documents, the transfer of property by the corporation does not occur until a month subsequent to the one specified by the shareholders' elections.

Does the delay in the transfer of the property invalidate the shareholders' elections? Probably not. Neither sec. 333 itself nor the regulations requires that the transfer of property by the corporation occur in a specific month designated by the shareholders. The only requirement is that the property transfer under the liquidation occur within "some one calendar month" [sec. 333(a)(2) and regs. sec. 1.333-1]. Also, although Form 966, which is required to be filed by liquidating corporations, asks for the code section under which the corporation is to be liquidated, it does not request that the month of liquidation be supplied. Finally, the instructions to Form 964 state that if the particular month of the property transfer is not known, the word "unknown" is to be entered in the appropriate box on the form.

The conclusion that the shareholders' elections under sec. 333 are not invalidated simply because the Form 964 that each filed shows the wrong month for the property transfer is supported by a recent discussion with IRS representatives in the national office. They were not aware of a reason, other than administrative convenience, why Form 964 requests that the month of the property transfer be specified. Although it may not be necessary to notify the IRS of the discrepancy immediately after the liquidation has occurred, probably taxpayers are well advised to do so. In any event, the correct month should be shown on the copy of Form 964 that is required to be attached to the shareholder's income tax return for his taxable year in which the distribution of the property in liquidation occurs.

Editors' note: The service has recently confirmed this approach in Rev. Proc. 79-27.

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 *sec. 333* 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.

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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 No. 7750009, issued August 30, 1977, to the Wilmington, Delaware district director.)

While the Tax Court's *Smith* decision is not likely to be the final word on the issues involved, protective refund claims may be in order for some taxpayers.

sec. 334 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.

A discussion of change in IRS positions for sec. 334(b)(2) computations appears in the report of the Rule 155 computations in the case of *R.M. Smith, Inc.* The AICPA Tax Division, on December 15, 1970, submitted a memorandum to Mr. Harold Swartz, then Assistant Commissioner, Technical, for the IRS, urging that the regulations under sec. 334(b)(2) (originally adopted December 2, 1955) be further amended to reflect the interplay of depreciation recapture. Note that the division recommended that the IRS allocate the basis adjustment for depreciation recapture to the assets involved, rather than to all property distributed, and that the interim earnings and profits adjustment exclude the depreciation recapture, except for the portion attributable to the interim period between purchase and liquidation. The second, but not the first, position seems to have been tacitly adopted by the IRS. An amendment of the regulations still is in order.

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.

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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* merged 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, according 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.*

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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

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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.

Sec. 337: transfers of franchises

sec. 337

The interaction of sec. 1253 (providing for the taxation of franchise transfers) and sec. 337 (providing for the tax treatment of sales made in connection with certain liquidations) points the way to what may be a significant opportunity to save taxes on the transfer of a franchise. A brief example will serve to illustrate the potential planning opportunities.

> *Example.* Corporation *X* owns the right to distribute a popular soft drink in state *A*. Apart from these distribution rights, which are valuable, *X* has little in the way of assets. Corporation *Y* wishes to purchase *X*'s business but does not want to end up with a substantial intangible asset with an indefinite life, which it cannot amortize for tax purposes. *X* and *Y* agree to make 40 percent of the total cash purchase price contingent on the quantity of soda sold by *Y* over the next five years (or the consideration allocated to the franchise, 50

sec. 337

percent would be attributed to contingent payments). Immediately after selling all of its assets to *Y*, *X* liquidates, pursuant to a preexisting plan of liquidation, distributing the cash and the rights under its contract with *Y* to its shareholders.

X escapes tax on the sale under sec. 337; its shareholders' subsequently receive payments from the receipt of the assets under sec. 331, and the shareholders' subsequent receipt of payments from *Y* are likely to be treated as a recovery of basis. *Y*, for its part, is able to take a deduction against ordinary income for its contingent payments under sec. 1253(d)(1).

A more detailed analysis of the tax treatment of this transaction is as follows: Sec. 337 provides that, if a corporation adopts a plan of complete liquidation and, pursuant to that plan, distributes within the following 12 months all assets not required to meet claims, no gain or loss will be recognized to the corporation on sales or exchanges made during the 12-month period. Unlike several other sections in the code, which override the tax-free treatment provided by sec. 337 (e.g., secs. 1245 and 1250), sec. 1253 coexists with sec. 337 on equal terms. Thus, a transfer of franchise rights in a transaction qualifying as a sale or exchange of property under sec. 1253 should, if the other conditions are met, give the transferor tax-free treatment under sec. 337.

In certain circumstances, a transaction under sec. 1253 will meet the sale or exchange requirement of sec. 337. Generally, the transfer of a franchise is not deemed to be a sale or exchange if the transferor retains a "significant power, right, or continuing interest" in the franchise [sec. 1253(a) and (b)]. However, if the only interest retained by the transferor is a "contingent payment" equalling 50 percent or less of the consideration being paid for the franchise (note that this is 50 percent of the consideration being paid for the franchise and not 50 percent of the total consideration), the transfer is treated as a sale or exchange, and the transferor may, presumably, use sec. 337 [secs. 1253(c) and 1253(b)(2)(F) and prop. regs. sec. 1.1253-2(d)(6)].

In a transaction governed by sec. 1253, the transferee receives an ordinary deduction each time it makes a contingent payment [sec. 1253(d)(1)]. Thus, both parties may have the best of all possible worlds. The transferor obtains tax-free treatment on the sale under sec. 337, and the transferee obtains a deduction against ordinary income for all contingent payments made to secure the franchise. However, since there is no authority specifically approving these tax results, some caution should be exercised in relying on them.

Foreign collapsible corporations

sec. 341

A foreign corporation can be a collapsible corporation for purposes of sec. 341. (See Rev. Rul. 56-104, below.) However, there has been a question as to whether a foreign corporation that has never done business or owned property in the United States will nevertheless be considered a collapsible corporation. This unexpected result is possible because the sale or exchange of the stock of such a corporation by its shareholders will perforce occur before the corporation realizes any *U.S. taxable income* from the properties it holds.

In 1956, the service ruled that the "mere fact that a corporation is a foreign corporation deriving all of its income from sources without the United States, and therefore has no taxable income for federal income tax purposes, does not in and of itself cause it to be considered a collapsible corporation" [Rev. Rul. 56-104, 1956-1 CB 178]. However, the ruling did not go further and say that such a corporation (which is not being utilized to avoid U.S. taxes) would never be collapsible. Moreover, until now, the service has refused to clear up this issue, even though it would appear that a corporation that would never realize any U.S. income could not fit the classic mold of a collapsible corporation.

A recent private ruling addressed this problem for the first time and in essence concluded that the shareholders of such a corporation could not possess the requisite collapsible intent; it held, accordingly, that the corporation would not be treated as collapsible for purposes of sec. 341.

Editors' note: The service will consider a ruling request as to whether a corporation has been "formed or availed of" pursuant to sec. 341(b) when the corporation (1) has been in existence for at least 20 years, (2) has had substantially the same owners during that period, and (3) has conducted substantially the same business during that period. (See Rev. Proc. 77-27.)

Partial liquidation of a subsidiary

sec. 346

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].

Planning for partial liquidation to avoid double tax

sec. 346

Zeta Corporation has owned two businesses for many years—an ice cream plant and a large hotel. Zeta would like to sell its hotel, which has appreciated greatly in value and is easily salable. Zeta proposed to distribute the proceeds of the sale to its shareholders in a partial liquidation, and was requesting a ruling that the shareholders would realize a capital gain on the distribution. We advised Zeta that, under this arrangement, Zeta and its shareholders would incur a double tax—once when Zeta makes the sale, and again when the proceeds are distributed to the shareholders.

Suggestion. Since Zeta does not have a buyer (and has not begun any sales efforts), it should first distribute all the assets (subject to the liabilities) of the hotel business to its shareholders. We should be able to obtain a ruling that in such a partial liquidation the shareholders will realize capital gain on the distribution. (See sec. 346(b).) Since the tax basis of the assets to the shareholders will be the fair market value of those assets on the date of liquidation, a subsequent sale by the shareholders (when they find a buyer) would involve little or no additional taxable gain to them. Moreover, since Zeta will not have engaged in any sales activity, the sale should be considered a sale by the shareholders, not by Zeta, under the *Court Holding* doctrine. Thus, by planning ahead, a sale of the hotel can be accomplished, in effect, with a single tax instead of the double tax initially contemplated.

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 busi-

sec. 346 ness 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.

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Use of sec. 351 and "practical merger" to acquire proprietorship

X Corporation would like to acquire the assets of *S*, a sole proprietorship, in exchange for newly issued *X* common stock amounting to 40 percent of its total outstanding stock. This transaction would not qualify as a tax-free merger since *S* is not in corporate form and the tax-free merger provisions only apply where corporations are parties.

Suppose, however, that *S* and *X* form a new corporation, *N*; *X* "practically" merges into *N* under sec. 368(a)(1)(C) in exchange for 60 percent of *N*'s stock, and *S* transfers its assets to *N* in exchange for the remaining 40 percent of *N*'s stock under sec. 351. Since the transferors, *X* and *S*, will together receive more than 80 percent of *N*'s stock, can the transfers qualify as a tax-free corporate *organization*? The service has recently held in a published ruling that such a transaction can qualify as tax free, provided there is a business purpose for the formation of *N*. For example, if *N* were formed in a different state from *X* in order to change the state of incorporation for business reasons, there would be a sufficient business purpose. (See Rev. Rul. 76-123; but, compare Rev. Rul. 68-349.)

Caution. Since this published ruling conflicts with prior published rulings, which may or may not be distinguishable, the safest bet is not to attempt such a transaction without a confirming private ruling.

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

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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.

Planning for lifo inventory in sec. 351 transactions

In Rev. Rul. 70-564, lifo inventory was transferred in a sec. 351 transaction by a corporation to a newly formed subsidiary or an existing subsidiary that did not use the lifo inventory method. It was ruled that the subsidiary does not necessarily carry over the lifo method but must make its own election, although it would carry over the parent's tax basis for inventory. The ruling stated that it was equally applicable if the transferee was an existing corporation. If the subsidiary does adopt lifo, the average-cost method would be used for the inventory acquired; that is, all the various lifo layers would merge and the average cost of the units would then be determined.

Note that this might be a way to drop the lifo method without first obtaining the consent of the IRS, and could be especially useful where the parent corporation wants to use up net operating losses. The technique envisioned would be to transfer the lifo part of the parent corporation's operations to a newly formed subsidiary. The subsidiary would adopt a fifo method of inventory. Effectively, all the lifo reserve would be included in the first year's taxable income of the subsidiary. The subsidiary would file a consolidated return with the parent.

Assuming a good business reason existed for the creation of the subsidiary, the net operating loss of the parent should be useable against the lifo reserve income generated by the subsidiary. It can be expected that the IRS would attack this transaction on several grounds, including the consolidated-return regulations; but nothing can be found in such regulations to specifically prohibit this result.

On the other hand, if the inventory is transferred in a sec. 351 transaction to a subsidiary already using lifo, the subsidiary would have to integrate the acquired lifo inventory into its own lifo layers, thus retaining the original acquisition dates and costs. (See Rev. Rul. 70-565 and *Joseph E. Seagram & Sons, Inc.*)

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

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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.

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Business purpose required for distribution

Sec. 355 provides that, if certain conditions are met, no gain or loss is to be recognized by a shareholder upon a distribution to him of at least 80 percent of the stock in a subsidiary of the distributing corporation. Although the statute is silent on the matter, the IRS and the courts agree that to qualify for nonrecognition treatment the divisive reorganization must have a business purpose. The question has been asked whether sec. 355 also requires a business purpose for the actual *distribution* or whether it is sufficient to merely show a business purpose for carrying on the businesses in separate corporations. It would appear that a business purpose for the distribution is required inasmuch as sec. 355 permits the tax-free disposition of an existing subsidiary and not merely a subsidiary resulting from a reorganization effected immediately before the distribution of the subsidiary's stock.(See *Estate of Moses L. Parshelsky* and *Henry H. Bonsall, Jr.*) *sec. 355*

One of the examples in the proposed regulations under sec. 355 illustrates the point. Corporation *T* is engaged in the manufacture of toys and candy. In accordance with the desire of the shareholders to insulate the candy business from the risks of the volatile toy business, *T* transferred the assets of the toy business to a new corporation, the stock of which is then distributed to *T*'s shareholders. The example concludes that the purpose of protecting the candy business was fulfilled by the transfer of the toy business assets and activities to a new corporation. Since it was not necessary to distribute the stock of the new corporation to *T*'s shareholders in order to accomplish the purpose, there was no business purpose for the distribution and sec. 355 is inapplicable. (See prop. regs. sec. 1.355-2(b)(2), example (3).)

The question arises whether the result in the example would have been the same had the assets and activities of the candy business, rather than those of the toy business, been transferred to a new corporation. If the stock of the new corporation remained with *T* corporation, the candy business would have continued to be subject to the risks and vicissitudes of the toy business. To protect the candy business, the distribution of the new corporation's stock to *T*'s shareholders would have been necessary and, therefore, would have had a business purpose.

But, if the transaction had been turned around as suggested, the service probably would have argued nevertheless that the business-purpose requirement had not been satisfied since the protection of the candy business could have been accomplished by reorganizing *T* Corporation in the manner described in example (3) of the regulations. However, it has been held that a divisive reorganization should not be invalidated merely because its business purpose might have been served by some other form of reorganization not requiring a stock distribution to shareholders. (See *Leslie L. Hanson.)*

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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.

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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 Lettering 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.

sec. 355 Corporate divorce: "split up" of brother-sister group through recap

Individuals *A* and *B* each own 50 percent of the outstanding common stock of corporations *X* and *Y*. *A* devotes all of his time to managing *X*, which is engaged in manufacturing electrical components, and *B* devotes all his time to managing *Y*, which is engaged in real estate construction.

After many years, *A* and *B* have had a disagreement over expansion policies and would like to part company. Each would like to own the corporation he has been active in and eliminate the ownership of the other individual. Accordingly, *A* would like to take over *X*, and *B* would like to take over *Y*. And, of course, they would like to accomplish this divorce on a tax-free basis.

Tax experts have been puzzling over this problem for many years. They have considered such approaches as a contribution by *A* and *B* of the stock of *X* to *Y*, followed by a spin-off by *Y* of the stock of *X* to *A* in exchange for all of his stock in *Y*. Another approach might be a contribution by *A* and *B* of the stock of *X* to a partnership (or corporation) with *A* and *B* as partners, followed by a distribution of the stock of *X* to *A* in liquidation of his partnership interest. Both transactions would seem to be tax-free. However, the service and the courts would apply the "step transaction" doctrine and treat both approaches as an exchange by *A* and *B* of *A*'s *Y* stock for *B*'s *X* stock, a taxable exchange. (See Rev. Rul. 77-11, citing regs. sec. 1.355-3.)

There may be an approach, however, that would accomplish *A*'s and *B*'s basic objectives; that is, (1) *A* and *B* would have complete voting control of their respective corporations, and (2) *A* and *B* would each receive all the future profits of their respective corporations. Suppose *X* and *Y* were recapitalized under sec. 368(a)(1)(E), *X* issuing nonvoting preferred stock to *B* in exchange for all *B*'s outstanding common stock in *X*, and *Y* issuing nonvoting preferred stock to *A* in exchange for all of *A*'s outstanding common stock in *Y*. The net effect of the recapitalizations is that *A* has complete control of *X* and is entitled to all future profits of that corporation (except for the preferred stock dividends), and *B* likewise has complete control and is entitled to all future profits of *Y* (except for the preferred stock dividends). Additionally, as a practical matter, where *X* and *Y* are relatively equal in value, the dividends paid by *X* to *B* and *Y* to *A* on their preferred stock would essentially offset each other.

The business purpose for such recapitalizations (i.e., that the elimination of the nonactive owner from voting control and future profits is essential to provide the proper incentive for the active owner) should be sufficient. We have recently obtained several private rulings in which such a business purpose has been held to be valid.

Care must be taken that the value of the preferred stock issued is approximately equal to the value of the common stock surrendered. If, for example, the preferred stock issued is less than the fair market value of the common stock surrendered, the service might consider that the difference represents a taxable exchange of common stock between *A* and *B*. Appraisals should be used whenever possible to support the values used to compute the exchange ratios. One must also take care to avoid the application of sec. 305(b) and (c).

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.

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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 oustanding 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

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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 sec. 355 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.

sec. 356 Contingent shares in reorganization require careful handling

The service has apparently adopted two ruling positions inconsistent with case law in respect of escrowed shares issued in a reorganization where the receipt of a portion of the shares of the acquiring corporation is contingent (e.g., on the future earnings generated by the acquired company).

On the one hand, the service considers escrowed shares to count towards satisfying the administrative requirement that at least 50 percent of the total number of shares (including the contingent shares) to be issued in the reorganization must be issued at the closing. On the other hand, in the event that any of such escrow shares are returned to the issuing corporation because of a failure to satisfy the earnings contingency, such return is considered to be a taxable event. Thus, in attempting to satisfy the administrative requirement that 50 percent of all the stock to be issued in such a contingent stock reorganization be issued at the closing, the risk is run that on a

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failure to meet the earnings contingency a tax will be imposed on the acquired corporation or its shareholders.

The service's theory is, apparently, that on placing the shares in escrow the shareholders of the acquired corporation become the beneficial owners of such shares and that their subsequent return to the acquiring corporation is a separate, taxable transaction not embraced by the original tax-free reorganization exchange. This position seems inconsistent with at least one court decision—*Estate of Evelyn McGlothlin.* In that case, a payment by the taxpayer in satisfaction of a guarantee issued in connection with a reorganization exchange of the stock of his company was held to be a part of the "purchase price" of the stock of the acquiring corporation and not a deductible loss.

These conflicting positions create even further complications in the event a contingent stock reorganization is followed by another reorganization, since the service apparently maintains the position that if all the contingent shares are not placed in escrow in the initial reorganization and the acquiring corporation in the initial reorganization is itself acquired in the subsequent reorganization, the initial reorganization (if it were of the "B" or "C" type) becomes taxable. The theory is that the shareholders of the acquired corporation in the initial reorganization are getting "boot" in the form of stock of the acquiring corporation in the subsequent reorganization.

> *Example. X* is acquired by *Y* in a "B" or "C" reorganization. The shareholders of *X* receive 50,000 shares at the closing and are to receive an additional 50,000 shares based on a five-year earnings formula. Subsequently, *Y* merges into *Z* before all of the contingent shares have been issued; the issuance of stock of *Z* to the shareholders of *X* in lieu of their right to receive contingent shares from *Y* results in the initial reorganization between *X* and *Y* becoming taxable.

This result is avoided, according to the service, if all the contingent shares are placed in escrow. Therefore, in any reorganization involving the receipt of contingent shares, it would seem advisable that the reorganization agreement authorize the creation of an escrow (even if one is not currently needed to satisfy the requirement that 50 percent of the shares be issued at the closing) so that, in the event of any subsequent reorganization involving the acquired company, the contingent shares may be issued into the escrow to avoid the result noted above. According to the service, it is not sufficient to amend the reorganization agreement when the subsequent reorganization becomes imminent in order to sec. 356 provide for an escrow. Keep in mind, of course, the problem of returning escrowed shares mentioned above.

Editors' note: Issuance of contingent shares can also be accelerated by terms of contingent-share agreement or by negotiation preceding subsequent reorganization entered into by an acquiring company without violating nontaxable treatment of the first reorganization. (See Rev. Rul. 75-237.)

The return of escrowed stock of the acquiring corporation due to the failure of the acquired corporation in a "B" reorganization to attain a specified earnings level does not result in gain or loss to a former shareholder of the acquired corporation where, under the escrow agreement, the number of shares to be returned was based upon their initial negotiated value, and the shareholder had no right to substitute other property for the escrowed shares. (See Rev. Rul. 76-42.)

In Rev. Proc. 75-11, the IRS has enumerated the conditions to be satisfied to obtain a ruling where part of the shares issued in a reorganization are placed in escrow.

See also Bogard, J., "Escrow Stock in Reorganizations; Its Issuance and Return; the Substitution of Cash in Lieu of Returning Stock," Journal of Corporate Taxation, *Autumn 1975, p. 377.*

Combining contingent and escrowed shares in tax-free acquisitions

Where it is difficult to determine the value of a corporation to be acquired for stock in a tax-free reorganization because its earnings record is short or erratic, it is common practice for the acquiring corporation to issue a fixed amount of its shares and to agree to issue additional shares if earnings meet specified levels within prescribed periods of time. Initially, the IRS took the position that contingent rights to acquire additional stock constituted "boot" when received in connection with a reorganization. However, after the Tax Court held that such contingent rights did not constitute "boot" because they could generate nothing but stock, the IRS receded from its position. (See *J.C. Hamrick.*)

Rev. Proc. 74-26, which supersedes Rev. Procs. 66-34 and 67-13, provides guidelines as to when favorable rulings will be issued in contingent-stock transactions. Six specific requirements must be satisfied, one of which is that at least 50 percent of the maximum number of shares of each class of stock that may be issued in the transaction is issued in the *initial distribution*. The reason for this requirement is not altogether clear; apparently, it is intended to fortify two other requirements that guard against overly speculative deals more nearly resembling taxable profit-sharing arrangements than tax-free exchanges—namely, the requirements that all of the stock must be issued within five years and that the maximum number of issuable shares be stated in the agreement. The 50 percent downpayment rule raises a question whether, in a "B" reorganization, for example, all the shares to be issued initially must be issued unconditionally to the exchanging shareholders.

By reason of Rev. Proc. 75-11, which amplifies Rev. Proc. 74-26, it appears that if an escrow arrangement is utilized in combination with a contingent-stock arrangement, only 25 percent of the maximum number of issuable shares must be issued outright to the exchanging shareholders initially. Rev. Proc. 75-11 recognizes that, subject to certain requirements, a portion of the acquiring corporation's stock may be placed in escrow for possible return to the corporation upon the occurrence or nonoccurrence of specified events. One of the requirements is that at least 50 percent of the number of shares of stock issued initially, *exclusive of shares subject to contingent payout at a later date*, must not be subject to the escrow agreement. In other words, if the number of shares of the acquiring corporation issued outright is at least equal to the number placed in escrow, the escrowed shares will be regarded as having been issued in the "initial distribution" within the meaning of that term as used in Rev. Proc. 74-26. Thus, if 25 percent of the maximum shares issuable is issued outright to the exchanging shareholders and 25 percent is placed in escrow subject to return to the acquiring corporation under specified conditions, the 50 percent downpayment requirement of Rev. Proc. 74-26 will be satisfied.

The willingness of the IRS to regard escrowed stock as issued is explained by other requirements of Rev. Proc. 75-11, namely, that the escrowed stock appear as issued and outstanding on the balance sheet of the acquiring corporation and that voting and dividend rights of the escrowed stock be vested in the exchanging shareholders. Where an escrow arrangement is used in making the initial distribution, the requirement that 50 percent of the stock must be issued outright to the exchanging shareholders is new; prior to Rev. Proc. 75-11, it was unclear to what extent the service would permit the consideration to be tied up in escrow.

sec. 356 Recently a corporation was willing to pay 100 shares of its stock for a new and untried business, provided a certain earnings level was met within five years. However, it was not willing to pay more than 25 shares outright. An agreement providing for the contingent issuance of 75 shares would not have satisfied the 50 percent downpayment requirement of Rev. Proc. 74-26, and placing 75 shares in escrow would not have satisfied the 50 percent requirement of Rev. Proc. 75-11. However, issuing 25 shares outright, placing 25 shares in escrow, and making 50 shares contingent appeared to satisfy the requirements of both revenue procedures.

Editors' note: The imputation of interest income on escrowed earnout shares is required under sec. 483. (See Alfred H. Catterall.)

sec. 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 recog-

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nized, 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. sec. 367

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.

Sec. 367: is notice required in a sec. 1036 exchange?

Temporary regs. sec. 7.367(b)-1(c) requires taxpayers who have realized gain or other income (whether or not recognized) from exchanges described in sec. 367(b) to file detailed notices of such exchanges with their IRS district directors. The regulations further provide that if this notice requirement is not complied with, the IRS will make a determination of whether a foreign corporation is considered to be a corporation, based on all the facts and circumstances surrounding the failure to comply.

Temporary regs. sec. 7.367(a)-1(b)(4) provides that an exchange described in sec. 367(b) include secs. 332, 351, 354, 355, 356, and 361 transactions with respect to which the status of a foreign corporation as a corporation is relevant to determining the extent to which gains shall be recognized and in connection with which there is no transfer under sec. 367(a)(1).

Temporary regs. sec. 7.367(b)-(4)(c) provides that if an exchange of stock in a foreign corporation is described in both sec. 367 sec. 354 and sec. 1036, the exchange will generally be considered to be governed by sec. 1036. This interpretation is consistent with several published rulings under "old" sec. 367, holding that no advance ruling was required for a sec. 1036 exchange regardless of whether the same transaction might also involve a reorganization under sec. 368(a)(1)(E) or (F). (See Rev. Ruls. 72-420, 66-171, and 64-156.)

The clear import of these regulations and rulings is that since sec. 1036 is not an exchange described in sec. 367, the latter doesn't apply to sec. 1036 exchanges. However, this does not seem to be the IRS's current view. In several private letter rulings recently issued (e.g., IRS Letter Rulings 7836019, 7831021, and 7835072), the IRS has taken the position that the notice requirements of the sec. 367 temporary regulations must be complied with in a sec. 1036 exchange involving a foreign corporation. The letter rulings hold that if a taxpayer fails to comply with these notice requirements, the IRS is empowered to make a determination of whether the foreign corporation should be treated as a corporation for purposes of the exchange.

In light of the fact that sec. 1036 is not an exchange to which sec. 367 applies, the IRS's position regarding the filing of notice for these exchanges seems unjustified, and it is hoped that the IRS will change its ruling position in this respect.

Clearance for outbound transfers of intangibles, i.e., corporate name, goodwill or going-concern value

Transfers of property to foreign subsidiaries under sec. 351 generally require a ruling from the IRS under sec. 367 that the "outbound" transfer is not pursuant to a plan to avoid U.S. tax. It is important that the sec. 367 request describe each item of property to be transferred in order to achieve total nonrecognition of gain. For example, in one recent case, a taxpayer organized a foreign subsidiary and obtained sec. 367 clearance for the assets that the taxpayer believed were being transferred. However, the subsidiary assumed a corporate name similar to that of its domestic parent. A revenue agent proposed an adjustment based on an outbound transfer of "goodwill" associated with the taxpayer's corporate name for which clearance had not been obtained. In view of such a possibility, it may be advisable when planning transfers under secs. 351 and 367 to request a ruling specifically covering the name to be assumed by the newly formed corporation.

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The agent's position in this case has not been tested at higher administrative levels or by the courts. Note, however, that where a domestic taxpayer has no rights with respect to use of its name in a foreign country, the "property" aspects of the agent's position is very questionable. But a determination of the property rights issue may not be easy to resolve under applicable foreign law.

Therefore, it would appear desirable to protect against such an assertion by including in the sec. 351-367 request reference to whatever intangible items there are that may be considered by the IRS to be "property" and that may also be considered transferred in the transaction. This cautious approach may even be appropriate in the mere cash incorporation of a new foreign subsidiary if it is to adopt the parent's name or will use the parent corporation's business contacts in the foreign country in its new operations. A bare clearance ruling without a determination as to whether the intangibles constitute property (or whether they have been transferred) will protect the taxpayer against a subsequent attack by the IRS on these issues.

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 *sec. 367* 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.

sec. 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 *sec. 368* 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.

Preferred stock recapitalization value freeze

In 1979 private letter rulings were issued that point out planning opportunities and potential problems associated with the preferred stock recapitalization value freeze. (See IRS Letter Rulings 7927033, 7927053, and 7932048.)

Typically, in addition to freezing the value of assets includible in an estate, the preferred stock serves the purpose of providing a steady source of income to an older shareholder. The two rulings in which noncumulative preferred stock changes to cumulative under specified situations illustrate a means of deferring dividend payments during the recipient's active employment and of guaranteeing income security to him during retirement and to his surviving spouse after his death. The ruling in which preferred dividends fluctuate with the consumer price index illustrates a means of providing income at a constant real level. It is an answer to the planning problem that preferred dividends set at the date of recapitalization are eroded by inflation.

Although the change from noncumulative to cumulative and a varying dividend rate do provide flexibility, neither of these techniques should be attempted without an advance ruling. If the change from a noncumulative to a cumulative dividend is at the discretion of the shareholder, the IRS might attempt to treat the annual failure to change to a cumulative dividend as a taxable gift to the common shareholders in an amount equal to the "passed" dividend. Further, in two of the rulings, no opinion was requested or expressed regarding the effect of a subsequent change from cumulative to noncumulative.

Presumably, the status of a flexible dividend is a valuation matter that would remain an open item until tax returns are filed and reviewed. An advance ruling, however, serves the purpose of providing assurance that the overall plan of recapitalization will not be challenged and that only questions of value remain to be determined.

Business "value capping" techniques

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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 corporation 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.

sec. 368 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.

"F" reorganizations: the different-taxable-years problem

In Rev. Rul. 75-561, the service reversed its position and held that the combination of two or more commonly owned operating corporations can qualify as a sec. 368(a)(1)(F) reorganization if the following three requirements are satisfied:

1. There must be complete identity of shareholders and their proprietary interests in the transferor and acquiring corporations;
2. The transferor and acquiring corporations must be engaged in the same business activities or integrated activities before the combination; and
3. The business enterprise of the transferor and acquiring corporations must continue unchanged after the combination.

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In addition, for the acquiring corporation to carry back losses arising after the "F" reorganization to a transferor corporation's prereorganization taxable year under sec. 381(b)(3), the acquiring corporation must be able to show that the losses are attributable to a separate business unit or division formerly operated by the transferor corporation and that the transferor corporation has income in its prereorganization taxable years against which such losses can be offset.

Rev. Rul. 75-561 did not address the problem of which accounting period should be used by the continuing corporation where the acquiring and the transferor corporation(s) have different taxable years. In the example given in Rev. Rul. 75-561, all of the corporations had calendar taxable years and the "F" reorganization was consummated on December 31. In *Associated Machine*, it was held that the acquiring and transferor corporation could be on different fiscal years without affecting the validity of an otherwise qualifying "F" reorganization. However, the court did not decide which fiscal year the continuing corporation should use after the reorganization. Note that under sec. 381(b)(1), regs. sec. 1.381(b)1(a)(2), and Rev. Rul. 57-276, the taxable year of the transferor corporation does not end when it is acquired in an "F" reorganization.

The national office of the IRS was asked to rule as to which taxable year the continuing corporation should adopt where the transferor corporation had a fiscal year ending June 30, and the acquiring corporation had a calendar taxable year. Both corporations were commonly controlled and engaged in integrated activities; that is, one corporation owned a hotel and leased it to the other corporation, which operated it. The "F" reorganization was consummated on December 31.

After extended discussions with the national office, it transpired that the service had not formulated a policy as to which accounting period is to be used when the corporations involved in an "F" reorganization have different taxable years. As an alternative solution, the transferor corporation requested permission to change its accounting period under sec. 442 from a fiscal year ending June 30 to a calendar year ending December 31. In order to dispose of the pending ruling request, the national office approved the transferor corporation's request to change its accounting period so that it would coincide with the accounting period of the acquiring corporation and thus eliminate the problem.

sec. 368 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 preexisting 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. *sec. 368*

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 oustanding 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 sec. 368 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 in doubt

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.

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"B" reorganizations involving insolvent corporations

A private ruling was recently obtained on the acquisition of stock of three related companies pursuant to a sec. 368(a)(1)(B) reorganization where two of the parties were insolvent. The ruling contained the following seven holdings usually issued for such reorganizations:

1. The acquisition by *P* of *S-1*, *S-2*, and *S-3*'s shares solely for *P*'s voting common stock, with *P* owning immediately thereafter at least 80 percent of *S-1*, *S-2*, and *S-3*, will constitute a "B" reorganization.
2. No gain or loss will be recognized to *P* under sec. 1032(a).
3. *P*'s basis for the *S-1*, *S-2*, and *S-3* shares received will be the same as the basis of such shares in the hands of their former shareholders under sec. 362(b).
4. *P*'s holding period for the *S-1*, *S-2*, and *S-3* shares includes the former shareholder's holding period under sec. 1223(2).
5. No gain or loss will be recognized to the former shareholders under sec. 354(a)(1).
6. The basis of *P*'s shares received by the exchanging shareholders will be the same as the basis of the *S-1*, *S-2*, and *S-3* shares surrendered pursuant to sec. 358(a)(1).
7. The holding period for the *P* shares will include the period during which the *S-1*, *S-2*, and *S-3* shares were held, as provided by sec. 1223(1).

In addition, the ruling also contained the following apparently standard paragraph:

> The above rulings are effective to the extent that the fair market value of the stock received is equal, in each instance, to the fair market value of the shares of *S-1*, *S-2*, and *S-3* stock surrendered. No opinion is expressed as to the tax treatment of the amount, if any, by which

> the fair market value of the shares of *P* voting common stock to be received by the exchanging shareholders, in each instance, exceeds, or is less than, the fair market value of the shares of *S-1*, *S-2*, and *S-3* stock surrendered. A determination of the fair market value of the stock received and surrendered is specifically reserved until the Federal income tax returns of the taxpayers involved have been filed for the taxable year in which the transaction is consummated.

However, since two of the corporations were insolvent, the following supplemental ruling was requested in order to clarify the effect on the reorganization if it is later determined that the values of the shares exchanged are not equal:

> If it is subsequently determined that there is inequality in the respective values of the shares exchanged which results in either an element of compensation or a gift, then only such compensation or gift will be recognized for federal income or gift tax purposes, and qualification of the proposed transaction under Section 368(a)(1)(B) will not be adversely affected.

A supplemental ruling was received as follows:

- The first sentence of the standard paragraph quoted above is deleted and the following sentence substituted:

  > Rulings (5), (6), and (7) are effective to the extent that the fair market value of the stock received is equal, in each instance, to the fair market value of the shares of *S-1*, *S-2*, and *S-3* stock surrendered.

- The above change will have no adverse effect on the prior rulings and those rulings will remain in full force and effect.

"B" reorganizations: conferring voting rights on preferred to meet control requirement

X Corporation wanted to acquire the stock of *Y* Corporation in a tax-free reorganization under sec. 368(a)(1)(B). *Y* Corporation had outstanding common stock worth $5,000,000 and nonvoting preferred stock with a face value of $250,000. The preferred stock was owned by one individual, *P*.

X was able to agree on a purchase price with the owners of the common stock but could not come to terms with *P*. Nevertheless, the acquisition was so important to *X* that it was willing to acquire the common stock and have the preferred stock remain outstanding with *P* as the owner.

However, sec. 368(c) requires, *inter alia*, that in a "B" reorganization, the acquiring corporation acquire at least 80 percent of the voting stock *and* 80 percent of all other classes of stock of the target corporation. Because of *P*'s refusal to come to an agreement, *Y* would not be able to acquire 80 percent of all *other* classes, i.e., the nonvoting preferred stock.

However, prior to the reorganization transaction, *Y* amended its corporate charter to confer voting rights on the preferred stock; *P* consented to this change. As a result, *X* Corporation could acquire 95 percent of *Y*'s voting stock and, since there would be no stock other than voting stock, there would be no "other" class of stock for purposes of sec. 368(c).

We have discussed this informally with the IRS national office, and they have suggested that they do not believe the "step transaction" doctrine would apply here and, accordingly, that the acquisition of *Y* by *X* would meet the control test of sec. 368(c) and thus qualify as a tax-free "B" reorganization.

"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 Target 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 sec. 368 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

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The first and third circuits recently reaffirmed the longstanding 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 *Chap-*

sec. 368 *man* 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 resulted.

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- 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.

Reorganizations: IRS ruling policy on certain overlapping exchanges

When a transaction that qualifies both as a sec. 351 exchange and as a "B" reorganization is followed by an "upstream" distribution of property, the national office of the IRS has taken the position that, for advance ruling purposes, the overall transaction will be tested under principles normally applicable to "B" reorganizations. One result of this position, as explained below, is that the service will not issue an advance *sec. 368* sec. 351 ruling where the subsequent distribution consists of between 30 and 70 percent of the fair market value of the distributing corporation's assets.

In one recent case where the service took this position, the shareholders of an operating company subject in part to ICC regulation wished to isolate the regulated assets in the operating company. They formed a new corporation and proposed to exchange their stock in the operating company for stock in the new corporation in a sec. 351 transaction. After the exchange, the nonregulated assets would be distributed to the new parent corporation. The nonregulated assets constituted 20 percent of the book value of the operating company's assets and 60 percent of the fair market value of its assets. No ruling had been requested as to the tax consequences of the subsequent distribution of assets.

In this context, the service believed that the overall transaction could have one of two tax consequences. Depending on the fair market value of the distributed assets relative to the fair market value of the distributing corporation immediately before the distribution, the overall transaction could be characterized as either—

1. A tax-free "B" reorganization followed by an intercompany dividend that would be eliminated on a consolidated return, or
2. A "B" reorganization followed by the "liquidation" of the distributing corporation (even though the distributing corporation continued to remain in business), thereby effecting a "C" reorganization.

Where the distributed assets constitute 30 percent or less of the fair market value of the distributing corporation, the service will follow Rev. Rul. 74-35 and issue an advance ruling that the overall transaction constitutes either a "B" reorganization or a sec. 351 exchange followed by a dividend. Where the distributed assets constitute more than 70 percent of the fair market value of the distributing corporation, the service will apparently rule that the overall transaction constitutes a "C" reorganization. (See Rev. Rul. 67-274.)

However, as a policy matter, the service is hesitant to establish a position in the middle range (i.e., 30-70 percent), fearing that such a position could lead to "taxpayer abuse." The service is apparently concerned that a position in this range would be too susceptible to differing interpretation. For example, in the service's view, some of the exchanging shareholders in such a situation could treat the overall transaction as a "C" reorganization with its attendant carryover of earnings and profits and other corporate attributes under sec. 381, while other shareholders could treat the transaction as a "B" reorganization followed by a dividend with no sec. 381 carryovers. *sec. 368*

Moreover, the service believes that some shareholders could file their returns on the basis that the distributed assets had first been received by the shareholders in a dividend distribution or a partial liquidation, and then contributed to the capital of the new corporation. In short, the service has trouble characterizing a transaction falling in this range in such a way that the characterization would have general application to all reorganization situations.

Therefore, even though the service acknowledges that the overall transaction is tax-free to the shareholders and the corporations, regardless of its characterization as a "B" reorganization followed by a dividend or as a "C" reorganization, the service's difficulty in formulating a general rule in this area and its unwillingness to consider each situation on a case-by-case basis make it advisable, in the context of securing an advance ruling, to consider alternate routes for handling the unwanted assets. In the case under discussion above, the shareholders' objective might have been achieved by the operating company's transfer of its nonregulated assets to a new corporation, followed by a sec. 355 distribution of the new corporation's stock.

"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 corporasec. 368 tion 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 comapny 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 sec. 368 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.

sec. 381 Divisive reorganizations and NOLs: Rev. Rul. 56-373 and sec. 382(a)

Corporation *X* has significant net operating loss (NOL) carryovers. The two individual shareholders have irreconcilable differences about management policies concerning the two separate businesses conducted by *X*. The individuals want to consummate a tax-free divisive reorganization whereby one shareholder will own all of one business and the other business will be wholly owned by the other shareholder. While it should be possible to qualify such a division as tax-free under secs. 355 and 368(a)(1)(D), a divisive reorganization may result in the loss of *X*'s NOL carryovers.

In Rev. Rul. 56-373, a corporation divided and transferred its assets and liabilities to two separate corporations in exchange for their stock. The corporation then distributed the stock in one of the new corporations to one of its two shareholders, and the stock in the other new corporation to the other shareholder, in exchange for both of their stock in the original corporation. The IRS ruled that the NOL carryover of the transferor could not be taken into account by either of the successor corporations in this tax-free "split up" because sec. 381 does not apply to divisive reorganizations. This approach to achieving the shareholders' objectives would thus appear to result in the loss of *X*'s NOL carryovers.

A taxpayer may attempt to avoid this result by transferring one of the businesses to a subsidiary and then distributing such stock to one of the shareholders in exchange for that shareholder's stock in *X*. However, while *X* remains viable under this approach, its NOL carryovers may nevertheless be lost. Under Rev. Rul. 56-373, the new subsidiary would apparently not succeed to any of the NOL carryovers. Moreover, sec. 382(a) may also eliminate the NOL carryovers of *X* if the 100 percent ownership of the remaining shareholder is at least 50 percentage points more than that shareholder's previous ownership. Sec. 382(a) is triggered by a purchase *or* a decrease in the amount of stock outstanding. Since *X* would probably not be considered as continuing to carry on a business substantially the same as conducted prior to the change in ownership, sec. 382(a) could apply in a context seldom associated with this provision, a divisive reorganization. (See regs. sec. 1.382(a)1(h)(7).)

The 1976 Tax Reform Act made a number of substantive changes in sec. 382(a) that are effective for taxable years beginning after June 30, 1978. Among the principal changes are an increase in the threshold level of change to 60 percentage points, substitution of a provision to scale down rather than eliminate the NOLs, and elimination of the continuation-of-business rule. Also, the '76 act added an exception to sec. 382(a) for a purchase or acquisition of stock by certain full-sec. 381 time employees. However, the '76 act retained the general rule that a decrease in the amount of outstanding stock may be an event that triggers sec. 382(a). Thus, in planning a divisive reorganization, the tax adviser must still consider the possible application of Rev. Rul. 56-373 and sec. 382(a) to the transaction.

Editors' note: The IRS has reaffirmed Rev. Rul. 56-373 in Rev. Rul. 77-133, by ruling that the NOL remains with the transferor in a "split off." Further, the Revenue Act of 1978 (sec. 368) postponed the changes in sec. 382 until June 30, 1980.

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 post-acquisition 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 post-acquisition 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. Post-acquisition 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.*, on the ninth circuit.) 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 considered. Generally, the corporation with the greater pre-merger income should be the surviving corporation so as to minimize the impact of the sec. 381(b)(3) restrictions.

NOL carryovers: application of sec. 382(b) to liquidation of subsidiary incident to reorganization

Sec. 381 provides for the carryover of corporate tax attributes from the transferor to the transferee in certain acquisitions. One of the items available to the transferee under sec. 381 is the net operating loss (NOL) of the transferor company; however, the amount of the NOL available is limited in certain circumstances.

If the acquisition of the assets of the loss company is by reason of a liquidation of a subsidiary under sec. 332, the loss carryover is available (subject to the conditions of sec. 381 (c)(1)) unless the liquidation falls under sec. 334(b)(2), if it is treated as a purchase of assets. (See sec. 381(a)(1).)

If the assets of the loss company are acquired in a transaction to which sec. 361 applies (i.e., a reorganization under sec. 368(a)(1)(A), (C), (D) in certain cases, or (F)), the loss carryover is also available (sec. 381(a)(2)), but the limitation of sec. 382(b) (change of ownership) applies.

Whether a liquidation of a subsidiary under sec. 332 occurs or whether a reorganization invoking the limitation under sec. 382(b) occurs depends upon the facts.

For example, assume that Corporation *X* plans to acquire Corporation *Y* in a nontaxable transaction. *Y* has several wholly owned subsidiaries, each of which has a NOL carryover. If *X* acquires the assets of *Y* in an "A" reorganization, the stock of *Y*'s subsidiaries thereafter is owned by *X*. If immediately thereafter, or as a part of the same transaction, the subsidiaries are liquidated into *X*, a question arises: Does the full NOL of the subsidiaries become available to *X* under sec. 381(a)(1) due to the fact that a liquidation under sec. 332 occurred, or are secs. 381(a)(2) and 382(b) applicable?

This essentially was the factual pattern in *Resorts International*, in which the Tax Court recast the transaction as a "C" reorganization rather than a liquidation under sec. 332 because the liquidation was not a "separate and unrelated transaction," there having been no intention by the taxpayer to continue the operation of the business of the subsidiary as a separate corporation. The lapse of time between the acquisition and liquidation (up to nine months in some instances) was viewed as a matter of the taxpayer's convenience.

In connection with a request for ruling, it was learned that the IRS will follow the *Resorts International* principle for purposes of advance rulings. Unless the acquiring corporation sec. 382 intends to operate the subsidiary in such a situation as a separate corporation, the service will treat the liquidation as part of the overall plan of reorganization and impose the limitation of sec. 382(b), and presumably that of sec. 383 as well (carryovers of unused investment credits, etc.).

Editors' note: The 1976 Tax Reform Act substantially modified the provisions of sec. 382. See, also, the editors' note to "Divisive reorganizations and NOLs: Rev. Rul. 56-373 and sec. 382(a)," page 224.

Deferred compensation

Corporate fringe benefit timetable sec. 401

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.

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- 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.

The pending congressional action to extend further the moratorium on Internal Revenue Service issuance of employee fringe benefit regulations (H.R. 5224) suggests extensive consideration by a closely held corporation of fringe benefit opportunities, perhaps to obtain "grandfather rights" against future, prospectively effective, regulations. In addition, the nondiscrimination rules of sec. 105(h), effective in 1980 for uninsured medical expense reimbursement plans, should be considered.

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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.

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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.)

Qualified plans: covering partnership employees

In IRS Letter Ruling 7834059, the IRS addressed the question of covering partnership employees under a corporate qualified plan. The ruling resulted from a request by *M* Corporation for a determination as to whether its proposed profit-sharing plan would meet the nondiscrimination requirements of sec. 401(a). *M*, *N*, and *O* were unrelated corporate members of a partnership. All three were classified as professional corporations and each had one full-time employee. The partnership had six full-time employees. *M* proposed to adopt a profit-sharing plan that would cover its full-time employee and one third of the compensation of each of the partnership employees. The IRS agreed that covering one third of the compensation received by the six employees would meet the participation and nondiscrimination requirements of sec. 401(a).

The IRS reached its conclusion by relying on Rev. Rul. 68-370, which holds that a corporation that participates in a joint venture is required to take into account the employees of the joint venture, and its distributive share of compensation paid to those employees, in determining whether the corporations' profit-sharing plan meets the coverage and nondiscrimination requirements of sec. 401(a). The service said that Rev. Rul. 68-370 has not been affected by the enactment of ERISA and that it may still be relied upon as authority for the conclusion that employees of a partnership or joint venture are considered employees of each member or partner for purposes of testing for coverage and nondiscrimination in contributions or benefits. Thus, being outside the controlled group and business rules of secs. 414(b) and (c) would not help corporate partners that establish plans excluding partnership employees. The IRS's position is clear: Partnership employees are considered to be employees of the respective partners for purposes of sec. 401(a)(3) and (4). Compare *Thomas Kiddie M.D., Inc.*, which held that partnership employees are not attributable to a corporate partner unless that partner has more than 50 percent control of the partnership. *sec. 401*

Editors' note: See also L. M. Garland *and the immediately preceding article. Legislation has been introduced to restrict this approach in the future.*

. . . new social security taxes affect integration rules

H.R. 10 (Keogh) retirement plans are generally required to contain a number of restrictive features that do not apply to corporate plans. In addition, if a Keogh plan includes one or more "owner-employees" (owners of more than a 10 percent interest in capital or profits), special rules apply regarding coverage, vesting, funding media, distribution of benefits, flexibility of contribution formula, excess contributions, payment of death benefits, and integration with social security.

The integration rules pertaining to plans with owner-employees are particularly restrictive. In the first place, only defined contribution plans may be integrated, and even these plans are not permitted to integrate if more than one third of the contribution in any particular year is attributable to owner-employees [sec. 401(d)(6)(A) and (j)(4)]. When a Keogh plan with owner-employees is integrated, the following method must be used:

1. Contributions on behalf of the owner-employees are reduced by the applicable self-employment tax (excluding the portion applicable to hospital insurance).
2. Contributions on behalf of common-law employees are reduced by the FICA tax (also excluding the hospital insurance portion) applicable to their wages. In the case of self-employed persons who are not owner-employees, this contribution is reduced by the comparable FICA tax that would have been applicable to their earnings had they been wages [regs. sec. 1.401-12(h)(3)].

sec. 401 The IRS has ruled that the calculation under (1) above cannot result in a combined self-employment tax and profit-sharing contribution in excess of the maximum Keogh contribution (presently $7,500) [Rev. Rul. 71-113]. The following example illustrates this restriction.

> Assume an integrated Keogh plan exists for a proprietor (*X*) who earned $80,000 during 1977; the plan provides for a contribution equal to 10 percent of earnings. The integrated contribution for *X* in 1977 would have been $7,500 − $1,155 (7% × $16,500), or $6,345, and *not* $8,000 − $1,155, or $6,845. If *X*'s earnings had been $70,000, however, the integrated contribution would have been $7,000 − $1,155, or $5,845.

The recent changes in social security rates and covered self-employment income will drastically reduce the maximum contributions that will be allowed on behalf of self-employed persons with integrated plans. Consider the following:

Year	Maximum contribution before integration	Self-employment tax	Contribution after integration
1977	$7,500	$1,155	$6,345
1978	7,500	1,256	6,244
1979	7,500	1,614	5,886
1980	7,500	1,826	5,674
1981	7,500	2,376	5,124
1982	7,500	2,559	4,941
1983	7,500	2,729	4,771
1984	7,500	2,898	4,602
1985	7,500	3,257	4,243
1986	7,500	3,437	4,063
1987	7,500	3,642	3,858

The relative cost of contributions for employees, as opposed to the self-employed, is likely to be greater in the future. As an individual employee's compensation rises, the net contribution for him (after integration) is also likely to rise because there is no maximum contribution that applies. This problem will only be avoided if Congress sees fit to raise the $7,500 maximum contribution applicable to the self-employed.

sec. 402 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).

sec. 402

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 *sec. 402* 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-'74 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.

sec. 402 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).

Planning pension distribution rollovers involving life insurance

The problem. One of the most useful planning tools introduced by the Employee Retirement Income Security Act of 1974 (ERISA) is the tax-free rollover of qualified plan distributions into individual retirement accounts (IRAs). Basically, under sec. 402(a)(5), a plan participant who receives a lump-sum distribution (as defined in sec. 402(e)(4)(A)) from a qualified plan and transfers the assets received within 60 days to an IRA recognizes no taxable income as a result of the distribution.

While the rollover provisions generally provide an excellent opportunity for tax deferral, rollover planning was, until recently, sometimes frustrated when distributions involved life insurance contracts. These situations arose when the pension plan invested in individual life insurance contracts on behalf of its participants. Terminating participants often wished to preserve the life insurance protection afforded by the policy held by the plan because of a currently uninsurable medical condition or the high current replacement cost of the policy itself. Therefore, many terminating participants requested that the plan distribute the individual life insurance contract itself (in lieu of the common procedure of distributing cash following the trustee's surrender of the policy).

sec. 402 If a life insurance contract is received as part of a lump-sum distribution, however, rollover to an IRA is not possible. In order to avoid recognition of income in rollover situations, sec. 402(a)(5) requires that all the property received in the lump-sum distribution be transferred to the IRA. However, sec. 408(a)(3) specifically provides that IRA trust funds cannot be invested in life insurance contracts. Therefore, taxpayers are effectively forced to choose between receiving the policy (rather than its cash surrender value) and qualifying for an IRA rollover.

The solution. With a minimum of planning, solution of the problem is now possible for all plan participants with the joint release by the Labor Department and the IRS of Prohibited Transaction Class Exemption no. 77-8, which is effective retroactively to January 1, 1975. Under the exemption, qualified plans may now sell individual life insurance contracts to (among others) plan participants without violating the prohibited transaction rules of Title I of ERISA [act sections 406(a) and 406(b)(1) and (2)] or the code [sec. 4975(a) and (b)]. Prior to the release of the exemption, sales of policies to participants who were "parties in interest" as defined in the Title I of ERISA (act section 406) and/or "disqualified persons" as defined in the code [sec. 4975(e)(2)] violated the prohibited transaction rules regardless of the fairness or circumstances of the transaction.

Therefore, the terminating participant who wishes to preserve the life insurance contract in force and, at the same time, roll over his distribution to an IRA should be advised to purchase the life insurance contract from the plan prior to receiving his distribution. By doing so, the participant obtains the policy and, at the same time, substitutes cash for the policy in the plan. Therefore, his lump-sum pension distribution will consist of cash and other property that may be transferred to an IRA in a qualifying rollover while he retains the favorable life insurance contract.

The purchase price. Finally, with regard to the purchase price of the policy, the exemption notes that the cash surrender value of a policy may not be equal to its fair market value. In Rev. Rul. 59-195, the service ruled that, for purposes of computing gain upon purchase, the value of a life insurance policy is its interpolated terminal reserve value at date of sale, plus premiums paid prior to the date of sale applicable to future periods. Therefore, any purchase at a price less than the valuation as determined under Rev. Rul. 59-195 could result in the recognition of income by the terminating participant. The exemption, however, merely requires that the purchase price received by the plan must at least equal the amount necessary to put the plan in the same cash position it would have been in had it cashed in the policy and made any required distribution to the participant of his vested interest. Obviously, the minimum price required by the exemption will often be less than the policy's fair market value as determined under Rev. Rul. 59-195. Therefore, the purchase price of the policy should be established under the revenue ruling rather than the exemption in order to avoid potential recognition of income.

Tax planning for distributions from qualified plans to retiring employees

Many employees are confronted with important financial decisions upon retirement. One problem in particular will often have significant tax consequences: How can credits accumulated under a qualified pension plan be withdrawn at the lowest tax cost to the employee? In light of the '76 Act, tax planning in this area is more important than ever.

The basic choice is whether credits should be withdrawn all at once or in several payments over a number of years. Three factors play an important role in that decision: (1) the total dollar amount of credits accumulated, (2) the amount and nature of other income anticipated in retirement years (i.e., capital or ordinary, taxable or nontaxable), and (3) the life expectancy of the retiree (i.e., estate tax effects on undistributed credits). Normally, the receipt of payments over a period of time would appear to result in the lowest tax to the retiree, yet certain provisions of the income tax law, estate tax considerations, and the employee's particular retirement income may suggest that a lump-sum distribution would be preferable.

Two elements greatly influence the potential tax impact of distributions to the employee: (1) the amounts attributed to employee contributions will determine the nontaxable portion of the distribution and (2) the terms of the plan will dictate whether the employee has the opportunity to choose between a single lump-sum payment or multiple payments.

Should the employee decide upon multiple payments, sec. 402(a)(1) provides that such amounts will generally be treated *sec. 402* as annuities (under sec. 72) so that the tax on this income is reduced by spreading the income over several years.

Should the retiring employee choose to receive a single lump-sum distribution, the ordinary income portion is generally subject to ten-year forward averaging at the tax rates of a single individual without reference to his nondeferred income under sec. 402(e)(1). (See also sec. 402(e)(4)(L).) This alternative may be particularly beneficial where tax preference items are large because of the capital gain potential of a distribution, or where preference items are a substantial portion of other retirement income. Regular income averaging could be employed if ten-year forward averaging isn't elected under sec. 402(e). However, the latter will generally result in a lower tax.

The '76 act makes annuity-type distributions increasingly attractive as opposed to a lump-sum payment. The minimum tax rate on preference items (including capital gains on lump-sum distributions) has increased by 5 percent and the exemption is substantially lower. The new maximum tax rules allow its application to deferred compensation and annuity payments; however, it cannot be applied to lump-sum distributions. In addition, there is a dollar-for-dollar offset of tax preference items against amounts eligible for maximum tax treatment. Also, under the '76 act estate tax changes, lump-sum distributions are no longer eligible for estate tax exclusion. (See sec. 2039(c).)

One additional item to be weighted is the effect of state and local taxes on distributions, particularly for lump-sum payments. State tax law may not provide relief similar to federal law for single payments of credits.

Lump-sum distributions: planning for ten-year averaging election

The '76 act provides, in new sec. 402(e)(4)(L), an irrevocable election to treat the entire amount of a lump-sum distribution from a qualified retirement plan as if earned after 1973. Such distributions are then treated as ordinary income subject to the favorable ten-year averaging computation under sec. 402(e)(1). Under prior law, or without the election, the amount earned before 1974 is subject to treatment as a long-term capital gain under sec. 402(a)(2).

The most obvious advantage to the election is that the current year's tax can be reduced by avoiding adverse minimum and maximum tax consequences that might accompany a relatively large long-term capital gain. However, note that this election might be beneficial even in circumstances where the election produces a *higher current year's tax.*

Specifically, such circumstances arise in situations in which an election retains for future use substantial capital loss carryovers. Such capital loss carryovers would otherwise be consumed in the current year by the capital gains portion of the lump-sum distribution.

Example. Taxpayer is *single* and has income and deductions as follows:

Wages	$45,000
Short-term capital loss	(30,000)
Pension plan distribution—assume all capital gain	38,000
Itemized deductions	(12,000)
Case 1—Taxpayer treats distribution as long-term capital gain	
Wages	$45,000
Capital gain (net of 50% deduction)	4,000
Itemized deductions	(12,000)
Taxable income	37,000
Total tax [sec. 1(c)]	$12,790
Case 2—Taxpayer makes special election under sec. 402(e)(4)(L)	
Wages	$45,000
Capital losses	(1,000)
Itemized deductions	(12,000)
Taxable income	32,000
Regular tax [sec. 1(c)]	10,290
Form 4972 tax	5,300
Total tax	$15,620

Conclusions

Taxpayer saves $2,830 in the current year *without the election,* but $29,000 in short-term capital loss carryovers are preserved *with the election.*

The capital loss carryover can save up to $20,300 if applied against short-term gains or, generally, at least $7,250 if applied against long-term capital gains. In either case, it is more than the current year's tax saving by claiming the sec. 402(e)(4)(L) election. All this demonstrates that lump-sum distribution tax planning must take this into account.

sec. 402

Direct rollovers by owner-employee from Keogh to corporate plan

In recent years, rollovers from Keogh plans to qualified corporate plans have been rare and, as a result, the number of inactive Keogh plans remaining in existence after corporate plans have been adopted has continued to grow each year. The reason for this is simple—most practitioners are not aware that such rollovers are allowable under current law.

By way of background, the Employee Retirement Income Security Act of 1974 (ERISA) provided specific rules with respect to rollovers. While the general concept of rollovers was not new with ERISA, the act gave vitality to this seldom-used tool. The rollover concept was a well-kept secret before ERISA, and only the most sophisticated tax practitioners were aware of its existence.

However, ERISA itself did not specifically provide for rollovers from Keogh to corporate plans. And because the concept was never well known, it is easy to understand why such rollovers are not used any more now than they were before ERISA.

With certain limitations, ERISA provides for rollovers from one individual retirement account (IRA) to another, from one qualified plan (corporate or Keogh) to an IRA, and from one qualified plan to another either directly or indirectly through an IRA conduit.

With respect to a rollover from one qualified plan to another, the distribution must either be a lump-sum distribution or as a result of a termination of a plan. The rollover must be accomplished within 60 days after the distribution, only amounts representing employer contributions may be rolled over, and the entire distribution, less employee contributions, must be rolled over in kind. Under sec. 402(a)(5), the rollover of a distribution from one qualified plan to another can be a rollover of *a common-law employee's* account in a Keogh plan to a corporate plan, and the rollover can be made directly or through a conduit IRA. It is clear, however, that under the language of sec. 402(a)(5), when an actual distribution is made from a Keogh plan to *an owner-employee,* sec. 402 prohibits a rollover, either directly or indirectly, to a qualified corporate plan. (See also prop. regs. sec. 1.402(a)-3(c)(1).) If, however, the assets are not distributed to the owner-employee but instead are transferred directly from the Keogh plan to a corporate plan, it appears that such transfer might constitute a tax-free rollover. Sec. 402(a)(5) does not apply to this situation since there is not a distribution to the employee, and the pre-ERISA law should apply.

In Rev. Rul. 71-541, the IRS gave its approval to this type of rollover. The ruling covered a rollover from a Keogh plan to a corporate plan where a partnership was terminated and its business was transferred to a corporation. The rollover included accounts of both owner-employees and common-law employees. The corporation's plan provided that (1) the trustee would be a bank, (2) separate accounts would be maintained for funds transferred on behalf of each former owner-employee, (3) no payment could be made before the former owner-employee attains age 59½ or becomes disabled, and (4) the distribution of a former owner-employee's interest in such an account must begin prior to the end of a taxable year in which he attains age 70½. The ruling points out that under sec. 401(d), each of these four provisions must be included in a corporate plan that includes former owner-employees as participants.

In addition, Rev. Rul. 71-541 provides that the rollover does not constitute a distribution affected by the premature distribution rules of sec. 401(d), and Rev. Rul. 67-213 provides that the amount transferred is not subject to the 10 percent limitation on employee contributions.

While it is not entirely certain that Rev. Rul. 71-541 will continue to be followed in light of ERISA, a knowledgeable official of the service has indicated that it will be. Many of the inactive Keogh plans could be terminated if this rollover procedure is still available. This would decrease administrative costs to both the taxpayer and the IRS. Until the service publishes such position, however, it would probably be advisable to obtain an advance ruling prior to attempting this type of rollover.

IRA rollovers allowed after age 70½

Several IRS letter rulings (e.g., IRS Letter Ruling 7919045) have allowed employees over age 70½ to roll over lump-sum distributions from qualified employee trusts into individual retirement accounts (IRAs) without the immediate recognition of income. These rulings reverse an earlier ruling position (see IRS Letter Ruling 7826117) that the recipient trust of such a rollover does not qualify as an IRA if the trust is established after the taxable year in which a participant attains age 70½.

sec. 402

Qualification of the recipient trust as an IRA is essential, since sec. 402(a)(5) provides that only an IRA or other eligible retirement plan may receive a lump-sum distribution from a qualified trust as a tax-free rollover. Otherwise, sec. 402 requires immediate taxation to the recipient of such a distribution.

At issue in these rulings is satisfaction of the sec. 408(a)(6) provision (the so-called minimum-distribution rule) that a recipient trust is not an IRA unless the trust instrument requires that distributions commence not later than the close of the taxable year in which the participant attains age 70½. IRS Letter Ruling 7919045 found this requirement to be satisfied if annual distributions commence in the taxable year of the rollover; however, distributions in the rollover year must at least equal the balance in the IRA at the beginning of the year (i.e., the rollover) divided by the participant's life expectancy at age 70½ reduced by the number of whole years elapsed since attainment of age 70½. (See prop. regs. sec. 1.408-2(b)(6)(v).)

Such distributions also avoid the 50 percent excise tax of sec. 4974, which is imposed to the extent that any amount actually distributed during any taxable year is less than the minimum amount required to be distributed (i.e., the amount required under sec. 408(a)(6)).

In contrast, IRS Letter Ruling 7826117 held that an IRA may not exist without distributions in the age 70½ year (an impossible requirement since the trust was not yet in existence) and that there was "congressional intent" not to permit the tax-free accumulation of income after retirement through an IRA. However, IRS Letter Ruling 7919045 held that since the rollover of funds into an IRA merely postpones the imposition of tax on a distribution and does not create a deduction for the amount rolled over, any policy to bar contributions after age 70½ is not violated.

Delayed lump-sum distributions may satisfy the five-year participant rule

Sec. 402 provides for very favorable tax treatment of a lump-sum distribution from a qualified plan, but sec. 402(e)(4)(H) limits much of that favorable tax treatment to employees who have been participants in the plan for five or more taxable years before the taxable year of distribution.

It has been suggested that the trust's retention of the employee's balance after his termination until completion of the five-year period would be sufficient to satisfy sec. 402(e)(4)(H). The use of the term "participant" in sec. 402(e)(4)(H) compared with the use of the term "active participant" in sec. 219(b)(2)(A) might support this interpretation. However, the law is unclear and the proposed regulations are not helpful. (See prop. regs. sec. 1.402(e)-2(e)(3).) It is understood that the latest position of the IRS National Office is that an employee who has separated from service may *not* satisfy the five-year requirement as a result of the fiduciary's delay of his distributions. See the information letter from A.D. Fields (chief, employee plans technical branch), reversing the position taken in an earlier information letter [BNA Pension Reporter no. 166, December 5, 1977]. *sec. 402*

The scope of the fiduciary's responsibility is another aspect of the problem that should be considered before this issue is resolved (which is not likely to be in the near future). Some attorneys are suggesting that failing to delay a distribution for a period that would satisfy the five-year requirement may, in some instances, be a violation of the requirement that the plan be administered solely for the benefit of the participants and beneficiaries.

Pension payment planning may produce permanent tax benefits this year

sec. 404

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 Revesec. 404 nue 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.

Timing contributions to a qualified employees' plan

Prior to ERISA, sec. 404(a)(6) provided that if an accrual-basis taxpayer made a qualified plan contribution for the preceding taxable year by the time the return for that year was due (including extensions), the payment would be deemed to have been made in the preceding year. Rev. Rul. 66-144 holds that this rule applies regardless of when the return is actually filed. In the ruling, a calendar-year taxpayer obtained an automatic three-month extension for filing, filed the return, and paid all taxes due by March 15, but made the payment to the trust on June 1. The IRS held that under sec. 404(a)(6) the contribution was deemed made in the prior year.

An analysis of this ruling raises some additional, interesting questions:

- In view of the ERISA amendment to sec. 404(a)(6), does Rev. Rul. 66-144 now also apply to cash-basis taxpayers?
- Since an extension is automatic upon the filing of Form 7004, does such form actually have to be filed to obtain the grace period for making the contribution to the plan?
- Would the ruling also apply to a taxpayer that incurred a net operating loss (to be carried back) for the year in which the payment is deemed made?

It would appear that the answer to all these questions is yes:

- ERISA amended sec. 404(a)(6) to extend the availability of the grace period to both accrual- and cash-basis taxpayers. Sec. 404(a)(6) now reads, "A taxpayer shall be deemed to have made a payment on the last day of the preceding taxable year if the payment is on account of such taxable year and is made no later than the time prescribed by law for filing the return for such taxable year (including extensions thereof)." Rev. Ruls. 76-28 and 76-77 and TIR 1334 (January 8, 1975) do not refer to Rev. Rul. 66-144, but logic dictates that a cash-basis taxpayer should be able to rely on Rev. Rul. 66-144.

sec. 404

- It is clear that Form 7004 must be filed to obtain the benefit of the grace period. Rev. Rul. 56-674 provides that even though the extension is automatic, it is not permitted as a "matter of right," and, thus, the taxpayer must follow the prescribed procedures, including filing Form 7004.
- Although the example in Rev. Rul 66-144 concerns a taxpayer with a tax liability for the taxable year, the ruling is not limited to such taxpayers. For a taxpayer with a NOL and cash-flow problems, there appears to be a tax-planning opportunity to file a return as early as possible, file Form 1139 (application for refund) promptly, file Form 7004, and postpone making the contribution to the employees' plan until the latest allowable date, in anticipation of receiving the refund before such date.

Keogh plans: old plans and new partnerships

An often overlooked fact when a sole proprietor takes in a partner is the effect that this organizational change has on the proprietor's Keogh plan. In many cases, the original proprietor (now a partner) continues to make a contribution to his plan just as he had in the past, oblivious of the fact that the Keogh plan now must be that of the employer partnership. The IRS has held that the contribution in such case is not deductible since the partnership is considered to be the employer of each of the partners and an individual partner cannot establish a qualified plan with respect to his own services to the partnership [Rev. Rul. 67-3]. Thus, where a new partnership is formed and the original sole proprietor wishes to continue his personal Keogh coverage, the partnership should adopt the former plan or an entirely new one.

It is also important that, once the partnership plan is established, all contributions to it are made by the partnership on behalf of the partner rather than by the individual partner himself. In order to be deductible, regs. sec. 1.404(e)-1 requires that the contribution must be paid by the partnership on behalf of the partner during the taxable year of the partnership or by the time prescribed by law for filing the return for the taxable year (including extensions thereof). The partner's deductible contribution on his personal return is the distributive share of the deduction allowed the partnership under sec. 404 that is attributable to the contributions made on his behalf sec. 404 under the plan. Therefore, a contribution made directly by the partner to the plan would not be deductible.

The temptation to make the contribution individually can be especially strong for the calendar-year partner of a fiscal-year partnership. Since the deduction is not actually claimed until the partner's individual return is filed, one could easily be misled into thinking that the contribution could be made by the self-employed individual at any time up to the time his personal return is filed.

Incorporating may increase deductions for H.R. 10 plan contributions

Incorporating one of two sole proprietorships or partnerships and electing subchapter S status for the corporation may increase the amounts that can be contributed to two qualified retirement plans.

In the case of a sole proprietor of more than one proprietorship, or a partner of more than one partnership, or a combination of both, each such business may have an H.R. 10 retirement plan. Contributions on behalf of the owner can be made to each of the plans. However, in the case of a self-employed individual, the deduction for contributions for his/her benefit is limited to the lesser of $7,500 or 15 percent of total earned income from those businesses with plans [sec. 404(e)(2)].

Similar limitations apply in the case of a more-than-5 percent shareholder of a corporation that has elected subchapter S status [sec. 1379(b)(1) and (d)]. However, contributions by the unincorporated business(es) and the corporation(s) are not combined in applying these limitations [secs. 404(e)(2), 401(c)(1)]. Therefore, larger total contributions can be made by having one plan in an unincorporated business and another in a subchapter S corporation.

Example.

	Proprietorship	Partnership
Self-employment income of owner-partner	$50,000	$50,000
Total deductible contribution, to be allocated to each business	$ 7,500	

Assume the partnership is incorporated as a subchapter S corporation and each former partner is a more-than-5 percent shareholder.

sec. 404

	Proprietorship	Subchapter S corporation
Self-employment income or salary	$50,000	$50,000
Maximum deductible contribution (15% of earned income up to $7,500)	7,500	7,500
Total deductible contribution	$15,000	

H.R. 10 plans: use of U.S. Retirement Plan Bonds after age 70½

sec. 405

Qualification of a trust under sec. 401(a)(9)(A) requires that a self-employed retirement plan (H.R. 10 plan) expressly provide for the distribution of an employee's entire interest not later than the year in which he attains age 70½ (or, in the case of a common-law employee, the year in which he retires, whichever is later). This requirement does not preclude contributions from being made on behalf of an owner-employee who has already attained age 70½, provided that the contribution is distributed to him in the same year in which it is made [regs. sec. 1.401-11(e)(7)]. In effect, the owner-employee will generally be taxed on his post-70½ benefits as earned.

If, however, the distribution is made in the form of U.S. Retirement Plan Bonds, the post-70½ distribution requirement may be satisfied with no taxable income recognized. Distribution of the bonds is not a taxable event and taxation may be deferred until the bonds are redeemed by the employee [sec. 405(d)(1)].

U.S. Retirement Plan Bonds have been issued by the Treasury Department since 1962 and are available for investment by pension and profit-sharing plans qualified under secs. 405 and 401. The bonds have an indeterminate maturity date. They may not be redeemed prior to attaining age 59½ (except for death or disability) and cease to bear interest 60 months following the date of death of the registered owner. The interest yield is fixed and relatively low (presently 6 percent, but bonds issued during the 1960s still yield only the indicated 3.75 percent, compounded semiannually). Interest is paid only upon redemption and is not subject to state or local income taxes. The bonds are registered in the name of an individual (or in beneficiary form) and are nontransferable. (See sec. 405(b).)

sec. 405 Purchase of the bonds results in immediate vesting in the employee. There is no partial vesting under a qualified bond purchase plan. Redemption of U.S. Retirement Plan Bonds results in ordinary income [sec. 405(d)]. The lump-sum distribution rules for capital gains treatment or ten-year forward income averaging cannot be applied to retirement bond redemptions. However, redemption may be spread over any length of time. Since the bonds have an indeterminate maturity date, redemption may be intentionally postponed until after death, in which case they will be taxable as income in respect of a decedent, in accordance with sec. 691.

A qualified bond purchase plan must be in written form if a deduction under sec. 405(c) is to be allowed. (See *N. H. Jones.*) The filing of a properly completed Form 4578 (Application for Determination of Bond Purchase Plan) will constitute a written plan for this purpose. Form 4578 is a relatively uncomplicated 1½-page form that permits a plan whose only investment is in retirement bonds to avoid the use of a trust to hold the participants' interests. A retirement bond plan may also be established under a separate document, or the trustee of an existing pension plan may purchase these bonds.

For owner-employees under age 70½, or for those who have common-law employees, the immediate vesting, low yield, and inflexibility of U.S. Retirement Plan Bonds make them an unattractive funding medium. To avoid these drawbacks, a trust may be used in conjunction with a bond purchase plan so that the flexibility of trust finding may be combined with the benefit of a tax-free distribution through bonds.

Under this arrangement, the H.R. 10 plan is funded in the usual manner through a trust or a custodial account. Prior to distribution, the plan allows the participant an option to have the trustee apply the amount allocated to him toward the purchase of U.S. Retirement Plan Bonds to the extent permitted within a single year (currently $10,000 in the name of each individual). These bonds will eventually be distributed to the participant in satisfaction of his interest.

If the option is exercised over several years, the participant may arrange to receive his entire distribution tax free by having the maximum $10,000 of bonds purchased for his account each year, until his entire interest is in retirement bonds. Any portion of his distribution that is not in retirement bonds would be taxable and eligible to qualify as a lump-sum distribution.

ERISA-prohibited transaction exemption: some DOL guidelines

sec. 408

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 currently pending, 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).

Integration for simplified employee pensions: a bonus for nonowner partners?

Beginning in 1979, a new qualified retirement device, the Simplified Employee Pension (SEP), defined at sec. 408(k), is available. Under a SEP, an employer can make deductible contributions to the individual retirement accounts of qualifying employees. As the law is now written, partners with a less-than-10 percent partnership interest (nonowner-employees) are afforded a significant advantage over other participants. Here's how it works.

sec. 408 Even though contributions may not discriminate in favor of qualifying employees who are officers, shareholders, or self-employed or highly compensated individuals, a SEP may be integrated with social security, thereby reducing contributions by the amount of social security tax paid by the employer. The effect of integration is to weight the allocation of SEP contributions in favor of highly compensated individuals. The maximum contribution, per employee, is the lesser of 15 percent of the first $100,000 of compensation or $7,500. The social security tax for 1979 is 6.13 percent of the first $22,900 of compensation ($1,404 maximum). Consequently, the maximum allocation, using integration, an employer can make on behalf of a common-law employee is $6,096. Contributions on behalf of an owner-employee (sole proprietor or more-than-10 percent partner) must be reduced under sec. 408(k)(3)(D) by the amount of his or her self-employment tax ($1,855 maximum). Therefore, the maximum contribution, using integration, on behalf of an owner-employee is $5,645.

Curiously, the new law is silent as to the treatment, for integration purposes, of self-employed individuals who are not owner-employees. Since no social security taxes are paid on behalf of such individuals by employers, the code does not prohibit (and therefore permits) contributions of up to $7,500 for partners with a less-than-10 percent interest, under an integrated SEP.

Does this mean that the integration rules under SEPs, in addition to favoring highly paid individuals, also provide an extra bonus for partners with a less-than-10 percent interest? Both the statute and the committee report are specific in applying the rule to "owner-employees" without reference to the broader term, "self-employed individuals." It is unclear whether this distinction was intended. However, when the regulations are promulgated, the service may take the position that contributions for nonowner partners under integrated SEPs will have to be reduced either by the amount of self-employment taxes paid, or the amount that would have been paid as social security taxes had the partner been a common-law employee. In the meantime, it appears that the letter of the law allows a tax break for these individuals.

Direct IRA rollovers can be made more often than once in three years

When Congress created the Individual Retirement Account as part of ERISA in 1974, it was apparently concerned with providing IRA participants with some flexibility in choosing the type of vehicle in which the proceeds could be invested. Accordingly, sec. 408(d)(3) provides that distributions from an IRA may be made to the participant without tax consequences, provided that such participant reinvests the same money or property received into another qualifying IRA within 60 days. Sec. 408(d)(3)(B) specifically limits the number of times such transfers can be made to one every three years. The committee reports state that the purpose of the restriction is "to prevent too much shifting of investments under this provision." *sec. 408*

The service has for many years held that a direct transfer of funds between the trustees of two plans will not cause the amounts to be considered distributed or made available to the participants [Rev. Ruls. 55-317, 55-368, and 68-160]. If, however, the funds are transferred to a participant, even though immediately transferred to a new trust, the distribution will be taxed unless the rollover provisions apply [Rev. Rul. 73-56].

A recent IRS letter ruling, 7737009, deals with a direct transfer of funds between trustees of Keogh (H.R. 10) plans in which a partnership is the employer. The ruling concludes, using as its authority the numerous published revenue rulings, that such a transfer will not be considered as distributed or made available to the participant.

Note that all of the published authority seems to deal with transfers between qualified plans. However, the theory should be the same with respect to an IRA, since sec. 408(d) taxes a distribution from an IRA when paid or distributed.

Checklist on employee participation in qualified plan

sec. 410

In the case of large pension plans, the professional administrator can attend to the (too) many requirements of ERISA; but the employer who is his own administrator runs the risk of disqualifying his plan through an unintentional oversight.

For instance, even after a plan has been approved, the code [sec. 410(a)(1)] states that "[a] trust shall not constitute a qualified trust" unless *every* employee is admitted as a participant to the plan after he has—

1. Attained the age of 25, or
2. Completed one year of service (three years in the case of a Keogh plan where the employer is a participant [secs. 401(d)(3), 410(a)(1)(B)(i)], whichever is *later*.

sec. 410 Once an employee has met these requirements, he must be made a participant of the plan no later than the *earlier* of—

1. The first date of the first plan-year beginning after the date he satisfied the requirements, or
2. The day six months after the date he satisfied the requirements [sec. 410(a)(4)].

Example 1. An employer has a Keogh plan whose year begins January 1. Employee *A*, born on May 9, 1949, was hired on May 15, 1973. *A* became 25 years old on May 9, 1974, but didn't complete three years of service until May 15, 1976. She became eligible for participation in the plan on May 15, 1976 (the later date) and must be admitted no later than November 15, 1976 (six months later).

Example 2. Employee *B*, also hired on May 15, 1973, was born on July 14, 1951. She completed three years of service on May 15, 1976, but didn't become 25 years old until July 14, 1976. She became eligible for the plan on July 14 (the later date) and must be admitted to the plan on January 1, 1977 (the first day of the first plan-year beginning after the date she satisfied the requirements).

The following questionnaire illustrates the information needed to determine when an employee must be added to the plan. For a calendar-year plan, the form must be prepared as of June 30 and December 31 each year. Column headings are as follows in the case of a Keogh plan:

- Name of employee
- Date employed
- Date born
- Age 25:
    - Yes
    - No
- 1,000 hours of service (years of service):
    - First 12 months:
        - Yes
        - No
    - Second 12 months:
        - Yes
        - No
    - Third 12 months:
        - Yes
        - No
- Date qualified
- Date admitted to plan

Under "date qualified," above, should be entered the date of the employee's twenty-fifth birthday or the date when he completed three years of service—whichever is *later*. If the employee is qualified, under "date admitted to plan," above, should be entered the date when the next plan-year begins or the date six months after the date the employee qualified—whichever is *earlier*. *sec. 410*

Pensions: minimum funding when due date falls on Saturday, etc. **sec. 412**

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).)

Sec. 415: sole proprietorship and successor corporation as commonly controlled businesses **sec. 415**

For purposes of the sec. 415 limitations on benefits and contributions under qualified plans, commonly controlled businesses are considered a single employer and contributions to all defined contribution plans are aggregated. Furthermore, all such plans must have the same limitation year. (See Rev. Rul. 75-481, modified by Rev. Rul. 76-318.) An IRS district office recently advised that a sole proprietorship and a controlled corporation were not commonly controlled businesses for purposes of these limitations in the following circumstances.

The individual incorporated his sole proprietorship busisec. 415 ness on January 1, 1977. As a cash-basis taxpayer, he reported income attributable to 1976 in 1977. The corporation and its retirement plans (profit-sharing plans and money-purchase pension plans) adopted a fiscal year ending June 30. The IRS stressed the references in regs. sec. 11.414(c)-2 to controlled organizations which are "conducting trades or businesses." It reasoned that regardless of the common control, the sole proprietorship and the successor corporation are two distinct entities rather than a controlled group because of the cessation of business by the sole proprietorship.

Accounting periods and methods of accounting

Does loss in a preceding year preclude automatic change of corporation's accounting period?

sec. 442

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 a 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 a NOL deduction. (See Rev. Rul. 65-163.)

sec. 442

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. *sec. 442*

Planning may save ten-year spread for accounting method change required on merger

sec. 446

Rev. Proc. 70-27 provides that income resulting from a change of accounting method (or practice) may be reported over a ten-year period, rather than bunched in income for the year of change. Permission to change the accounting method (and to use the ten-year spread) must be requested within six months of the beginning of the taxable year (or nine months upon showing of good cause, e.g., extreme hardship).

When a corporation is acquired by another corporation in certain tax-free exchanges, sec. 381(c)(4) and the related regulations generally require the same method of accounting to be used in the future for both corporations; thus, one corporation may have to change its accounting method. Where such a change is required, the regulations make *no* provision for any possible ten-year spread of the bunched income resulting from the change. The Treasury is apparently unwilling to rule that the ten-year spread is available in this circumstance.

Thus, where a merger of two corporations is being considered, it may be advisable to *voluntarily* request permission for a change in the method of accounting of one of the corporations during the first six months of its taxable year, and to request the ten-year spread treatment. After the merger occurs, the ten-year spread will still be available, and the bunching-of-income problems can be avoided.

Similarly, if the proposal to merge originates in the latter part of the year, it may be advisable to defer the effective date until the first month of the succeeding year, so that the voluntary change can first be requested.

Timing a change of accounting method to reduce adjustment

X Corporation has been using an incorrect method of valuing its inventory for the last 10 years. Its corrected inventory, presently reflected at $410,000, should be $600,000. *X* anticipates a sharp inventory reduction in 1977. It might apply to the IRS to change its method of accounting for inventory for sec. 446 the calendar year 1976. The commissioner will likely grant permission to make the change, and will require *X* to spread the adjustment ($190,000) over a ten-year period. However, the ruling would also provide that if inventory value should drop more than one third (i.e., $200,000) in a single year from the date-of-change level, the entire adjustment of $190,000 would be accelerated and included in income in such year (e.g., 1977).

Planning hint. Since a substantial inventory drop is anticipated, it would be best to wait until the following year before applying for a change of method. For example, suppose *X* waits until 1977 to apply. At such time inventory has dropped to $200,000, and even under the correct method would be only $300,000. By waiting a year to make the change, *X* will have an adjustment of only $100,000 and be able to spread that adjustment over a ten-year period, thereby avoiding acceleration of the adjustment.

Editors' note: For changes required by excess inventory as defined in Thor Power Tool Co., *see "Inventories: IRS seeks to implement* Thor," *page 278.*

Negative adjustment from change of accounting method creating NOL

T Corporation received a ruling approving a change from the accrual to the cash method of accounting. As a result of such change, income that was previously accrued would again be included at the time of receipt under the newly approved cash method. In order to avoid the adverse effect on taxpayers of such a "doubling up" of income, the rulings division provides for "negative" adjustments. For example, if, at the end of 1974, *T* had income accrued but not yet received of $100,000 and expenses accrued but not yet paid of $70,000, there would be $30,000 of income that would be again realized by *T* in the year of change (1975) under the cash method. Accordingly, the rulings division would allow a negative adjustment of $30,000. This adjustment would be spread over the lesser of ten years or the period the taxpayer had been using the accrual method.

If the year of change (1975) should result in a net operating loss (NOL) (without regard to amortization of the negative adjustment but taking into account the "doubled up" income), then the ruling requires *T* to notify the rulings division of that fact. The IRS will not revoke the ruling. However, it will require that amortization of the negative adjustment begin not with the year of change but with the year following the year of change. In other words, the full negative adjustment can be taken, but amortization of the adjustment will begin a year later. The rulings division believes that should there be a NOL, the service does not want the amortized portion of the negative adjustment to be added to that loss, thereby allowing a carryback and immediate realization of that amount; at the same time, the "doubled up" income has no tax effect since the loss absorbs it. *sec. 446*

However, it is not clear what the result would be if amortization of the negative adjustment *creates* a NOL; for example, if *T* had $1,000 of taxable income before amortization of the negative adjustment, the adjustment would eliminate that income and in addition generate a NOL of $2,000. The rulings division does not seem to clearly require that *T* notify them in such event; yet, the same principle would seem to apply and notification would seem to be called for.

The same principles would also appear to apply to *any* change of accounting method that requires a negative adjustment in order to avoid a doubling up of income—for example, a change from the method of accruing contract "retainages" to the method of deferring such amounts until the project is completed and accepted.

When is a contract "completed" for purposes of long-term contract reporting?

sec. 451

Early in 1976, the long-term contract regulations were substantially revised by TD 7397. Prior to this revision, the regulations provided that income from long-term contracts is to be "reported for the taxable year in which the contract is finally completed and accepted" [regs. sec. 1.451-3(b)(2)]. The new regulations include a similar rule that, except in the case of a dispute, a "long-term contract will not be considered 'completed' until final completion and acceptance have occurred." However, the new regulations provide that a contract may not be intentionally delayed for the purpose of deferring federal income tax, and they make it clear that a subcontractor's contract with the primary contractor is completed when the subcontractor's work is completed and the job has been accepted by the primary contractor [regs. sec. 1.451-3(b)(2)].

Although the regulations have always provided that there

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must be *final* completion and acceptance, the service has sought to impose a "substantially completed" test. While the application of a substantially completed test had been generally supported by the Tax Court (see, e.g., *Ehret-Day Co.*, *Nathan Wohlfeld*, and *Luther G. Turner*), it has been rejected by the courts (see, e.g., *E. E. Black Ltd.*, *Thompson-King-Tate, Inc.*, and *Frank L. King, Jr.*). In a recent case that was decided with respect to a year to which the 1957 long-term contract regulations applied, the Tax Court, although making reference to the substantial completion test of *Ehret-Day*, held that under the facts a contract that was over 98 percent complete was not finally completed and accepted as provided in the regulations, nor was it substantially completed. (See *F.D. Rich Co.*)

The long-term contract regulations were reproposed two times. The first notice of proposed rule-making provided that the term "completed" means finished to the point where the remaining costs to finish the contract are not significant in relation to amounts already incurred. For this purpose, remaining costs would not be considered significant if they equaled 5 percent or less of the total costs already incurred. (See prop. regs. sec. 1.451-3(b)(2).) The next version of the proposed regulations dropped the 5 percent test and instead provided the following:

> The term "completed" means finished at least to the point where—
>
> (i) The remaining costs required to entirely finish the contract are insignificant in comparison with the amounts already expended with respect to such contract;
>
> (ii) No substantial dispute exists as to the acceptability of the work performed on the portion finished; and
>
> (iii) The contract has been completed in all respects which are essential for the basic utility of the subject matter of the contract.

The next notice of proposed rulemaking, issued on November 21, 1972, abandoned all of the prior attempts to impose a substantial completion test, returning to "final completion and acceptance" except in the case of an intentional delay or a dispute. The final regulations adopt the latter rules, adding the special rule concerning subcontractors.

When a contract has been finally completed and accepted is, of course, a factual determination to be made on a contract-by-contract basis. While the service may have concluded that a "remaining costs" test and a "basic utility" test would present certain interpretative and administrative difficulties, it remains to be seen whether IRS agents will abandon the "substantially complete" test in applying the final long-term contract regulations. *sec. 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.

Sec. 453: sale and redemption of family corporation stock integrated

sec. 453

In many cases, a purchaser of stock will find it desirable to acquire a corporation in a manner that enables the acquired corporation's assets to be used to satisfy part of the purchase sec. 453 price—a transaction sometimes referred to as a "bootstrap." (See *Ferm R. Zenz.*)

In such an arrangement, the seller generally sells a portion of his stock to the purchaser and thereafter the corporation redeems his remaining shares. If the stock sale or the redemption is intended to qualify for installment sale treatment, it is important to consider whether the 30 percent down payment limitation of sec. 453 is applied to the sale and redemption considered together or is applied to each separately.

In *Chick M. Farha*, the court held that the transactions had to be considered together and therefore the sale of the stock did not qualify for installment sale treatment. The facts were particularly unfavorable to the taxpayer due to significant differences between the redemption price per share and the selling price per share (i.e., the seller apparently attempted through subterfuge to maximize the cash received in the year of sale). The Tax Court decision contains particularly strong language to the effect that the sale and redemption must be considered as one transaction for purposes of sec. 453. While such a position may be subject to argument since the form of the transaction is that of two sales to two separate purchasers, the precedent of *Farha* cannot be ignored for planning purposes.

Wraparound mortgages in installment sales

Current restrictions on the money supply have accelerated the use of wraparound mortgages in real property sales. Apart from tight money, there may be tax reasons for employing this financing technique.

A wraparound mortgage is a form of mortgage financing in which the seller remains liable for existing mortgages on the property and the buyer agrees to be liable to the seller for the entire purchase price of the property sold, regardless of the amount of the seller's mortgage. The buyer's payments are sufficient to cover payments by the seller on his existing mortgage. Of course, wraparound mortgages are possible only when the seller is willing to remain liable for the balance of his existing mortgage in exchange for a wraparound mortgage on the property sold. He may be willing in the circumstances discussed below.

A seller who wants to obtain the benefits of the installment sales provisions of sec. 453 may want to use a wraparound mortgage, particularly when the excess of the existing mortgage over his basis in the property is large enough to preclude compliance with the installment sale requirement that payments in the year of sale do not exceed 30 percent of the selling price [regs. sec. 1.453-4(c)].

Situations may occur where both parties to a real estate sale could benefit from the assignment of a larger portion of the purchase price to interest. When a wraparound mortgage is used, the buyer is obligated to the seller for the entire purchase price of the property, and the parties are free to negotiate an appropriate rate of interest on the buyer's obligation. This presents an opportunity for tax planning. By using a wraparound mortgage and maximizing the allocation of interest, the buyer can obtain a larger interest deduction. To the extent that gain on the sale is treated as ordinary income to the seller, it may be advantageous for him to realize as much as possible of the proceeds as interest (investment) income for the purpose of computing the limitation on deduction of investment interest under sec. 163(d). Obviously, when planning this aspect of a wraparound transaction, the parties must be cognizant of various state surtax requirements on interest income as well as other potentially deleterious factors.

As provided in regs. sec. 1.453-1(b), the total "contract price" rather than the "selling price" is the denominator of the fraction used to determine that part of each installment payment to be included in income. For purposes of computing the "contract price," regs. sec. 1.453-4(c) provides that mortgages (whether "assumed" or taken "subject to" by the buyer) are included only to the extent that they exceed the seller's basis for the property. However, when wraparound financing is employed, the entire purchase price (irrespective of mortgage amounts) is available in determining the contract price. The resulting gross profit percentage is lower than if conventional financing had been used. Consider the following example.

Property is sold for $40,000 with the purchaser assuming a mortgage of $20,000. The corresponding "contract price" is $20,000, and the proportion of each payment to be included in income is determined as follows:

$$\frac{\text{gross profit}}{\$20{,}000} = \text{gross profit percentage}$$

If a wraparound mortgage had been used, the result would have been as follows:

$$\frac{\text{gross profit}}{\$40{,}000} = \text{gross profit percentage}$$

In this situation, the gross profit percentage is halved, and a method

sec. 453

is provided for deferring more of the gain until the later years of the contract.

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

sec. 453

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.

Series E bond election on decedent's final return

sec. 454

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 sec. 454 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 io 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 bond election may avoid individual NOL

The above item discussed the tax-planning possibility of making an election under sec. 454(a) on a decedent's final return. This election reports the taxpayer's total cumulative increase in redemption values of Series E savings bonds all at once. Thus, the taxable income in a decedent's final return, if any, could be small.

For the living, there is another tax-planning device that utilizes the sec. 454(a) election. In addition to the economic losses incurred, a net operating loss sustained by an individual is almost always also a disaster from the tax point of view. This results from the modifications required by sec. 172(c) and (d). By reason of these modifications, an individual taxpayer loses the following three principal benefits when converting a taxable loss into a NOL:

1. The 50 percent long-term capital gain deduction;
2. Nonbusiness deductions in excess of nonbusiness income; and
3. Deductions for personal exemptions.

Moreover, with respect to a year to which a net operating loss is carried, by reason of sec. 172(b)(2)(A), there is also a disallowance of the 50 percent long-term capital gain deduction and the deductions for personal exemptions. As a result of these rules, much of the potential benefit of a NOL is lost by an individual.

An individual who has sustained a taxable loss and finds that his NOL benefits are vitiated either completely or substantially by the modifications contained in sec. 172(d) should consider making a sec. 454(a) election. This could permit the total cumulative increase in redemption values of Series E bonds to be reported without significant, if any, tax cost.

Of course, the individual must continue to accrue the increment for income tax purposes for all subsequent tax years, and this may be a disadvantage. An alternative, assuming that the amount of the taxable loss and NOL can be reasonably determined before the close of the loss year, would be to redeem before the year end the appropriate amount of Series E bonds that would in effect provide the maximum amount of interest income capable of being sheltered. This has the advantage of avoiding an election that is binding in future years. In addition, it permits the realization of a more "custom tailored" amount of income since the sec. 454(a) election applies to all Series E bonds.

Expense accrual for the self-insured corporation

sec. 461

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 ocsec. 461 curring 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.

sec. 461

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*.

Recapture of losses under the new "at risk" rules

sec. 465

The '78 act imposes new restrictions effective for taxable years beginning after December 31, 1978, on the tax benefits available from tax-sheltered investments. Besides extending the "at risk" limitations of sec. 465 to more taxpayers and to more activities, the act also provides for recapture of losses where the amount at risk is less than zero at the close of the taxable year for the activity. Generally, a taxpayer is at risk in a tax-sheltered investment to the extent of his adjusted basis in the activity as of the end of the taxable year, reduced by any basis *sec. 465* attributable to nonrecourse financing, financing arrangements that otherwise protect investors against personal loss, and amounts borrowed from related persons. Transitional provisions provide for computing the amount initially at risk in situations where the taxpayer invested in the activity prior to the effective date of the '78 act (or the effective date of the '76 act if the activity was subject to the original sec. 465).

After the at-risk amount as of a particular date has been determined, subsequent transactions may increase or decrease it, in some cases below zero. It is at these transactions (those creating a negative at-risk amount) that the new provisions for loss recapture are aimed. (See new sec. 465(e).) The loss recapture rule means that a taxpayer will not be able, without losing past tax benefits, to use the shelter of an investment and then effectively withdraw from that investment after his at-risk amount has been fully used. Thus, for example, withdrawals of cash from an activity or acquisition of protection against loss by guarantees or intervening liabilities or others will activate the loss recapture rule when the at-risk amount is reduced below zero at the end of the taxable year.

When the taxpayer's at-risk amount drops below zero, he is required by sec. 465(e) to include in his gross income, as income from the activity, the negative at-risk amount. For example, suppose that a taxpayer who had $1,000 at risk in an investment as of December 31, 1979, withdraws $2,000 from the cash reserves of the activity. His at-risk amount, upon withdrawal of the cash, exceeds zero by $1,000; that is, he has a negative at-risk amount of $1,000. He would have, in addition to any other results from his engagement in the activity, gross income of $1,000 due to the operation of sec. 465(e). The taxpayer would, however, have a deduction equal to the amount of gross income he had to report. This deduction would be allocable to the activity in the first succeeding taxable year and would be allowable only if not suspended by sec. 465 in such year. Furthermore, the loss recapture income would be limited in amount by the aggregate of reductions required by sec. 465(b)(5) in the at-risk amount caused by deductions taken in taxable years beginning after December 31, 1978, reduced by any loss recapture income previously reported under sec. 465(e).

The only apparent means of avoiding sec. 465(e) loss recapture problems is careful timing and compliance with contractual formalities that govern the liability of the investor for economic losses of the investment. Cash or other assets could be used for most of the taxable year of an activity without running afoul of sec. 465(e). Since the at-risk amount is determined at the close of the taxable year, withdrawals of assets early in the year could be offset by contributions of assets late in the year. Fixing the taxable year of the activity with an eye toward such carefully timed transactions could avoid strains on the investor's cash flow. Other possible alternatives would probably involve the law of debtor-creditor relations. Specifically, financing could be arranged so that the investor is personally liable to the extent assets securing financing arrangements do not satisfy the indebtedness. Assets with indeterminable, but reasonably estimative, values will be the vogue, and the risk element in tax-sheltered investments will become all the more important. Investors may also avoid the application of sec. 465(e) by investing in real estate or equipment leasing by closely held corporations, activities to which the at-risk limitations specifically do not apply. *sec. 465*

Besides avoidance of the loss recapture provision, there is also the possibility of mitigating it. The investment tax credit is one particularly feasible method of doing so. Investment in an activity that uses large amounts of qualifying investment credit property would not avoid the at-risk limitations on allowable deductions but would, nevertheless, shelter the investor's income from other sources. Similarly, an investor could arrange financing so that during the "risky period" of the activity he is not personally liable for economic losses. The liability could later be changed into a personal one after this high-risk period had passed, and the investor could then deduct losses previously "suspended" under sec. 465, perhaps recovering tax benefits lost by virtue of the loss recapture provision. In the final analysis, the strengthened at-risk limitations, including the loss recapture rule, will require investors to evaluate more carefully the risk involved in tax-shelter investment proposals.

Editors' note: See sec. 102(a)(1)(A)–(D) of the Technical Corrections Act of 1979 for changes in the at-risk rules pertaining to attribution rules and closely held corporations, clarification of recapture rules, and equipment-leasing activities.

Full-absorption rulings: some recent experiences

sec. 471

The following points are noted in connection with recent private rulings granting the taxpayer permission to change to the full-absorption method of inventory costing (under regs. sec. 1.471-11(e)) with the resulting sec. 481(a) adjustment spread over a ten-year period:

- In one case, the taxpayer requested permission to change to the full-absorption method and, for the same transition year, requested permission to change to the accrual method for deducting vacation pay. The change to full absorption resulted in a positive adjustment and the change to the accrual method for vacation pay resulted in a negative adjustment of an approximately equal amount. The taxpayer requested permission to take into income in the year of transition the net difference between these two adjustments. Although permission to change each accounting method was granted, the IRS would not permit a netting of the two sec. 481(a) adjustments but required that each be spread separately over ten-year periods.
- In several rulings, no adjustment was required under sec. 481(a), since the difference between the inventory valued under the full-absorption method and the taxpayer's prior method was eliminated by the "pre-1954 inventory balance," as provided for under regs. sec. 1.471-11(e)(1)(iii).
- We have attempted on several occasions to obtain a "one shot" pick-up of a sec. 481(a) positive adjustment. It was argued that a one-shot pick-up was available because no ten-year adjustment period election under regs. sec. 1.471-11(e)(3)(i) was made. However, the IRS rejected the taxpayer's contention and insisted that the adjustment be spread over a period of at least two years, since that regulation uses the word "ratably," which was interpreted to mean more than one year.
- Lifo-method taxpayers who elected the cut-off method under regs. sec. 1.471-11(e)(3)(ii)(B) were required to cost the lifo layer acquired during the transition year and subsequent years under the full-absorption method, while those who elected the transitional rules of regs. sec. 1.471-11(e)(3)(ii)(A) were required to recompute base-year costs and revalue all layers of the lifo inventory under the full-absorption method.

Editors' note: The service recently ruled in Rev. Rul. 79-25 that taxpayers adopting the full-absorption method of inventory costing, who wish to include in inventory some or all of *those items listed in regs. sec. 1.471-11(c)(2)(ii) that were previously excluded, must establish to the satisfaction of the service that income will be more clearly reflected by including these costs.* *sec. 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: 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 sec. 471 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 business that are distinguishable from *Thor*, such as—

- Market is lower than cost, e.g., use of replacement cost [regs. 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 sec. 471 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 simi-

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lar 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 sec. 471 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.

sec. 471

- 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 *sec. 471* 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.

Lifo—timely election without Form 970 information

sec. 472

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 *sec. 472* 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 conformity requirements: subsidiary's earnings on parent's financial statements

P Corporation accounts for its investment in a 50 percent-owned subsidiary, *S*, under the equity method. *S* adopted the lifo method of inventory valuation. In *P*'s financial statements, *P* wanted to adjust the lifo earnings reported by *S* to the fifo method.

Informal inquiries were made of the IRS national office as to whether this would violate the lifo conformity requirement of sec. 472(c) and (e). The IRS indicated that the proposed practice would probably not cause a problem in the year of adoption because the earnings per share of *S* on a fifo basis could be determined from *S*'s financial statements, since comparative per share earnings are reported in that year. (See Rev. Proc. 73-37, as amplified by Rev. Proc. 75-10, and Rev. Rul. 73-66, as amplified by Rev. Rul. 75-50.) However, this disclosure would not be allowed in subsequent years, and thus it might be necessary for *P* to resort to audit workpapers or the books and records of *S* to compute *S*'s earnings on a fifo basis. The IRS believes any such references to audit workpapers or the books and records of *S* would amount to reporting to *P* on a basis other than lifo and thus be in violation of the conformity rule.

Editors' note: See Insilco Corp., *wherein the Tax Court held that a parent corporation could issue consolidated financial statements using the moving-average inventory method, where three subsidiaries used lifo. See also Rev. Rul. 79-58, wherein the service ruled that disclosure in a calendar-year consolidated financial statement of the effect on income of an acquired member's change to the lifo inventory method in a short taxable year, which falls within the calendar year of the financial statement, is permitted under Rev. Proc. 75-10. Further, the IRS has issued prop. reg. 1.472-2(e), which, although relaxing the conformity requirements, does not cover the above problem.*

Lifo index method guidelines in embryonic state

The lifo regulations permit the use of a sampling for computing the lifo value of a dollar-value pool. The regulations state that an "index may be computed by double-extending a representative portion of the inventory in a pool or by the use of other sound and consistent statistical methods" [regs. sec. 1.472-8(e)(1)].

The AICPA Federal Tax Division, in its presentation of lifo problems to the IRS on February 21, 1975, asked that guidelines be issued on use of the index. The troublesome words in the regulations are "representative portion of the inventory" and "sound and consistent statistical methods." The regulations do not define either of these terms and so far there have sec. 472 been no rulings issued to serve as guidelines in this area.

As a result of various rumors of what would be acceptable to the IRS, the national office was approached to discuss this matter. The technicians at the national office stated they would not accept the common 70 percent rule of thumb. (That is, a sample constituting approximately 70 percent of the value would not necessarily be considered a representative portion of the inventory.) In determining what would be a sound and consistent statistical method, the service expressed a definite preference for the estimation sampling techniques outlined in the appendix to Rev. Proc. 64-4. The appendix is entitled "Standards of Probability Sampling for Legal Evidence." The IRS stated that judgment samples such as the 70 percent rule of thumb would generally not be accepted at face value and that audit samples generally designed to test for overstatement would not be acceptable for computation under the index method. The IRS's preferred method of estimation sampling is based upon the normal distribution theory. Since this subjects the entire inventory to selection, it can be designed to provide a high degree of reliability. A sample based on this method may be relatively small, such as 3 to 5 percent of the items, and yet be 35 to 55 percent of dollar value.

Under the regulations, the district director has the right to determine the eligibility to use the index method and the appropriateness of the method to compute the index. A statement describing the method being used in computing the index is required to be attached to the return of a taxpayer electing the index method. The taxpayer is also required to file a copy of that statement with the commissioner in Washington, D.C. Thus, a taxpayer would be well advised to follow the estimation sampling techniques discussed in Rev. Proc. 64-4 so as to have a method that would be considered statistically sound.

Editors' note: The IRS is still studying the problem. (See "Washington Report," The Tax Adviser, *March 1977, p. 171 and "Lifo—An Analysis of Some Computational Procedures,"* The Tax Adviser, *January 1978, p. 4.)*

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 directlv 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.

Technological changes and quantity discounts as "new items" entering dollar-value lifo pool

Regs. sec. 1.472-8(e)(2)(iii) prescribes the treatment of a new item entering a dollar-value lifo pool under the double-extension method. It provides that the base-year unit cost of the entering item shall be the current-year cost of the item unless the taxpayer is able to reconstruct or otherwise establish a different cost.

The IRS national office recently issued a technical advice memorandum that takes an expansive view of what constitutes a "new item" under this regulation. The taxpayer was a manufacturer using the dollar-value link-chain method. Unit costs were materially affected by quantity discounts on certain raw *sec. 472* material purchases, as well as changes in engineering specifications and other technological changes. The taxpayer wanted to consider such changes as giving rise to "new items" subject to regs. sec. 1.472-8(e)(2)(iii), which would significantly reduce the year's lifo increment. The year at issue was the year in which the taxpayer changed to lifo. The IRS national office, in agreeing with the taxpayer, said:

> Any given part affected by technological, material, quantity-price differential or similar change should be considered to be a new item entering the inventory subject to the provisions of Section 1.472-8(e)(2)(iii) of the regulations, under most of the circumstances mentioned.

In explaining its rationale, the national office makes the following comments in its technical advice memorandum:

> Although no description is given in the regulations for either the index method or the link-chain method, both methods require the application of the double-extension method rules, to some degree. The regulations provide that the index method may be used where the double-extension method can be shown to be impractical because of technological changes, the extensive variety of items, or extreme fluctuations in the variety of items. In the cases where changes in technology or in the variety of items are the cause for the use of the index method, it is necessary to develop new base year costs as provided in Section 1.472-8(e)(2)(iii) of the regulations. The same thing is true where the link-chain method is used. There are also those instances where the purchases during the year are less than the quantities of an item in inventory at the end of the year, resulting in an index which does not clearly reflect the base year costs of the inventory.
>
> Thus, where the relationship between the costs at the base date and the current year is affected by something other than inflation, such as technological changes, it is necessary to correct the base year costs. It must also be stressed that where an item is in the inventory at both the beginning and the end of a taxable year, but neither purchased nor manufactured during the year, there would be a distortion of the effect of inflation if the same costs were used as both the base year and current year costs in computing an index for the inflation of the year.

As to the items described in the last sentence in each of the two quoted paragraphs, the IRS explained that its intention was that such items be excluded from the sample used in deriving the link-chain index.

Editors' note: The Tax Court recently held that the addition of a catalytic converter and a solid state ignition did not make a 1975 vehicle a different "item" from a 1974 vehicle within the *meaning of regs. sec. 1.472-8(e)(2)(iii); thus, no adjustment to base-year costs was required. (See* Wendle Ford Sales.*)*

Lifo election upon leaving affiliated group

Corporation *X* is a common parent filing a consolidated return for the fiscal year ending February 28. On March 3, it forms wholly owned subsidiary *Y*. On June 30, it sells *Y* outside the group. Assume it is advantageous for *Y* to elect lifo.

Y is considering in which period it should elect lifo and determines that it is more advantageous to wait until the short period commencing July 1. Consider the following comparative schedules:

Effect of Lifo in Deconsolidation

I. *Conversion of ordinary deduction to short-term capital gain*

	Fifo	Lifo
X's original basis in *Y*	$600	$600
Y's loss for P/E 6/30/78 (lifo reserve)	—	(100)
Adjusted basis	600	500
Proceeds of sale	600	600
Gain	$ —	$100

II. *Comparison of adopting lifo by* Y *in either period*

		Adopt lifo for	
	Fifo	P/E 6/30/78	P/E 2/28/79
P/E 6/30/78			
Beginning inventory	$ —	$ —	
Purchases	1,000	1,000	
Ending inventory	(500)	(400)	
Cost of sales	500	600	
P/E 2/28/79 (no addition to lifo reserve)			
Beginning inventory	500	400	500
Purchases	6,000	6,000	6,000
Ending inventory	(1,000)	(900)	(1,000)
Cost of sales	$5,500	$5,500	$5,500
Permanent lifo reserve	$ —	$ 100	$ —

Schedule I shows that *Y*, in *X*'s consolidated return, would have broken even on a fifo basis, but on lifo contributes a $100 loss equal to its lifo reserve. But this loss results in an investment adjustment reduction in *X*'s basis of *Y* stock, and a consequent $100 short-term capital gain upon sale of *Y*. Thus, there is no difference in *X*'s consolidated current taxable income and tax liability whether or not *Y* elects lifo in its first (consolidated) return.

Schedule II shows that *Y*'s $5,500 cost of sales in its later separate return period is the same regardless of the period in which it elected lifo. It also reveals that the earlier consolidated-period election produces a lifo reserve of $100, which must eventually be restored to income. However, if the lifo election is deferred until the separate return, there is no lifo reserve for eventual taxation.

Thus, if *Y* waits to elect lifo after it leaves the affiliated group, it will always have a $100 higher inventory basis at no additional tax cost to itself or to *X*.

Does *Y* have a choice when it may elect lifo? If *Y* were to formally adopt lifo for the period ending February 28, 1979, would the IRS rule that the adoption also retroactively covered the period ended June 30, 1978, since both periods fall within the same 12-month accounting year? Does this mean *Y* must elect lifo as of June 30, 1978, if it wants to use lifo as of February 28, 1979?

It appears that the IRS national office probably would not take the position that formally adopting lifo at February 28, 1979, would also cover the short period during which *Y* was a member of *X*'s consolidated-return group, provided *Y* can show the actual results of its operations during the consolidated period on a fifo basis. If it is not possible to determine *Y*'s operations on a fifo basis, Form 970 should be filed by *Y*, both as part of the short period during which it was part of *X*'s consolidated return and as part of *Y*'s separate return so as to protect the lifo election.

Apparently, this issue has not previously come to the attention of the IRS.

Lifo—the link-chain method is under IRS pressure

A number of taxpayer clients have filed requests for change to the "link chain" method of computing the lifo value of a dollar-value pool. The IRS has held these up believing that the method is being used, or sought, by some taxpayers who are not eligible pursuant to the regulations [regs. sec. 1.472-8(e)]. A major area of concern appears to be situations where technological changes could result in a substantial reduction in labor costs. It is understood that a published ruling is being considered, but it may not set objective, quantitative standards for eligibility; determinations would be made on a case-by-case basis. Use of the method will presumably be restricted to taxpayers who can demonstrate its appropriateness by showing that use of either an index or double-extension method could be unsuitable.

The link-chain method can usually be justified where there are many thousands of items in inventory, *and* these items change frequently so that double-pricing back to the base year becomes wholly impractical. Applications should emphasize the latter point. If the use of the link-chain method is challenged on audit (which may occur), major emphasis should be on inability to cope with numerous changes in product or product identification. Early action on most requests for use of the link-chain method is not expected until the IRS position is further clarified.

Lifo conformity: acquisition of inventory through business combinations

Rev. Proc. 72-29 provides that differences between the value of lifo inventories reported on the financial statements and those reported on the tax return, due to the application of APB Opinion no. 16, will not be violations of the reporting conformity requirements of sec. 472(c) and (e)(2).

That revenue procedure was apparently *intended* to apply to only those situations where business combinations were treated as a "purchase" for tax purposes *and* as a "pooling of interest" for financial accounting purposes, *or* vice versa. (See BNA portfolio 74-3rd, p. A-7.)

However, in a recently issued private ruling, the IRS allowed a "combination" to qualify under Rev. Proc. 72-29 where the transaction was a "purchase" (taxable) for *both* tax and financial accounting purposes.

This ruling supports the view that a literal reading of sec. 2 of Rev. Proc. 72-29 allows *all* "combinations" governed by APB Opinion no. 16 to be covered, despite the *apparent* intent with which Rev. Proc. 72-29 was originally written.

It may still be advisable, however, to obtain private rulings when business combinations are encountered which are outside the apparent original intent of Rev. Proc. 72-29.

sec. 472 *Editors' note: Prop. reg. 1.472-2(e) does not resolve the above problem.*

Revocation of lifo election by amended return

Regs. sec. 1.472-5 provides that an election to adopt the lifo inventory method is irrevocable. As a result, it is often assumed that the taxpayer is bound by the lifo election unless permission to change accounting methods is granted by the IRS national office. However, it may be possible to effectively revoke the lifo election by an amended return for the year of the election.

The IRS accepted an amended return revoking the lifo election in the following circumstances: (1) the corporation filed its tax return for its fiscal year ended July 31, 1974, and validly elected lifo and (2) the corporation filed an amended return by May 30, 1975, using its former method of inventory valuation. With the amended return, the corporation paid the additional tax plus interest. (The IRS had not examined the return for the year of the lifo election prior to the filing of the amended return.)

In discussions with the IRS, the service emphasized that its willingness to accept the amended return effectively revoking the lifo election was limited to the factual situation involved. The IRS generally stressed the discretion available to it in accepting amended returns. However, in view of regs. sec. 1.472-5, it is noteworthy that it was willing to accept the amended return even under these circumstances.

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.

Editor's note: The service has confirmed this position in Rev. Rul. 79-127, involving the transfer of assets by a partnership.

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 associates 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 base-year 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 base-year 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 base-year cost might then be applicable. The determination of when the improvements are substantial enough to warrant an adjustment to base-year 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. *sec. 472*

Editors' note: The service has acquiesced in Wendle *(1980-24 IRB 5). The pooling requirements for automobile dealers, however, remains an open issue. Many dealers do not use the "subpooling" technique and have not been questioned on audit. The Tax Court, however, is considering at least two cases (*Fox Chevrolet *and* Richardson Ford Sales*) wherein the service has argued that each new model year must be placed in a new pool apart from the prior model year.*

"LIFO profits" to be taxed on certain liquidations after 1981

The Crude Oil Windfall Profit Tax of 1980 (P.L. 96-223) contains a provision that taxes so-called LIFO inventory profits—the excess of inventory costs determined using the FIFO method over the cost of the same inventory using LIFO—on plans of corporate liquidation governed by sec. 337 or sec. 334(b)(2). The rule will apply to sales of inventory under sec. 337 and distributions in liquidation under sec. 334(b)(2) occurring pursuant to plans of liquidation adopted after 1981. The rule will not apply to the liquidation of subsidiaries under sec. 332 if inventories distributed to the parent corporation receive a carryover basis under sec. 334(b)(1).

The act contains another provision permitting a refund of the tax on LIFO inventory profits, at the election of the taxpayer, on replacement of inventories after certain involuntary liquidations of LIFO inventories pursuant to governmental requests, Department of Energy regulations, international boycotts, and other major foreign trade interruptions.

Both provisions were agreed to as a compromise package presented to the windfall tax conferees. The compromise was the deferral of the effective date of the provision taxing LIFO profits in sec. 337 and sec. 334(b)(2) liquidations until after 1981 rather than from date of enactment—the effective date of the provision in the Senate version of the bill. The provision taxing LIFO inventory profits on corporate liquidations was added to the windfall tax bill on the Senate floor at the insissec. 472 tence of the Treasury Department when Treasury learned that the provision benefiting taxpayers on the replacement of involuntarily converted LIFO inventories was to be introduced.

During the discussion of the LIFO proposals by the windfall tax conferees, it was proposed that the provision taxing LIFO inventories on corporate liquidations be dropped from the windfall tax bill, but the proposal was not adopted. However, House Ways and Means Chairman Ullman indicated that, despite the compromise reached by the conferees on the effective date, hearings may be held to reconsider the substantive aspects of the corporate liquidation LIFO provision after passage of the act.

sec. 481 New ten-year spread rules for sec. 481 adjustments

The IRS has recently changed its unpublished ruling policy with respect to how the ten-year spread under Rev. Proc. 70-27, relating to changes in accounting method, is to be taken into account. The service will now apply a two-step approach. If two-thirds of the sec. 481(a) adjustment is attributable to the taxable year preceding the taxable year of change (i.e., the amount as of the beginning of the year of change is at least three times as great as the amount at the beginning of the preceding year), then two-thirds of the sec. 481(a) adjustment is taken into account over the remaining seven years.

The IRS draws upon sec. 446(e) and Rev. Proc. 75-18 for its authority to require the sec. 481(a) adjustment to be taken into account in the above-described manner. Sec. 2.02 of Rev. Proc. 75-18 provides, in part, that "[r]egardless of the number of years that a taxpayer has been in existence or has used the method of accounting which is being changed, if an insubstantial portion of the adjustment referred to in section 3.01 [of Rev. Proc. 70-27] is attributable to events in earlier years, then the period over which the adjustment is to be spread may be reduced accordingly."

It is understood that these new rules will apply to positive and negative adjustments. It is also our understanding that if the entire sec. 481(a) adjustment is attributable to the preceding year, then a one-shot pick-up in the year of change is required.

More on IRS rules for spreading adjustments

sec. 481

Assume *X* Corporation requested a change of accounting method from the cash to the accrual basis for the taxable year ending December 31, 1976. As of January 1, 1976, *X* had receivables of $300,000 and payables of $100,000. In order to avoid omission of these amounts when the change to the accrual method is made for the calendar year 1976, the IRS will require an adjustment increasing income by $200,000. Can this income adjustment be spread over a ten-year period? Although prior IRS rules did permit this, there are now exceptions to this rule.

First of all, under Rev. Proc. 70-27 the adjustment can generally be spread over the period during which the original accounting method was used, with the IRS having the right to disregard any years in which the use of the method was "insubstantial." Thus, to illustrate the general rule, if *X* were using the cash method for six years, the $200,000 adjustment would be spread ratably and included in income over a six-year period, $33,333.33 per year.

Recently some new unpublished rules have been developed by the service that apply to such changes of method. As pointed out above, if two-thirds or more of the adjustment arose in the year prior to the year of *X*'s change (i.e., during 1975), a different rule would apply. The amount of the adjustment attributed to 1975 would be permitted to be spread over a three-year period. Any balance would be permitted to be spread over the seven-year period following such three-year period. For example, if in our case $150,000 of the adjustment arose in 1975, $50,000 would be included in income in each of the following three years; thereafter, $50,000 would be included in income over the remaining seven years, or $7,111.11 per year.

In addition to the above restrictions, taxpayers who are manufacturers must be alert to another limitation. Where such a manufacturer changes to a new inventory method, and any portion of such change relates to the failure to change to the "full absorption" method of including overhead costs, the IRS will not permit any spread of the adjustment. Regs. sec. 1.471-11(e) provides for an election to change to the full-absorption method under special transition rules and allows a ten-year spread-forward of the adjustment. However, Rev. Proc. 75-34 stipulated that once the transition period expired, no spread-forward would be allowed; and that transition period has now expired.

sec. 481

Application of Rev. Proc. 75-34 in this fashion appears unduly harsh. For example, if, in the above case, the change was a change of inventory method by a manufacturer and only $2,000 of the $200,000 adjustment was attributable to failure to include all overhead costs under the proper full-absorption method of inventory costing, no part of the $200,000 adjustment would be allowed to be spread, and the entire amount would have to be included in income in 1976.

. . . and still more

When a taxpayer requests permission to change a method of accounting, the service ordinarily requires, as a condition of its approval of the change, that the adjustment required by sec. 481(a) be reflected in income over a period of ten years (Rev. Proc. 70-27, as clarified by Rev. Proc. 75-18), unless the method from which the taxpayer is changing has been used for less than ten taxable years. As indicated above, the national office of the IRS has adopted a new policy with respect to how the spread of the sec. 481(a) adjustment is to be taken into account.

Taxpayers requesting permission for a method change are now asked to provide the amount of the adjustment that would have been required under sec. 481 if the requested change had been made for the year preceding the year of transition, i.e., the taxable year immediately preceding the proposed year of change. If 66⅔ percent or more of the sec. 481(a) adjustment is attributable to such preceding year, then that percentage of the adjustment will be required to be taken into account ratably over a three-year period, with the balance to be taken into account over the remainder of the spread period. If the entire sec. 481(a) adjustment is attributable to the preceding year, then the full amount must be taken into account in the year of change. These new rules apply to positive *and* negative sec. 481(a) adjustments.

Example. X Corporation requested permission on Form 3115, Application for Change in Accounting Method, to change its overall method of accounting from the cash receipts and disbursements method, which it had used for ten years, to the accrual method for its taxable year ending December 31, 1977. The sec. 481(a) positive adjustment required at January 1, 1977, was $100,000. Had the change been effected for 1976, the positive adjustment under sec. 481(a) at January 1, 1976, would have been $32,000. Since the per-

> centage of the adjustment attributable to the year preceding the year of change is 68 percent ($68,000 ÷ $100,000), $68,000 must be reflected in income ratably over the three-year period beginning with the year of change (1977) and the remaining $32,000 must be reflected in income over the remaining seven taxable years.

Information regarding the prior year's sec. 481(a) adjustment is being requested orally by IRS representatives in connection with all requests for change in accounting method. However, the service has accepted reasonable estimates of the amount of the adjustment. In one recent case where the exact amount of the prior year's adjustment would have been unreasonably burdensome to compute, the IRS accepted a representation, made under penalty of perjury, that two-thirds or more of the required sec. 481(a) adjustment was not attributable to the year preceding the year of change, together with an explanation of why the requested information could not be provided.

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.

sec. 482

Sec. 482: imputed income to parent for guaranteeing subsidiary's loans

Revenue agents auditing multinationals have recently proposed a sec. 482 adjustment imputing "loan guarantee fee" income to parent corporations guaranteeing loans obtained by foreign subsidiaries. Such a proposed adjustment is novel, as there does not appear to be any case or ruling approving a sec. 482 allocation based upon an intercompany guarantee. (Cf. *Latham Park Manor, Inc.*, where such an adjustment, contended for by the taxpayer-subsidiary as a set-off under regs. sec. 1.482-1(d)(3), was denied.)

The proposed adjustment may be predicated on a belief that intercompany guarantees fall within the ambit of "other services" as used in regs. sec. 1.482-2(b)(1), which provides the following:

> General Rule. Where one member of a group of controlled entities performs marketing, managerial, administrative, technical, or other services for the benefit of, or on behalf of another member of the group without charge, or at a charge which is not equal to an arm's length charge as defined in subparagraph (3) of this paragraph, the district director may make appropriate allocations to reflect an arm's length charge for such services.

On analysis, however, the proposed adjustment appears to be based on a misinterpretation of the regulation. It could be argued that the phrase "other services" in the regulation refers to types of services similar to "marketing, managerial, administrative, [or] technical" services. An accommodation guarantee, if a "service," is one that is fundamentally different in kind from the specifically enumerated services, all of which entail some "activity" rather than mere passive accommodation. This interpretation is buttressed by the reference in the quoted regulation to subparagraph (3) for purposes of determining what the arm's-length charge for such services should be. Regs. sec. 1.482-2(b)(3) defines an arm's-length charge in two contexts. The first is where the service is an integral part of the business activity of the member rendering or the member receiving the service. In such case, the arm's-length charge is prescribed to be the charge that would have been made to an unrelated party. The second context is where the service is not an integral part of either business, and in that case, regs. sec. 1.482-2(b)(3) provides that

> [T]he arm's length charge shall be deemed equal *to the costs or deductions incurred with respect to such services by the member or*

> *members rendering* such services unless the taxpayer establishes a more appropriate charge under the standards set forth in the first sentence of this subparagraph . . . [emphasis added].

Applying this standard, the parent's cost of rendering the guarantee service would consist of the postage expense of mailing the guarantee instrument to the lender plus other nominal related costs. Hence, no allocation appears to be appropriate.

The same conclusion is compelled by other provisions of the sec. 482 regulations. For instance, the practical effect of a parent's guarantee is the same as if the parent had directly borrowed the funds in question from the subsidiary's lending institutions and in turn lent them to the subsidiaries at the same rate of interest. In that case, the taxable income of each member would have been exactly the same as in the case of a guarantee, and yet there could be no possible allocation under sec. 482. In that case, the controlling provisions would be regs. sec. 1.482-2(a)(ii):

> [I]f the loan or advance represents the proceeds of a loan obtained by the lender at the situs of the borrower, the arm's length rate for any taxable year shall be equal to the rate actually paid by the lender increased by an amount which reflects the costs or deductions incurred by the lender in borrowing such amounts and making such loans, unless the taxpayer establishes a more appropriate rate under the standards set forth in paragraph (a)(2)(i) of this section.

Again the only possible allocation would be the nominal costs that might have been incurred in processing the loan.

Also, the proposed type of adjustment is not consistent with the position the government successfully argued in *Tulia Feedlot, Inc.* In that case, the taxpayer corporation did pay guarantee fees to its stockholders and claimed sec. 162 deductions for such payments, but the court held,

> [W]e think that the $4,500 guarantor's fee was a distribution of property made by a corporation to its shareholders . . . and not an ordinary and necessary business expense. . . .

If a sec. 482 allocation is made charging the parent with a fee, regs. sec. 1.482-1(d)(2) requires an "appropriate correlative adjustment to the income of any other member of the group involved in the allocation." Applying this rule would apparently result in the allowance of a deduction to the subsidiary, but such deduction is inconsistent with *Tulia Feedlot*. And if the correlative adjustment is not made, it would appear that the sec. 482 allocation for the guarantee fee is improper.

sec. 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

sec. 482

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.*

Controlling income from deferred payment sales

sec. 483

The imputed interest provisions of the code (sec. 483) do not apply to a seller of property if no part of any gain on the sale or exchange would be considered as gain from the sale or exchange of a capital asset or property described in sec. 1231.

sec. 483 (See regs. sec. 1.483-2(b)(3)(i).) Thus, the years in which income resulting from the sale of inventory will be reported under a deferred-payment contract may depend on how the seller negotiates. For example, a taxpayer sells inventory with a basis of $88,000 on December 31, 1976. He is to receive $20,000 down and $20,000 on December 31 for the next four years. He knows that he cannot bargain to receive more than $100,000, regardless of how the contract is negotiated, and that all income will be ordinary. However, he prefers to have the income reportable in 1976 because of an expiring NOL carryover. The accrual-basis seller can achieve this 1976 recognition by bargaining for a higher deferred selling price and no interest. Of course, the installment-sale provisions of sec. 453 would not be elected in this case. If he prefers less income in 1976 and interest income reportable over the term of the contract, he can bargain for a lower selling price plus interest.

Note that under alternative 1 in the illustration below, sec. 483 would still be applicable to the *buyer* pursuant to regs. sec. 1.483-2(b)(3)(ii). On the other hand, there would not be any interest *imputed* to the buyer at 7 percent (compounded semiannually) under alternative 2, since there is *stated* simple interest of at least 6 percent per annum.

Illustration

		Alternative	
		1	2
Year income is reportable	Description	Contract provides for no interest	Contract provides for simple interest, approximately 6.8%
1976	Selling price	$100,000	$ 88,000
	Basis	(88,000)	(88,000)
	Ordinary gain	12,000	0
1977	Interest income		4,600
1978	" "		3,600
1979	" "		2,500
1980	" "		1,300
Total income resulting from sale		12,000	12,000
Cash collected		$100,000	$100,000

Exempt organizations

Request for extended advance ruling period by new charity

sec. 501

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.

Hospital shared-service organizations: choosing the right format

Hospital *X* is tax exempt under sec. 501(c)(3). With a view toward reducing its cost of providing health services, *X* is considering the formation of a shared-service organization to provide laundry services for itself and several nearby hospitals. One of the hospitals that wants to participate in the shared services is a proprietary institution (not exempt from federal income tax).

The question arises whether a shared-service organization can provide the laundry services and qualify for tax exemption. In addition, can such services be provided to proprietary as well as tax-exempt hospitals?

Although there are many ways of establishing a shared-service program, there are two basic types of exemptions to choose from—sec. 501(c)(3) organizations and sec. 501(e) organizations (cooperative hospital-service organizations). Generally speaking, qualification as an exempt organization under sec. 501(c)(3) is the most favorable status for a shared-service organization. Aside from the deductibility of contributions, the principal advantage of sec. 501(c)(3) qualification, as compared with a cooperative hospital-service organization under sec. 501(e) or a nonexempt cooperative under subchapter T, is that the former can avoid taxation without having to allocate or pay all of its net earnings over to patrons after the close of the taxable year. This freedom from the payout or allocation requirements imposed on cooperatives under sec. 501(e) permits a sec. 501(c)(3) shared-service organization to realize and retain an excess of receipts over expenditures. Such an excess creates cash flow, which may be needed to retire indebtedness or simply to build up capital reserves for expansion and acquisition of new equipment.

Another advantage of sec. 501(c)(3), in our case, is that laundry services can be included in the activities provided by sec. 501(c)(3) organizations. (The IRS has not formally conceded this, although several federal district courts have held for the taxpayer on the issue.) The inability of a shared-service organization to provide laundry services within the statutory framework of sec. 501(e) is the major reason why this latter form of organization is undesirable here. (See sec. 501(e)(1)(A).)

Although there are no published rulings or cases on point, another advantage of operating a shared-service organization under sec. 501(c)(3) is that such an organization probably can provide an insubstantial part of its services to nonexempt organizations (other than hospitals), e.g., old-age and nursing homes, clinics, etc. Under sec. 501(e)(1)(B), a sec. 501(e) organization is generally unable to provide services to any proprietary organization or any exempt organization other than sec. 501(c)(3) organizations or governmental hospitals.

That limitation is the result of narrower statutory language. Unlike sec. 501(c)(3) organizations, which must be devoted "exclusively" to charitable purposes, sec. 501(e)(1) limits operations "solely" to certain services and for the benefit of the class of organizations specified in the statute. Although regulations have not yet been promulgated under sec. 501(e), we understand that the IRS will probably take the position that the term "solely" is to be read more narrowly than the term "exclusively." Since a sec. 501(c)(3) organization will probably not be so limited, some services can probably be rendered either to nonexempt members or nonmembers.

Thus, for example, if 5 to 10 percent of the activities of a shared-service organization seeking exemption under sec. 501(c)(3) are provided to nonexempt members, it would still appear that its primary activity is providing shared services to tax-exempt hospitals (to the extent of 90 to 95 percent of its activities), and it should therefore be considered primarily engaged in activities that further its exempt sec. 501(c)(3) purposes.

However, since there is no authority on point, it is possible the IRS may resist the right of any sec. 501(c)(3) organization to provide services to nonexempt organizations, regardless of the degree. Accordingly, existing shared-service organizations should request an advance ruling on the issue, and shared-service organizations seeking exemption should specifically spell out the nature of their intended activities.

Editors' note: Where the IRS will allow the providing of services to outsiders, the shared-service organization must also consider the applicability of sec. 512 regarding the unrelated business income realized.

sec. 501

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. *sec. 501*

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.

Exempt club cannot deduct losses from use of facilities by nonmembers in determining unrelated business income

sec. 512

Under sec. 512(a)(3), social clubs that are exempt from income tax under sec. 501(c)(7) are subject to the unrelated business income tax on gross income (except exempt function income) less allowable deductions directly connected with the production of such income (except those deductions connected with exempt function income). Unrelated business income of social clubs would include their investment income and income from making their facilities available to nonmembers.

In a recent technical advice request, an exempt club made its dining room, bar facilities, and private meeting rooms available to outside groups sponsored by club members for sec. 512 the same prices it charged members for use of these facilities. The club had an overall loss from operating these facilities and allocated the loss between members and nonmembers in the ratio of gross receipts. Member and nonmember receipts were determined in accordance with the recordkeeping standards required by Rev. Proc. 71-17. The portion of the loss determined to be allocable to nonmembers was deducted from the club's investment income in determining its unrelated business taxable income.

In its examination of the club's returns, the IRS did not challenge the method of allocating expenses between members and nonmembers and agreed that losses from any unrelated trade or business can be deducted from investment income in determining unrelated business taxable income. However, the national office's technical advice sustained the revenue agent's determination that the club's facilities were made available to nonmembers without a profit motive, so that expenses allocable to this activity were deductible only to the extent of income from nonmember use of the facilities.

The national office concluded that the club intended to make the facilities available to nonmembers at less than cost to suit the purposes of the members. Thus, in this case, the members were underwriting part of the cost of supplying the goods and services to nonmembers. Its memorandum cited *International Trading Co.* and *Five Lakes Outing Club* in support of this conclusion. In those cases, the expenses for which a deduction was disallowed as an offset to income from non-club-related activities were allocable to activities that benefited the shareholders or members of the nonexempt club. In the instant case, however, the allocation of expenses to outsiders was not challenged. The technical advice results in reallocating the losses of the nonmember activity back to the members.

Unrelated business income: the advertising problem

Revenue from advertisements in publications of tax-exempt organizations is taxable in many instances as unrelated business income under sec. 512. If gross revenue from advertising exceeds expenses directly attributable to advertising, the organization can offset the net production and distribution expenses of the readership portion of the publication against the advertising revenue. The production and distribution ex-

penses attributable to the readership portion of the publication are first reduced by circulation income. However, the net expenses attributable to the readership content of the publication can offset net advertising revenue only to the extent that a loss is not created.

In December 1975, the IRS amended regs. sec. 1.512(a)-1, dealing, *inter alia*, with unrelated business income for exempt organizations that publish magazines generating advertising income. This regulation provides a framework for allocating dues to circulation income when a publication is sent to dues-paying members without an additional charge. In such instances, circulation income is determined as follows:

- If 20 percent or more of the total circulation of the periodical consists of sales to nonmembers, the allocable amount per issue will be the amount that is charged to nonmembers.
- If the above is not applicable, and membership dues from 20 percent or more of the members who do not receive the periodical are less than those received from other members who receive the periodical, the difference in dues is used as the subscription price.
- In all other instances, the total membership receipts (dues, fees, other charges) are multiplied by the following fraction:

$$\frac{\text{Total publication expenses}}{\text{Total publication expenses plus cost of other exempt activities}}$$

Since the adoption of this regulation, two experiences with the IRS are illustrative of what can be in store. In one situation, no allocations of production and distribution expenses were necessary because direct advertising expenses exceeded gross advertising revenues. This produced a NOL, which the service allowed to be carried forward.

The other situation involved an association that sold space in its annual convention book to members. The book was circulated to all members. Customarily, only their names, addresses, and general businesses were listed. Since all members dealt in relatively the same product, no advantage was expected or received. The position taken by the association was that not all advertising is the same. To support this, *American College of Physicians* and Rev. Rul. 76-93 were cited.

sec. 512 We further pointed out that regs. sec. 1.513-1(d)(4)(iv), example (7), provides that income from advertising products within the general area of professional interest of an organization's members is unrelated, ***but only*** when the basic objective of the advertiser is to promote the sale of the advertised product and where any informational function is purely incidental. In our situation, the facts were reversed: The sales promotion was incidental to the information provided. The IRS agreed that such advertising did not constitute unrelated business income within the meaning of the statute.

Tax advisers should be on the alert when evaluating the unrelated business income of exempt organizations. Is advertising really advertising in the commercial sense? If so, should a separate charge for the publication (in lieu of a dues increase) be made to achieve a more predictable and possibly a fairer result, thus avoiding the allocation prescribed by the regulations?

sec. 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 lent 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 lent 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. *sec. 514*

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.

sec. 514 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.

sec. 528 Taxability of condominium management associations after the '76 act

Prior to the '76 act, condominium associations could be taxed at regular corporate rates on their excess assessments over necessary expenditures made for any taxable year. With the passage of the '76 act, however, condominium associations can now elect to be treated as tax-exempt organizations for taxable years beginning after December 31, 1973.

Basically, the newly added sec. 528 provides that if an election is made, "homeowners' associations" (including "condominium management associations") will not be taxed on "exempt function income" (membership dues, fees, and assessments from the owners of condominium units) but will be taxed on any other income (e.g., interest amounts received from nonmembers for parking, swimming pool, etc., and amounts paid by association members for *special* use of facilities that are not covered by regular assessments). Federal income tax will be computed on this nonexempt income less directly related expenses and less a specific deduction of $100. The normal corporate surtax exemption is not allowed, nor are net operating losses and special deductions such as the dividends-received deduction.

Because of the denial of the normal surtax exemption and the special corporate deductions, the election would not be beneficial for associations having substantial nonexempt income, such as dividends and interest.

Although the '76 act provides an opportunity to reduce taxes for the majority of condominium associations, there are several other ways to reduce taxes in lieu of the sec. 528 election.

In Rev. Rul. 75-370, the IRS held that special assessments

sec. 528

collected from the homeowners by a taxable condominium-management corporation and placed in a separate bank account for specific capital expenditures were not includible in the corporation's gross income. Rev. Rul. 75-371 held that special assessments collected and placed in a separate bank account for the purpose of acquiring personal property were contributions to capital and not taxable to the corporation. Also, according to Rev. Rul. 70-604, assessments in excess of expenses for a taxable year are not taxable income to the corporation if, at an annual meeting held during the taxable year, the homeowners vote to return the excess assessments to themselves or to apply the excess against the following year's expenses.

Furthermore, if a condominium association qualifies under subchapter T (secs. 1381-88), it may retain up to 80 percent of its otherwise taxable income, received from the homeowners, without paying taxes.

With these alternatives, it is now possible for qualified condominium associations to eliminate or significantly reduce their federal income taxes.

Corporations used to avoid income tax on shareholders

FPHC may be preferable to CFC status

sec. 551

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.

sec. 551 If *B* were not a 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 a 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 a 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)].

sec. 562

PHCs: *Fulman* not an ill wind for all dividends in kind

In the computation of "undistributed personal holding company income," a personal holding company is entitled to deduct dividends paid. (See sec. 545(a).) With respect to dividends paid in kind, two courts of appeals disagreed on whether the deduction should be measured by the fair market value of the property or by its tax (adjusted) basis. In *Arthur S. Fulman*, the Supreme Court resolved the conflict by upholding the validity of regs. sec. 1.562-1(a), which designates the tax basis of the property as the measure of the dividends-paid deduction.

On the other hand, sec. 301(b)(1)(A) specifies that the amount of income taxable to an individual (or other noncorporate) shareholder is measured by the fair market value of the distributed property. The interplay between these rules of measurement can be used to achieve a substantial overall tax saving where a PHC has individual shareholders and holds property that has declined in value. That is, in lieu of selling such property and paying a cash dividend, the PHC can distribute the property as a dividend in kind.

The potential saving is demonstrated by the following simplified example.

Example. S, an individual, owns all of the stock of *X*, a PHC; *S* is in the 70 percent tax bracket. *X*'s undistributed PHC income, before the dividends deduction, is $200,000. *X* owns a security (a capital asset) with a tax basis of $200,000 and a fair market value of $100,000; the security has been held for over one year. *X*'s taxable income consists of ordinary taxable income exceeding $50,000 and a $100,000 capital gain which is long-term; thus, the alternative tax rate of 30 percent applies to the capital gain. *X* is not liable for the minimum tax.

The following computations consider only the federal income tax consequences.

	X	S	Overall
Alternative 1			
X sells security, realizing a $100,000 loss, and pays a $200,000 cash dividend:			
X's tax benefit from loss—30% of $100,000	$(30,000)		$(30,000)
S's tax on dividend—70% of $200,000		$140,000	140,000
Overall tax cost	$(30,000)	$140,000	$110,000
Alternative 2			
X distributes security in lieu of cash:			
X's tax benefit	0		
S's tax on dividend—70% of $100,000		$70,000	$70,000
Overall tax cost	0	$70,000	$70,000
Tax saving under Alternative 2			$40,000

sec. 562 Under both alternatives, the indicated dividend distribution avoids the PHC tax.

If *X*'s $100,000 capital gain were short-term (taxable at 48 percent) instead of long-term, the tax saving would be reduced by $18,000 (to $22,000), since *X*'s tax benefit from the loss under alternative 1 would be increased to $48,000 (at the 48 percent rate). On the other hand, the tax benefit would be $30,000 greater (or $70,000) if *X* cannot use the capital loss currently or as a carryback and probably will not utilize it as a carryforward within five years.

The above example illustrates the overall tax saving that can result when a PHC offsets "undistributed personal holding company income" with a dividend in property that has declined in value, instead of selling the property and distributing the proceeds as a dividend—even though the PHC thereby gives up a tax deduction for the unrealized loss.

The above discussion and illustration are limited to PHC distributions to individual shareholders. With respect to a corporate shareholder, similar distributions are generally inadvisable.

The Supreme Court's *Fulman* decision took away a tax-planning opportunity—a PHC's use of the full fair market value of appreciated property to reduce undistributed PHC income, without having to pay tax on the unrealized gain. At the same time, as the Court's dissenting opinion points out, the Supreme Court, in effect, gave PHCs the above tax-planning opportunity in exchange.

Editors' note: Although corporate tax rates have changed, the above discussion is not affected.

sec. 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

sec. 563

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.

PHC: filing date of consent dividend election

sec. 565

Shareholders of a corporation that receives varying amounts of passive income occasionally find, to their dismay, that the corporation has become a personal holding company within the meaning of sec. 542. The corporation is then confronted with the burden of paying a PHC tax at the confiscatory rate of 70 percent on top of its ordinary income tax. The PHC tax is rarely acceptable, and the inevitable remedy is to distribute dividends to the shareholders.

However, when the corporation's PHC status is not perceived until after the corporation's year end, the corporation may be unable to make actual distribution sufficient to reduce the undistributed PHC income to zero. In such situations, consent dividends may be used to alleviate the problem. Regs. sec. 1.565-1(b)(3) provides that the consent form may be *sec. 565* filed "at any time not later than the due date of the corporation's income tax return for the taxable year for which the dividends paid deduction is claimed." Suppose the corporation's PHC status is not determined until after the original due date of the corporation's tax return. For example, this may be the case where the corporation has obtained an extension for filing its return. When will a consent form in this case be considered timely?

No cases or rulings have been found construing the language of regs. sec. 1.565-1(b)(3). Some commentators assume this regulation means that a consent must be filed no later than the 15th day of the third month after the corporation's year end, and that extensions of time to file the income tax return, not being mentioned, are not comprehended therein. If this is a correct interpretation, additional pressure is put on a corporation to fully comprehend its tax posture by the original due date of the corporate return. There is nothing in the code or regulations to indicate this was intended. Because of the purpose behind the consent dividend procedure, it is not only arguable but reasonable to infer that extensions should cover the consent dividend filing period as well as the tax return filing period.

The question concerning the filing date was discussed with the national office of IRS. The IRS representatives indicated that they were not aware of any authority to the effect that the due date of the return means just that and not the extended due date. The general conclusion was that the question still remains open. Accordingly, if for some reason consent dividend forms have not been filed by the original due date of the tax return, there is strong argument that the forms may be filed during the extended period.

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		52,115
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. 565 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% 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.

Consolidated returns. Note that use of a consent dividend in removing rental income from PHC income has applicability in the area of consolidated returns. Under sec. 542(b)(1) the PHC test is generally made on a consolidated basis by reference to "consolidated adjusted ordinary gross income" and "consolidated personal holding company income." However, if an affiliated group is considered an "ineligible affiliated group" under sec. 542(b)(2), the test must be made on a separate company basis. An "ineligible affiliated group" results if (1) any member derived 10 percent or more of its AOGI from sources outside the group *and* (2) 80 percent or more of that income is PHC income.

It would be detrimental to make the PHC test on a separate-company basis if the group is not a PHC on a consolidated basis.

Example. Common parent *A*, a manufacturing company with only nominal PHC income, owns 80 percent of the stock of *B*, a company that holds stocks, bonds, and commercial rental real estate. Practically all of *B*'s income is from sources outside the group. *B*'s adjusted income from rents is 50 percent or more of its separate AOGI under sec. 543(a)(2)(A), but the excess dividends test of sec. 543(a)(2)(B) is not met. Therefore, its rents constitute PHC income, and, together with its dividend and interest income, it is a PHC. With these assumptions, the group appears to be an "ineligible affiliated group," which dictates that the PHC test be made on a separate-company basis even though on a consolidated basis the PHC test is not met.

sec. 565 In this situation, a consent dividend in an amount sufficient to remove *B*'s rents from PHC income could retain the group's privilege of making the PHC test on a consolidated basis. To illustrate, company *B* has the following statistics:

	Total	Outside group	Inside group
Rents	$430,155	$430,155	—
Interest	52,115	48,786	$3,329
Dividends	800	800	—
Other	9,134	9,134	—
OGI	492,204	488,875	3,329
Rental adjustments	261,323	261,323	—
AOGI	$230,881	$227,552	$3,329
	(100%)	(98.56%)	1.44%

As in our earlier illustration, if the shareholder approves $3,000 of consent dividends and the company has actually paid $1,000 of dividends during the year, rents are removed from PHC income, and the company is no longer a PHC. Furthermore, the PHC test is then made on a consolidated basis, since there is no longer an "ineligible affiliated group," as follows:

PHC income (after consent dividend)

	Total	Outside group	Inside group	
Rents	—	—	—	
Interest	$52,115	$48,786	$3,329	
Dividends	800	800	—	
PHC Income	52,915	A 49,586	3,329	
AOGI	230,881	B227,552	$3,329	(1.44%)
A ÷ B		21.79%		

Therefore, even though 98.56 percent of *B*'s income is from outside the group, only 21.79 percent of that income is PHC income.

sec. 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. *sec. 593*

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

Depletion: representative market price and the meaning of "regularly"

sec. 613

In Rev. Rul. 77-296, the IRS held that a market or field price for mineral concentrates established by an integrated miner/manufacturer, using prices paid by it for concentrates of like kind or grade, is presumed not to be representative under regs. sec. 1.613-4(c)(6) if that price, when added to the total cost of all nonmining processes, "regularly" exceeds the actual sales price of the manufactured product. In that case, a taxpayer cannot use such price for purposes of determining gross income from mining. The regulations provide that in order to rebut this presumption, it must be established that the loss on nonmining operations is directly attributable to unusual, peculiar, and nonrecurring factors, rather than from the use of the market or field price. The examples of such nonrecurring factors contained in the regulations are fire, flood, explosion, earthquake, or strike.

This ruling appears to be a mere restatement of regs. sec. 1.613-4(c)(6) and does not address itself to the question of what the term "regularly" means. The definition of that term is the key to a determination of whether the presumption will be raised in a given case. Once the presumption is raised, a taxpayer may find it difficult to rebut, absent a specific nonrecurring factor.

Revenue agents in a number of audits have attempted to apply this presumption on a year-by-year basis, thus limiting the scope of the term "regularly" to the tax year under examination. This position is in conflict with the case authority in the area. In *Bloomington Limestone Corporation*, the court addressed itself to this question and defined "regular" as year after year. The facts of the case showed that by using the representative price adjustment, profits from mining existed in eight of eleven years, and profits from manufacturing in six years. The manufacturing losses were shown to be caused by market conditions. The taxpayer closed down one mill and cut down operations in another. The court concluded, under the regulations applicable to prior years (similar in relevant respects to the current regulations), that manufacturing losses were not regular enough to raise this presumption. (See also *Gray Knox Marble Co.*)

Percentage depletion under the new "at risk" provisions

With the enactment of sec. 465, much of the attractiveness of so-called "tax shelters" had disappeared. One such shelter is the oil and gas limited partnership. Before the limitations imposed by sec. 465 became law, an individual might invest in a drilling partnership. Once exploratory drilling had located and proved oil and gas reserves, these reserves could be pledged to secure bank loans on a nonrecourse basis, and the proceeds used to complete development of such reserves. The limited partners were then able to deduct intangible drilling costs on the additional wells drilled, up to the amount of their percentage interest in the nonrecourse loans.

Sec. 465 now limits the amount of the partners' deductible losses to the amount that they are "at risk" for such losses. "At risk" amounts under sec. 465(b) include the amount of money plus the adjusted basis of the property contributed. "At risk" amounts also include borrowed capital to the extent that the borrower is personally liable for repayment of such loans or has pledged property securing a nonrecourse liability if the pledged property is not used in the activity.

The explanation of this provision in the Senate committee report is, in part, as follows: "To prevent a situation where the taxpayer may deduct a loss to an excess of his economic investment in certain types of activities, the amendment provides that the amount of the loss (otherwise allowable for the year under present law) which may be deducted in connection with these activities cannot exceed the aggregate amount with respect to which the taxpayer is *at risk* in each such activity at the close of the taxable year (emphasis added)." "Loss" is defined under sec. 465(d) as the "excess of the deductions allowable under this chapter for the taxable year (determined without regard to this section) and allocable to an activity to which this section applies over the income received or accrued by the taxpayer during the taxable year from such activity."

Since it appears that a partner may now deduct only his share of the partnership losses for which he is at risk, what effect does this have on the deduction for percentage depletion? That is, may an individual deduct his allowable percentage depletion even though he has no "at risk" basis to offset against this depletion? sec. 613

Suppose, for example, in year 1, an individual invests $100x in a limited partnership. Also suppose that he was allocated $100x of the IDC costs. (Whether under sec. 704(c) this allocation has substantial economic effect is of no concern for this example.) During year 1, the individual would have at risk $100x and would have taken a $100x deduction on his individual return, so that at the end of year 1 his risk would be zero. Assume that during year 2 the exploratory well begins producing and that gross income from the property equals $100x and the net income from such property equals $50x. The tentative percentage depletion to the individual (since depletion is now computed at the individual level) would be $22x (that is, the lesser of 22 percent of gross income of $100x or 50 percent of net income of $50x). This also assumes that the taxpayer qualifies for percentage depletion under sec. 613A(c), the small producers' exemption, and that he has sufficient other income so as not to be affected by the overall 65 percent of taxable income limitation.

Suppose further that the partnership return for year 2 shows, in addition to gross income of $100x and the allocable expenses of $50x, $50x of general expenses not associated with the producing property, so that the partnership return for year 2 shows zero taxable income. At the end of year 2, the partner has $22x of tentative percentage depletion from the "activity," which he may or may not deduct in his individual return, depending on whether the "at risk" rules apply to percentage depletion.

The '76 act section 204(c)(1), referring to sec. 465, states in part, "IN GENERAL.—Except as provided in paragraph (2) and (3), the amendments made by this section shall apply to losses attributable to amounts paid or incurred in a taxable year beginning after December 31, 1975. For purposes of this subsection, any amount allowed or allowable for depreciation or amortization for any period shall be treated as an amount paid or incurred in such period."

The conspicuous absence of depletion in this excerpt gives some weight to the position that percentage depletion should not be considered when computing losses for the "at risk" provisions. The conference committee reports also state in part, "In general, the 'at risk' provisions apply to losses attributable to amounts paid or incurred (and depreciation or amortization allowed or allowable) in a taxable year beginning after December 31, 1975."

These excerpts, together with the fact that percentage depletion has historically been allowed without giving any consideration to the economic investment, lead one to conclude that the "at risk" provisions are not applicable to the percentage depletion deduction. This conclusion was also reached in *Miller's Oil & Gas Federal Income Taxation.* Thus, it would seem proper to advise clients that percentage depletion appears to be deductible regardless of their "at risk" basis, but that such position is not specifically supported in the code.

Editors' note: Prop. regs. sec. 1.465-45(d) (June 5, 1979) indicates that depletion must be *taken into account in determining a taxpayer's sec. 465(d) loss.*

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 of 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

sec. 613

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.

Sec. 617 election as an accounting method

sec. 617

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, *sec. 617* 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.

sec. 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

Tax-free "sale" of capital assets through a Clifford trust

secs. 651-63

The Clifford trust is commonly employed by affluent taxpayers to shift unearned income from themselves to a child or other relative who pays federal, state, and local income taxes at a low rate.

Besides advantageous income shifting, the Clifford trust offers another tax advantage if it is established as a complex trust—that is, if the trustee is granted discretion to accumulate income rather than to distribute it. A complex trust is in a position to avail itself of the distribution rules under sec. 661. These rules permit the distribution of property in kind in lieu of the payment of income in cash to beneficiaries of the trust. Such a payment has the following tax results:

- No gain is recognized by the trust unless the payment satisfies a specific dollar obligation of the trust [regs. sec. 1.661(a)(2)(F)(1)].
- The deduction taken by the trust in arriving at its taxable income is the fair market value of the property at the time of distribution [regs. sec. 1.661(a)(2)(F)(2)].
- The basis of the property in the hands of the beneficiary is its fair market value at the time of distribution [regs. sec. 1.661(a)(2)(F)(3)].

Thus, the grantor can establish the trust with low-basis property that has appreciated in value. Instead of distributing cash to the income beneficiary, the trust distributes the low-basis property that is included in the beneficiary's income at its fair market value. Upon termination of the trust, the cash held by the trust (or substitute investment property purchased for cash) reverts to the grantor. In effect, the grantor has converted the property originally transferred to the trust into cash without realizing a taxable capital gain.

It should be noted that the foregoing results cannot be *secs. 651-63* achieved through a simple Clifford trust. Since such a trust is required to distribute its net income, a distribution of property would be in satisfaction of a specific dollar obligation of the trust with the result that the trust would realize a taxable capital gain in the amount of the difference between the basis of the property distributed and the trust's distributable net income.

Distribution in kind by fiduciaries: the vanishing capital gain

A technique available to the fiduciary of an estate or complex trust that should not be overlooked is the distribution of property in kind within the distribution rules of secs. 661 and 662.

Generally, in computing the taxable income of an estate or complex trust, a deduction is allowed under sec. 661(a), to the extent of distributable net income (DNI), for the sum of—

1. The amounts of income for the taxable year that are required to be distributed currently and
2. Any other amounts properly paid, credited, or required to be distributed for such taxable year.

For the purposes of (2), unless a transfer of property meets the specific bequest exception of sec. 663(a)(1), distribution of property in kind is considered "any other amounts" [regs. sec. 1.661(a)-2(c)].

As a general rule, no gain or loss results to the fiduciary from a distribution in kind, and the beneficiary takes the same tax basis as the property had in the hands of the estate or trust. However, there are two exceptions to the general rule.

First, a distribution of property in satisfaction of a specific monetary bequest is treated as if the property had been sold at its fair market value and the cash equivalent had been distributed. In this case, the fiduciary must recognize gain or loss on the distribution, and the beneficiary's basis for the property is its fair market value. Such a distribution does not result in a deduction to the fiduciary or in income to the beneficiary.

The second exception is that, to the extent that the fair market value of the property at the time it was distributed (or credited or required to be distributed) represents a distribution of DNI, such value is included in the beneficiary's gross income and becomes his basis for the property. A corresponding amount is deductible by the fiduciary. For this purpose, distributions of property are taken into account in determining the fiduciary's and the beneficiary's taxable income only to the extent that DNI exceeds cash distributions [regs. sec. 1.661(a)-2(f)(2)]. *sec. 651-63*

Example. During 1972, a complex trust has DNI of $50,000. The only distribution made in 1972 to the trust's sole beneficiary consisted of marketable securities having a tax basis of $35,000 and a value of $45,000 at the date of distribution. As a result of such distribution, the trust is entitled to a deduction of $45,000, and the beneficiary must include $45,000 in gross income. The beneficiary's basis in the securities is also $45,000.

The application of the second exception to the basis rule means that the beneficiary gets a stepped-up basis for the property without the trust having to pay a tax on the appreciation in its value. Thus, while he is taxable on the unrealized appreciation, it is not taxed twice, as would have been the case if the trust had sold the property and distributed the proceeds, because the beneficiary can immediately sell the stock with no taxable gain.

The property distribution technique should also be considered in the case of a terminating trust that has a large potential accumulation distribution. Through proper planning, appreciated assets equal to the accumulation distribution could be distributed within the year immediately preceding the year of termination, thereby achieving a step-up in basis to their fair market value. The remaining assets in the trust could then be distributed during the final short period of the trust with a carryover of the trust's basis to the beneficiaries.

On the other hand, a fiduciary should not distribute property that has depreciated in value since the result would be a decrease in basis without a concomitant tax benefit.

This discussion illustrates only a few situations in which the distribution-in-kind technique can be successfully utilized; there are other instances where the thoughtful fiduciary might capitalize on the "vanishing capital gain."

Editors' note: To attain maximum benefit from the basis step-up, cash should be distributed only in the termination year. (See regs. sec. 1.661-1(a) and 2(f)(3).)

Annuity trust vs. unitrust: don't ignore the factors in making the choice

sec. 664

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 *sec. 664* 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.

sec. 664

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.

Multiple trusts: the code and the regs.

sec. 667

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 *sec. 667* 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% 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 '76 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. *sec. 667*

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."

Clifford trusts: use combined with grantor loan **sec. 673**

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).

sec. 673

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

Elections at the partnership level that may be inapplicable to some partners

sec. 703

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 as 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 purposes 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 *sec. 703* 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.

sec. 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

sec. 706

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.

Conversion of general partnership into limited partnership

sec. 708

The IRS appears to have resolved in favor of taxpayers the long-unanswered partnership issue concerning the tax consesec. 708 quences 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.

sec. 752 Liabilities in two-tier partnerships

There is some uncertainty about the treatment of liabilities in multi-tiered 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*

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.

New partner and old debt

A and *B* own a 100 percent interest in a partnership. The partnership admits new partner *C*, who will have a 25 percent interest in the capital and profits, and a 99 percent interest in the losses. *C* pays cash directly to the partnership for his capital contribution. It has been suggested that *A* and *B* would realize gain or loss under the following reasoning:

- The reduction of *A*'s and *B*'s share of liabilities is, pursuant to sec. 752, considered a distribution of cash.
- Accordingly, under sec. 751(b), regs. sec. 1.751(1)(b), and regs. sec. 1.751(1)(g), example (5), partners *A* and *B* have sold their interest in sec. 751 property for money.

Nevertheless, a partnership technician at the IRS informally indicated that Rev. Rul. 75-423 might apply. That ruling held that a change in ownership resulting from the admission of a new partner did not result in a sale or exchange of partnership interests by or between members of the partnership. Since we did not have a sale or exchange, sec. 751(a) should not be applicable. However, we did have a constructive cash distribution under sec. 752(b). Thus, we would have a recovery of basis under sec. 731(a). If the amount of the constructive distribution of cash under sec. 752(b) exceeds the basis in the partnership interest, then the excess might be ordinary income under sec. 751(b)(1)(B).

How do we measure the sec. 752(b) constructive cash distribution that results from *C* becoming a partner and thereby becoming responsible for some share of the liabilities? The general rule is that the loss-sharing ratio is also the liability-allocation ratio [regs. sec. 1.752-1(e)]. However, where none of the partners has any personal liability with respect to a partnership debt (e.g., a nonrecourse mortgage), then that debt shall be allocated on the profit-sharing ratio. Since the instant debt was nonrecourse, and since *C* only had a 25 percent interest in profits, *A* and *B* each received a constructive cash distribution of 12.5 percent of the debt—which, fortunately, was less than their tax basis in the partnership (which basis, of course, reflected the full cost of the acquired property subject to the nonrecourse debt). *sec. 752*

Don't make unnecessary optional adjustment to basis election

sec. 754

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.

sec. 754 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.

Regulated investment companies and real estate investment trusts

Conversion of operating company to regulated investment company

sec. 852

An operating company that principally holds current assets, such as receivables and inventories, with a "bulk sale" value approximating the basis of these assets and a large accumulated earned surplus may find it attractive when selling its business to continue in existence as a personal holding company. The corporation tax on the asset sale is small, and the capital gain tax on a complete liquidation gain reportable by the shareholders under sec. 331 is avoided. The former operating company can reinvest the sales proceeds in a portfolio of dividend-paying common and preferred stocks to take maximum advantage of the sec. 243 dividends-received deduction. The remaining 15 percent of the dividend income often is fully or partly offset by general and administrative expenses of the corporation.

Typically, the corporation in this case becomes a personal holding company—that is, where five or fewer individuals own, directly or indirectly, at any time during the year, more than 50 percent in value of the company stock. This personal holding company status requires the corporation to distribute its entire earnings (with the dividends-received deduction added back) to its shareholders, who then pay ordinary income tax on these "force out" dividends.

If the corporation is not a personal holding company because the five-or-fewer stockholder test is not met, it will be subject to the sec. 531 tax on accumulated earnings as a mere holding or investment company. (See sec. 533(b) and Rev. Rul. 77-399, involving a "tax-sheltered trust" regulated investment company not paying dividends, which was held subject to the sec. 531 tax.)

sec. 852 Consideration should be given to utilization of the newly amended sec. 852(b) for these larger companies. The '76 act enlarged sec. 852(b) to permit formation of a municipal bond investment company in the conventional mutual fund format, as opposed to the wasting or liquidating trust format required under former law.

The new law can be used by the former operating company, provided there are more than 100 stockholders (even though there may be a large family concentration of stock ownership). The company then can invest the sales proceeds in a municipal bond portfolio, and would not be a personal holding company if its income is confined to capital gains and tax-exempt interest income.

Although the company is not subject to the personal holding company dividend-payment requirement, it presumably will distribute all capital gains and interest income as a "mutual fund." The shareholders will be entitled to "conduit" dividend reporting for these long-term gains and to exempt municipal bond interest income.

Converting operating company to municipal bond fund to achieve higher net yield

The '76 act added sec. 852(b)(5) to the code to permit regulated investment companies (mutual funds) to "flow through" to their shareholders by distributing the tax-exempt character of interest from municipal obligations. One consequence of this amendment is a new trend among owners of some unsuccessful operating companies to shift their investment into municipal bond funds. A possible drawback to such a shift is the capital gains tax and minimum tax on the shareholders who liquidate their investment in order to reinvest the net proceeds.

But where the value of the company's assets is not substantially above tax basis, the conversion to a mutual fund can be achieved with minimum tax cost if the company sells all its assets and liabilities for cash and transforms itself (without liquidating) into a closed-end regulated investment company. The resulting entity invests its cash in tax-exempt bonds, and the shareholders who choose not to redeem their shares may obtain a higher net yield from exempt bond interest than from dividends from their operating company. In order to transform itself into a regulated investment company, the operating company must qualify under the Investment Company Act of 1940 and meet the requirements of sec. 851.

Another possible remedy is for the operating company to be acquired by an already existing regulated investment company. Notwithstanding sec. 368(a)(2)(F), a tax-free reorganization can be effected between one investment company and an operating company that is going out of its previous business. The IRS has announced that it will once again consider requests for advance rulings in this area. (See Rev. Proc. 77-1.) *sec. 852*

REITs: use of "stock pairing" arrangements to increase after-tax corporate distributions

sec. 856

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 a 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), a REIT must *sec. 856* 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. *sec. 856*

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 a 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 a REIT's investment adviser can be the independent contractor merely if it operates as a separate entity, with separate officers and employees main-

sec. 856 taining 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.

sec. 857 REITs: the NOL deduction problem

A Real Estate Investment Trust (REIT) has a 1978 loss from operations of $100,000 and a capital gain of $900,000. Therefore, current taxable income and earnings and profits (E&P) are $800,000. The REIT also has a net operating loss (NOL) carryover deduction of $850,000. The REIT would like to distribute its current E&P to its shareholders as a capital gain dividend.

If the NOL carryover is deducted before the sec. 857(b) special REIT deductions (which include dividend distributions), the trust will have no ordinary taxable income and, under sec. 857(c), a REIT's capital gain dividends are limited to the lesser of its net long-term capital gain or its REIT taxable income before the dividends-paid deduction. Any dividends paid during the current year would therefore be ordinary income dividends out of current E&P. On the other hand, if the NOL is deducted after the special REIT deductions, the REIT will have $800,000 of taxable income before dividend distributions. Thus, there would be a limit of $800,000 for capital gain dividends. The issues become, When is the NOL deducted? and Which of these two situations will apply?

Sec. 172(d)(7) and the format of the tax return suggest the NOL should be deducted after the special REIT deductions. Sec. 857(b)(2) implies that the NOL should be deducted before the special REIT deductions. (Sec. 857(b)(2) defines REIT taxable income and, although NOL deductions are not specifically mentioned, it is apparent that this section contemplates that a NOL deduction is reflected in taxable income before REIT adjustments.)

There seems to be no clear answer as to which of these sections controls. However, based on the apparent congressional intent, it appears that the dividend in the above example should be a capital gain dividend, as follows:

Computation of REIT taxable income:	
Operating income	$(100,000)
Capital gains	900,000
	800,000
Dividends paid	(800,000)
REIT taxable income	0
Limitation for capital gain distributions:	
REIT taxable income	0
Add back dividends paid	800,000
Capital gain limitation	$800,000

The basis of this approach is sec. 172(d)(7)(B), which provides that in determining the amount of a loss carryover to a given year, taxable income of prior years is computed with the deductions allowed by sec. 857(b). Thus, as illustrated in the first computation, no carryover is deductible under these facts. The limitation for capital gain dividends is "REIT taxable income (determined without regard to the deduction for dividends paid . . .)" [sec. 857(b)(3)(C)]. It does not seem logical that in determining this amount, the carryover should be considered used. The capital gain distribution limitation should be as shown in the second computation above.

This approach gives credence to the taxing scheme of a REIT. The REIT is allowed to distribute capital gains to its shareholders. Under the facts presented, a dividend paid in the current year would be taxable (and not a return of capital) because the REIT has current E&P. Since capital gains caused the E&P, it follows that distributions of this E&P should be considered capital gain distributions. To hold otherwise would defeat the REIT "pass-through" concept. The limitation on the amount that can be treated as a capital sec. 857 gain distribution prevents a REIT from classifying distributions of accumulated E&P as capital gain distributions where there is an operations loss and net capital gain in the current year. This also supports the contention that the makeup of distributions out of current E&P should not consider loss carryovers.

Tax based on income from sources within or without the United States

Who gets the foreign tax credit—simple trust, income beneficiary, or neither?

sec. 901

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

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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."

Accrual of contested foreign income tax

The accrual of a contested tax liability takes an interesting turn when the tax involved is a foreign income tax eligible for credit under sec. 901. As illustrated by a recent district court case, *Mediterranean Refining Co.*, this situation can result in very undesirable tax consequences.

The normal contested tax rule, as expressed in the Supreme Court case of *Dixie Pine Products Co.*, provides that a contested tax is accruable and deductible only in the taxable year

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in which the liability is finally determined. For example, if a property tax is assessed in 1977, but the taxpayer appeals the assessment until reaching an agreement in 1979, such tax is accruable and deductible in 1979. When the contested tax is a foreign income tax eligible for credit in the U.S., however, two accrual rules apply. When determining the year in which such tax offsets U.S. tax, an exception to the normal rule applies to provide that it accrues in the taxable year to which it relates. (See *Cuba Railroad Co.* and Rev. Rul. 58-55.) In the above example, if the tax was a foreign income tax eligible for credit in the U.S., it would have been deemed accruable in 1979 (the year final liability was determined) but creditable in 1977 (the year to which it relates). Although the rationale for this dual rule is to allow the contested tax to be offset against the U.S. tax imposed on the same income that was subject to such tax, the *Mediterranean* case illustrates that this may not always be accomplished and, in fact, the credit may be totally lost.

In *Mediterranean*, the court concluded that a 1962 foreign tax that was still being contested by the taxpayer in 1973 would not be accruable until the liability was finally determined. As such, a refund claim for 1962 based on the allowance of the tax as a credit was rejected. In that case, the tax, when and if finally determined, will never be creditable. Why? In order to claim a credit for such a tax, it is necessary to reopen the tax return for the earlier year to which it relates. Because of a special statute of limitations provided by sec. 6511(d)(3), a ten-year period is available. However, if the liability is finally determined after this ten-year period, it can never be creditable because reopening the earlier year will be barred by the statute of limitations. The mitigation provisions are apparently no help here. (See secs. 1311(b)(2)(B) and 1312(4).) In *Mediterranean*, a *deduction* for the tax in the year of final determination may be available if the taxpayer also deducts all other foreign taxes in that year. Otherwise, there will be no benefit from paying the foreign tax liability.

Editors' note: Mediterranean *has been affirmed by the second circuit.*

Foreign social welfare taxes may be creditable

Several foreign countries require individuals to make payments to the government under a compulsory social welfare system that provides for illness, accidents, maternity, old age, sec. 901 survivors, and forced inactivity. A U.S. citizen who works in such a country may be required to make contributions to the social welfare system if he is considered a resident or, in some cases, simply if he receives a salary or self-employment income derived from the foreign country. The contribution to the system can be equal to a fixed percentage of an individual's salary or income, which is similar to a "tax" on income.

The question presented is whether such a social welfare contribution paid by a U.S. citizen to a foreign country qualifies for a foreign tax credit against his U.S. income tax liability.

Sec. 901 allows a credit against U.S. income tax for foreign income, war profits, and excess profits taxes paid or accrued by a U.S. taxpayer. For a particular foreign tax to qualify as a creditable tax, it must be shown that the tax imposed by the foreign law is a tax on income within the U.S. concept thereof [*Mary D. Biddle*].

Although the payments made by a U.S. citizen are referred to as contributions, such payments appear to be "taxes" within the U.S. concept. Also, if the contributions are measured by a percentage of income, they appear to be "income" taxes. If the social welfare contributions of a U.S. citizen are based on his income and are considered to be taxes within the U.S. concept, the contributions ought to be creditable taxes against U.S. tax liability.

The above reasoning was the basis for allowing a foreign tax credit for social welfare payments made to Venezuela [Rev. Rul. 69-338] and Great Britain [Rev. Rul. 72-579].

Foreign tax credit: IRS rulings on foreign "income" taxes

Rev. Ruls. 78-61, 78-62, and 78-63 establish criteria for determining whether a foreign tax is creditable as either an "income" tax or a tax "in lieu of" an income tax under secs. 901 and 903. Based on these criteria, the IRS revoked two long-standing rulings that held that payments to oil-producing countries were creditable and modified its position with respect to a number of other rulings and cases. Rev. Rul. 78-61 holds that in order to be creditable, a tax must be the substantial equivalent of an income tax in the U.S. sense. For purposes of this determination, the following three criteria are set forth:

1. The gain on which the foreign tax was levied must be "actually realized" in the U.S. sense.

2. The purpose of the tax must be to reach net gain and the tax must be structured to be almost certain of doing so. sec. 901
3. The tax must be imposed on the receipt of income, rather than the exercise of a privilege or a franchise, such as exploiting natural resources.

These rulings are the result of a four-year study by the service on the creditability of taxes paid to oil-producing countries. Of more general interest to U.S taxpayers with foreign income from non-oil operations is whether these criteria represent any departure from prior practice with respect to the features of a creditable income tax. In general, the three requirements are based on existing case law and prior rulings, which are amply cited in the three new rulings. However, the real difficulty has always been, and will continue to be, the application of these general criteria to specific taxes. A brief discussion of the new rulings follows.

Rev. Rul. 78-61. The Ontario Mining Tax (OMT) is imposed on a "profit" that is based on the value of mined ore either sold or incorporated in a manufacturing process by the taxpayer. In computing net income for OMT purposes, the taxpayer is permitted to reduce the value of the ore only by prescribed deductions. The nondeductible expenses include interest, royalties, or rent paid to the landowner, and, in some instances, depletion.

The ruling concludes that the OMT is not creditable because it fails to satisfy the three criteria. The tax is imposed on the value of mineral output incorporated in the manufacturing process; thus, it is not considered imposed on the realization or receipt of income in the U.S. sense. Because the taxpayer's ability to claim deductions for significant expenses is limited, the tax is considered not to be "almost certain" of taxing net gain in the U.S. sense. The ruling further concludes that because the tax is imposed *in addition to* the regular Ontario corporate tax, it is not creditable as "in lieu of" an income tax.

Rev. Rul. 78-62. The ruling applies the criteria set forth in Rev. Rul. 78-61 to revoke or modify the IRS's position on the taxes in a number of long-standing cases and rulings. For example, taxes computed using a formulary base, such as rental value of property, will not be treated as being almost certain of reaching net gain (a French tax in *Herbert Ide Keen*, a Haitian tax in Rev. Rul. 272). Also, taxes not imposed on the sale of inventory will be treated as failing to be imposed on gain realized in the U.S. sense (e.g., imposed on purchases of inventory items). (See *Burk Bros.*) Analogizing to U.S. taxes withheld on periodic income payments to nonresident aliens and foreign corporations, the ruling holds that a Mexican tax on gross income derived by nonresidents of Mexico from mining activities is a creditable tax. (See *Santa Eulalia Mining Co.*)

Rev. Rul. 78-63. The ruling applies the criteria set forth in Rev. Rul. 78-61 to revoke Rev. Ruls. 68-552 and 55-296, dealing with Libyan and Saudi Arabian taxes imposed on oil companies. Each tax used the posted-price mechanism for the valuation of oil produced and sold. The ruling held that the Libyan company tax and surtax failed to qualify as an income tax because taxable income was computed by reference to an artificial value (i.e., the posted price) and the tax base included the value of oil exported. The surtax did not qualify as an "in lieu of" tax because the taxpayer also paid the company tax. Since the Saudi tax covered by the 1955 ruling was imposed on a posted price, it did not tax net gain as required by the criteria. Finally, this tax was not an "in lieu of" tax since Saudi Arabia did not impose a general tax.

Questions. The question still remains, quite apart from these OPEC rulings, how to apply these subjective criteria of "what is substantially equivalent to a U.S. income tax" to the world's great variety of tax systems. Why should a foreign country be required to compute its tax base basically the same way as the U.S.? For example, why did the IRS seek to disallow a credit for the Swiss dividend withholding tax on a distribution from a Swiss subsidiary to its U.S. parent, which the Swiss tax authorities treated as a constructive dividend although the U.S. parent excluded the amount from gross income in accordance with Rev. Proc. 65-17? (See *Schering Corp.*) The court agreed with the taxpayer's position that the withholding tax was creditable even though the U.S. did not regard the payment as a dividend.

There are many other examples of foreign income taxes being computed in ways not used in the U.S. For example, if an administrative or liaison office in a foreign country is taxed on a percentage of its expenses, that should be no reason to disallow the credit for the foreign tax imposed on such income. It is merely another country's equivalent of our "safe haven" rules under sec. 482, providing for an arm's-length profit.

These and other questions involving the three criteria enunciated in these rulings are likely to be the subject of future rulings and cases.

sec. 901

Editors' note: See Rev. Rul. 78-222, where Indonesian taxes paid under oil and gas production sharing contracts qualify as creditable income taxes; Rev. Rul. 78-233, where taxes imposed on interest by the state of Mexico of the Republic of Mexico do not qualify; Rev. Rul. 78-234, where Tanzanian taxes imposed on management or professional fees by nonresidents do not qualify, but where taxes imposed on the gross amount of dividends, interest and royalties do qualify; Rev. Rul. 78-235, where the 5 percent Mexico City tax imposed on certain interest income and the 15 percent additional tax on such tax do not qualify; Rev. Rul. 78-258, where the amount allowable with respect to the 25 percent withholding tax imposed by Brazilian decree on interest paid by Brazilian borrowers to foreign lenders is limited to the amount withheld in excess of the subsidy granted the borrowers; Rev. Rul. 79-291, where Italian social security taxes do not qualify; and Rev. Rul. 80-4, where a payment to the Netherlands Antilles pursuant to the election described in Rev. Rul. 65-16 qualifies.

Foreign tax credit: "bunching" foreign mineral taxes affects sec. 901(e) reduction

Sec. 901(e) provides a limitation on the use of any foreign income, profits, and excess profits taxes paid or accrued during a taxable year with respect to foreign mineral income. The objective of the rule is to curtail the use of these taxes as credit to the extent that they are attributable to the U.S. percentage depletion allowance, but is that really the result?

The calculation of the disallowance includes, in effect, reduction of the credit by the excess of—

a. The *lesser* of the foreign mineral taxes *or* U.S. tax on foreign mineral income computed without the sec. 613 percentage depletion allowance *over*

b. The U.S. tax on foreign mineral income (after the sec. 613 allowance).

If the foreign country does not have a percentage depletion concept, the two figures in *a* may approximate each other, and there will be a disallowance every year. But what if the foreign mineral taxes of one year are accelerated (or deferred) to a preceding (or succeeding) year?

If foreign mineral taxes are bunched in this way, the total should exceed the U.S. tax computed without the percentage depletion allowance. Thus, the sec. 901(e) disallowance will not change, and more accelerated (or deferred) foreign minsec. 901 eral taxes will be available as a credit. Consequently, the timing of foreign mineral taxes appears to have a genuine impact on their availability as a U.S. foreign tax credit.

sec. 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:

$$\begin{array}{c}\text{Dividend}\\\text{received}\end{array} \times \frac{\text{Foreign taxes paid by FC}}{\text{Earnings \& profits of FC}} = \begin{array}{c}\text{Foreign taxes}\\\text{deemed paid}\end{array}$$

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 pr:or 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.

sec. 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).)

sec. 905

Foreign tax credit: sec. 905(c) and fluctuating exchange rates . . .

Sec. 905(c) provides that if accrued foreign income taxes claimed as a credit for U.S. tax purposes are adjusted when subsequently paid, the taxpayer must notify the IRS so that a redetermination of U.S. tax liability can be made. Thus, if a U.S. taxpayer accrues a foreign tax liability of 200x, but the actual tax paid (without regard to exchange rate fluctuations) is subsequently determined to be 180x, there is an obligation to notify the IRS of the adjustment and pay an increased U.S. tax. However, does the taxpayer have an obligation to notify the IRS when an increase or decrease in the accrued tax results solely because of fluctuations in foreign exchange rates between the accrual and payment dates? Using the above example, if the foreign tax liability of 200x is the same on both the date of accrual and date of payment but, due to fluctuating exchange rates, the U.S. dollar equivalent on the accrual date is $400 and on the payment date is $380, is there an obligation to notify the IRS pursuant to sec. 905(c)?

In a recent case, *First National City Bank*, the court concluded that sec. 905(c) required notification in situations where there is no change in the foreign tax liability stated in terms of the foreign currency but merely a change in the U.S. dollar amount of the foreign tax due to foreign-exchange fluc-

sec. 905

tuations. In reaching its conclusion, the court accepted the IRS position set forth in Rev. Rul 73-506 and approved a similar conclusion reached in *Comprehensive Designers International, Ltd.*

Because of the recent frequent exchange-rate fluctuations in many foreign currencies in terms of the U.S. dollar, taxpayers claiming foreign tax credits may be required to notify the IRS pursuant to sec. 905(c), and additional tax payments or refund claims will be required.

Sec. 911—foreign income exclusion vs. income averaging

sec. 911

Sec. 911(a) provides that U.S. citizens residing abroad, etc., may exclude from gross income that portion of earned income, as limited by sec. 911(c), derived from sources without the United States.

Sec. 911(e)(1) allows an individual qualifying under sec. 911(a) to elect not to have the provisions of the section apply. Sec. 911(e)(2) provides that such an election may not be revoked without the consent of the commissioner.

Sec. 1304(b)(1) provides that if income averaging is elected, the limited foreign income exclusion of sec. 911(a) shall not apply for that taxable year.

It appears that when a taxpayer elects income averaging, he is not electing under sec. 911(e) to irrevocably forgo the foreign income exclusion. Thus, a taxpayer could alternate between electing income averaging for one or more years and electing the sec. 911(a) foreign income exclusion for other years. The IRS appears to agree with this position.

The benefits of income averaging may be especially beneficial in the year of relocation to the foreign country because of the usually substantial moving expenses incurred. Sec. 911(a) provides that deductions or credits allocable to the foreign income exclusion will not be allowed. But, by electing income averaging, the taxpayer's moving expenses would be fully deductible and the entire sec. 901 foreign tax credit would also be allowable.

Therefore, the choice between the benefits of income averaging and foreign income exclusion, especially in the year of relocation, should be carefully considered in tax planning for U.S. citizens working abroad.

sec. 911

Sec. 911: bona fide residence for entire short taxable year

In essence, a citizen of the U.S. is entitled to exclude a limited amount of income earned outside the U.S. during a period in which he is a bona fide resident of a foreign country for "an uninterrupted period which includes an entire taxable year" [sec. 911(a)(1)]. The question arises as to whether the quoted requirement is satisfied where a U.S. citizen died during a year in which he was a bona fide resident of a foreign country from the beginning of the year, but within 12 months after he became a resident of the foreign country. In other words, for sec. 911(a)(1) purposes, does a short taxable year ending with the decedent's death qualify as "an entire taxable year"?

Example. On December 30, 1976, *D*, a U.S. citizen, was transferred from the employer's New York office to its Paris office. *D* died on June 25, 1977. From December 30, 1976, through June 25, 1977, *D* was a bona fide resident of France. Did the short taxable year ended June 25, 1977, constitute an entire taxable year? If so, the sec. 911 exclusion provisions apply to income earned by *D* in France from December 30, 1976, to June 25, 1977.

Based on an analysis of the relevant code sections and the opinions in two conflicting decisions on this issue, we concluded that *D* was a bona fide resident of France for *D*'s entire 1977 taxable year. The conflicting court decisions are *Esther Witt* and *Est. of Theodore Roodner.*

Conflicting cases. In *Witt*, the decedent (*W*) was a bona fide resident of Venezuela from April 27, 1952, until his death on January 3, 1953. The taxpayer contended that the income earned by *W* in Venezuela after April 26 was excludible because the three-day period ended January 3, 1953, constituted *W*'s "entire 1953 taxable year." However, the district court rejected the taxpayer's contention solely on the ground that the legislative history suggests that "entire taxable year" as used in sec. 911, means a full 12-month period.

The court said that Congress "had in mind a situation where the taxpayer was a resident of a foreign country for an entire taxable year, meaning a full 12-month period and not a fraction of a calendar year such as would constitute under some circumstances the taxable year of a taxpayer in the event of death." Unfortunately, the court did not cite or otherwise discuss the legislative history from which it deduced the intent of Congress.

In the conflicting *Roodner* decision, *R* was a bona fide resident of Argentina from November 1, 1970, to June 25, 1971, the date of his death. The Tax Court held that the period January 1, 1971, to June 25, 1971, was *R*'s "entire 1971 taxable year" for sec. 911(a)(1) purposes. *sec. 911*

The Tax Court's opinion deals specifically with statutory provisions, legislative history, and the court decisions relied on by the IRS. The Tax Court observed that in sec. 911(a)(1) Congress specifically used "taxable year," a technical term that is clearly defined in the code [secs. 441(b)(3) and 7001(a)(23)] to mean "the period for which the return was made." Further, the court analyzed the legislative history underlying the "entire taxable year" language and, contrary to the district court, concluded that the legislative history did not support the IRS position. Finally, the Tax Court pointed out how the cases cited by the IRS served to undermine, rather than support, its position. As to the *Witt* decision, the Tax Court stated in a footnote, "We respectfully disagree with that opinion."

Joint return. While *R*, in *Roodner*, apparently filed a separate return for his short period, the filing of a joint return (which would cover the surviving spouse's 12-month taxable year) should not affect the result. Regs. sec. 1.6013-1(d) makes clear that if a spouse dies in a joint-return year, the taxable year of the deceased spouse begins on January 1 and ends on the date of death.

Model for tax planning? In *Roodner*, the IRS (apparently dead serious) argued that a decision for the taxpayer "will open wide the door to potential abuse." The court replied, "[W]e think it is incredible that other taxpayers will consider [this] fact pattern . . . a desirable model for tax planning."

Expatriate housing expense deduction: recapture rule is a one-edged sword

sec. 913

Individuals working abroad can deduct certain excess foreign living costs, including "qualified housing expenses" (QHE), which are defined by sec. 913(e) as the excess of the individual's reasonable housing expenses over his base housing amount. The latter is 20 percent of the excess of the individual's "housing income" (generally, net earned income) over the sum of his housing expenses and other specified deductible foreign living costs. The specified costs consist of the cost-of-living differential, school expenses, home-leave travel expenses, and hardship-area deduction.

As originally enacted, sec. 913(e) provided that, for QHE purposes, if compensation is deferred until the year immediately following the year in which the services are rendered, such compensation will be considered received in the year earned. Apparently, the Treasury and Congress were concerned that expatriates would arrange to defer the receipt of compensation for more than one year in order to reduce the base housing amount and thereby inflate the QHE deduction.

Accordingly, the Technical Corrections Act of 1979 (P.L. 96-222) substantially changed the rules concerning the treatment of deferred compensation in the base-housing-amount computation. (See sec. 913(e)(7).) First, the act provides that compensation must be included in the year in which it is received instead of in the year in which the underlying services were performed. This change eliminates the necessity for filing an amended return for the prior year in which the deferred compensation was earned. Secondly, the act introduces a rule for recapture of an excess QHE deduction when compensation is deferred from a year in which the deduction is claimed to a year in which no deduction is claimed. The recapture rule does not apply to compensation deferred for more than three years.

The excess QHE deduction is the amount by which the total of deductions actually claimed in all relevant years exceeds the total amount that would have been deductible if the deferred compensation had been taken into account in the "services rendered" years. The excess QHE deduction is taxable as income in the recomputation year.

The Senate Finance Committee report illustrates the recapture amendment as follows:

> In 1979, *A* earned and received $200 of income, and incurred housing expenses of $70. In 1980, *A* receives $400 of earned income (of which $300 is attributable to 1980 and $100 to 1979) and incurs $60 of housing expenses. For the two years, *A*'s actual deductions total $44 while the recomputed deductions would total only $36, determined as follows:

	Actual		Recomputed	
	1979	1980	1979	1980
1. Housing (net earned) income	$200	400	300	300
2. Housing expenses	70	60	70	60
3. Line 1 less 2	130	340	230	240
4. Base housing amount—20% of line 3	26	68	46	48
5. QHE deduction—line 2 less 4	44	-0-	24	$12

Therefore, $8 ($44 less $36) is "recaptured" as taxable income in 1980. sec. 913

An inequity results if the taxpayer has a QHE deduction for only the year in which the deferred compensation is received. That is, if the total recomputed housing deduction is greater than the total actual deduction, the new recapture rules do not allow the greater amount. The following example illustrates this inequity.

In 1979 *B* earned and received $300 of income and incurred housing expenses of $50. In 1980 *B* receives $400 of earned income (of which $350 is attributable to 1980 and $50 is attributable to 1979) and incurs $70 of housing expenses. For the two years, *B*'s total actual and recomputed QHE deductions would be $4 and $14 respectively, determined as follows:

	Actual		Recomputed	
	1979	1980	1979	1980
1. Housing (net earned) income	$300	$400	$350	$350
2. Housing expenses	50	70	50	70
3. Line 1 less 2	250	330	300	280
4. Base housing amount—20% of line 3	50	66	60	56
5. QHE deduction—line 2 less 4	—	$ 4	—	$ 14

If the "recapture principle" were applied consistently, *B* would be entitled to an additional deduction of $10 ($14 less $4) in 1980. However, the new sec. 913(e)(7), rather inequitably, does not provide for the allowance of the additional deduction that can result under the recapture computation. The Technical Corrections Act itself is in need of an equitable correction.

CFC's purchase of U.S. parent's accounts receivable may not be investment in "U.S. property"

sec. 951

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 sec. 951 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 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. *sec. 951*

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.

Sec. 956: ramifications of pledging CFC stock—comments and recommendations

sec. 956

Rev. Rul. 76-125 holds, in essence, that where a U.S. shareholder pledges his stock in a controlled foreign corporation as collateral against his indebtedness to a bank, the CFC is a guarantor [sec. 956(c)] and thus a holder of an obligation of a U.S person [sec. 956(b)(1)(C)]. Consequently, the loan is considered an investment in U.S. property under sec. 951(a)(1)(B) to the extent of the CFC's earnings and profits.

In *Daniel K. Ludwig*, the service's attempt to expand the sec. 956(c) guaranty concept via Rev. Rul. 76-125 was rejected. Interestingly, although the ruling (obviously based on the *Ludwig* facts) was not published until after the deficiency notice was issued to the *Ludwig* taxpayers, the service relied on the ruling in the litigation. The Tax Court admonished the service for this, stating, "[T]he Courts [including the Supreme Court] have not looked with favor upon bootstrapping revenue rulings issued shortly prior to the initiation of litigation."

The facts in *Ludwig* are as follows: *L*, an individual U.S. shareholder, pledged the stock of his wholly owned CFC (Oceanic) as collateral for a bank loan. Oceanic's sole asset was all of the stock of another CFC. In the loan agreement, *L* represented that his Oceanic stock was free of prior encumbrances and that Oceanic's assets were and would remain free and clear. On the other hand, *L* did not directly commit Oceanic's assets to obtain the loan. Oceanic itself promised nothing in connection with *L*'s indebtedness and did not assume any liability with respect to it. Consistent with its ruling, the service contended that the provisions in the loan agreement and the representations made by *L* reflected an intention by him and the bank to commit Oceanic's assets in case of default.

In deciding that Oceanic was not a guarantor of *L*'s indebtedness, the Tax Court reasoned, in essence, as follows:

sec. 956

- In order for a CFC to be considered a holder of a U.S. person's obligation, sec. 956(c) requires the CFC itself to be the guarantor. Since Oceanic did not assume a liability as pledgor or guarantor, it is not a party to the transaction. (Note: Implicitly, this line of reasoning is premised on the separate entity concept.)
- Sec. 956(c) does not support the ruling's attempt "to stretch the [meaning of the] statute and regulations to cover a situation with which they do not deal." It is the direct commitment of the CFC's assets or the use of the CFC's credit that is treated as an indirect repatriation of funds under sec. 956, and not the pledge of its stock by a shareholder. Thus, secs. 951 and 956 do not reach every economic benefit derived from the ownership of the stock in a CFC.
- The restrictive provisions in the loan agreement (i.e., *L* would not cause Oceanic to borrow money except for business reasons, to pay dividends, etc., without the lender's consent) do not give the lender a direct claim against Oceanic or its assets. These restrictions are common and do not constitute an indirect guarantee by Oceanic.

Comments. The following points should be made:

- Although nonacquiescing to the decision, the service has not appealed it. Furthermore, we understand, the service does not intend to relitigate this issue at the present time.
- We understand that the service will attempt to attack this particular arrangement through a revision of the regulations. It is doubtful, however, in light of the relevant legislative history and the Tax Court's cogent opinion in *Ludwig*, whether the service can successfully "revise the statute" by regulations. Legislation is a function of Congress, not the service.

Recommendation. A U.S. shareholder's pledge of a CFC's stock to obtain a loan might be considered an investment in U.S. property—under the substance-over-form doctrine—if substantive restrictive provisions in the loan agreement enable the lender to have direct access to the CFC's assets in the case of default by the shareholder. Therefore, it is recommended that the terms of similar loan agreements conform to those of the *Ludwig* case; that is, only the U.S. shareholder should be personally liable, and the lender's sole recourse is to look to the shareholder and his assets (including the pledged CFC stock) for repayment.

Editors' note: See next item.

IRS to amend sec. 956(c) regs. to provide "unique" definition of "guarantor"

Sec. 956(c) provides that "a controlled foreign corporation shall, under regulations prescribed by the Secretary, be considered as holding an obligation of a United States person *if such controlled foreign corporation is a pledgor or guarantor of such obligation*" (emphasis added).

Rev. Rul. 76-125 deals with the application of sec. 956(c) to facts that may be briefly summarized as follows:

> An individual U.S. shareholder (*A*) pledged the stock of his wholly owned CFC (*X*) as collateral for a bank loan. In the loan agreement, *A* agreed not to cause or permit *X* to do anything that would adversely affect the book value of *X*'s assets as of the date of the loan.

The ruling holds, in essence, that because its stock was pledged as collateral against *A*'s bank loan, *X* is a guarantor of the loan and therefore a holder of an obligation of a U.S. person (i.e., U.S. shareholder *A*). Consequently, under secs. 951 and 956, the amount of the loan may constitute taxable income to *A*.

However, the position taken in the ruling was unequivocally rejected in *D.K. Ludwig*. Basically, in a comprehensive and cogent opinion, the Tax Court reasoned in part:

> The IRS is seeking to stretch the statute and regulations to cover a situation with which they do not deal. Since neither the code nor the related regulations provide a specific technical definition of "guarantor," the term should be given its normal and customary meaning—i.e., a guarantor is "one who makes a guaranty." There are two essential elements in a "guaranty," namely, (*i*) an undertaking or promise on the part of the guarantor and (*ii*) a liability of the guarantor to make payment if the primary obligor fails to do so. Since both elements are missing here, *X* can hardly be considered to have made a "guaranty" within the usual meaning of that term.

As anticipated, the service is seeking to strengthen its position on this issue by elevating the ruling into the regulations. On April 20, 1979, the IRS issued proposed regulations [regs. sec. 1.956-2(c)(2), (3), and (5)] which assert that a CFC is a guarantor where its assets serve either directly or indirectly as security for a loan of a U.S. person. (Although not within the *sec. 956* scope of this item, it should be noted that the proposed regulations go so far as to treat a CFC as a guarantor if its assets serve to "otherwise facilitate" a loan to a U.S. shareholder.)

In effect, the IRS is seeking to give the term "guarantor" a unique meaning—which is neither expressly provided by the statute nor supported by legislative history—through an amendment of a regulation which has been in force for some 15 years. It is true that regulations promulgated pursuant to a specific grant of authority by a code section, such as sec. 956(c), are ordinarily given great weight by the courts.

On the other hand, the IRS's discretion in issuing such regulations "is not unbridled and may not be arbitrary." In fact, the *Ludwig* opinion includes dictums that suggest the Tax Court might take a dim view of the proposed "legislative regulations" if they are finalized:

> . . . this Court has been reluctant to sustain expansive interpretations of statutory language by the Commissioner when, as here, such interpretations have *not* been promulgated in regulations despite such a specific grant of interpretive regulatory authority. . . . Had the Secretary or his delegate, charged with responsibility for drafting the applicable regulation, thought section 956(c) was applicable when a controlled foreign corporation's stock was pledged, the regulation would have said so. Failure to include such a provision in the regulation suggests that the Secretary or his delegate thought the statute would not accommodate that interpretation [emphasis added].
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> ● ● ● ●
>
> Whether [this] explains the omission of the stock pledge type of transaction from section 956(c) or whether the omission was an oversight, we can find no basis for [the IRS's] expansive interpretation of that section in the statutory language, its legislative history, or the implementing regulations. If the draftsmen's handiwork fell short of fully accomplishing the objectives sought, *it must be left to Congress* to repair such shortfall [emphasis added].

Thus, the proposed regulation flies in the face of the opinion in *Ludwig*, which, for some reason, the IRS failed to appeal.

sec. 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. *sec. 959*

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 the} 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.

Using Lifo to increase foreign tax credits

sec. 964

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,

sec. 964

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:

$$\frac{\text{Dividend}}{\text{E\&P}} \times \begin{array}{c}\text{Foreign}\\\text{taxes}\end{array} = \begin{array}{c}\text{Deemed}\\\text{foreign taxes}\end{array}$$

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

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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.

Avoiding DISC disqualification for personal holding company status

sec. 992

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.*

sec. 992 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.

sec. 993 DISC: sales or leases to U.S. customers for redisposition overseas

DISC benefits, of course, are available on the sale or lease of certain property to customers outside the U.S. (and its possessions). It is equally clear that DISC benefits are available when one DISC sells or leases property to another unrelated DISC. However, one occasionally overlooked area of DISC deferral is the sale or lease of property to U.S. customers when that customer resells or subleases such property overseas.

Property will be deemed to be sold or leased for direct use, consumption, or disposition outside the United States under sec. 993(c)(1)(B) if the property is sold or leased to a domestic customer for ultimate delivery outside the United States. Regs. sec. 1.993-3(d)(2)(*i*)(*b*) provides that such delivery must occur within one year after the original sale or lease (see also ann.72-23). For this purpose, delivery outside the United States includes delivery to a carrier or freight forwarder for delivery outside the United States.

While this rule appears to give rise to a double DISC benefit on the same property, it does not permit DISC benefits to accrue to different taxpayers with respect to the same profit element inherent in the sale or lease. Rather, it allows DISC benefits on the entire profit element to be shared by all parties involved as if the sale or lease were originally consummated between a U.S. seller or lessor and a foreign purchaser or lessee. For example, assume Company *A* sells property with a cost basis of $100 within the United States to Company *B* for $150. Within one year, Company *B* resells that property abroad for $175. *A* would be entitled to flow $150 of sales and $100 of cost of sales, and *B* would be entitled to flow $175 of sales and $150 of cost of sales, through their respective DISCs. While both companies receive DISC benefits with respect to the sale of the same property, the full $75 of profit

sec. 993

inherent in the sale was afforded DISC benefits (subject, of course, to intercompany pricing rules) only once.

Establishing that the property was ultimately delivered outside the U.S. is accomplished in the same manner as with any other DISC transaction, i.e., the seller or lessor must be able to provide the documentation required by regs. sec. 1.993-3(d)(3). Although physically securing possession of supporting documents from unrelated parties may cause inconvenience, having access to these documents at the time of an examination should satisfy the requirements of the regulation. But see also regs. sec. 1.993-3(d)(3)(i)(*f*), which sanctions "any other proof" found satisfactory by the IRS.

In order to ensure the benefit, however, it is strongly suggested that clients obtain this documentation at the time of original shipment or provide in the contract that they be furnished with the appropriate documentation at the time the goods are shipped to their overseas destination. Note that in Rev. Rul. 77-249, the IRS held that a statement furnished to a DISC at its year end from a broker/consolidator, representing that no goods purchased by the broker/consolidator would be resold within the U.S. and that all would be shipped overseas within one year from the date of sale, satisfied the requirements of sec. 993(c)(1)(B).

As a sound planning technique, tax consultants should also advise their clients to follow up with domestic customers in those cases where it is anticipated that the goods will be used domestically but where it is possible that the ultimate destination will be outside the United States.

Tax-free merger of three DISC subsidiaries allowed by IRS

sec. 995

A manufacturing corporation had three wholly owned DISC subsidiaries. To eliminate duplications and promote economies and efficiencies 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

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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 earnings 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 DISC's 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 of 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.

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Liquidation of or distributions by corporations with DISC subsidiaries after the '76 act

The '76 act amended secs. 995(c) and 751(c) to close what was believed to be an unintended loophole. Under prior law, it was possible for a shareholder to avoid taxation on deferred DISC income by distributing the DISC stock under the provisions of secs. 311, 336, 337, or 751(c), since neither of the recapture conditions was satisfied, i.e., gain was not recognized nor was there termination of the corporate existence of the DISC. The amendment to sec. 995(c) provides that if a shareholder distributes, sells, or exchanges stock of a DISC or former DISC in a transaction to which sec. 311, 336, or 337 applies, the excess of the fair market value of the stock of the DISC over basis shall be treated as a dividend within defined limits regardless of whether gain is otherwise recognized or whether the DISC remains in existence. The effective date is for sales, exchanges, or other dispositions made after December 31, 1975.

Thus, any time a corporation owning a DISC is liquidated under sec. 332, even though basis is not determined under sec. 334(b)(2), the accumulated DISC income will be triggered. For example, a "B" reorganization combined with a later liquidation (assuming that the step-transaction doctrine was not applicable) would trigger the gain, but an "A" or "C" transaction would not, since sec. 361 is applicable to the transaction, not sec. 336.

With respect to the liquidations of pre-existing subsidiaries, the transaction may constitute an "F" reorganization (see Rev. Rul. 75-561), but characterization as an "F" reorganization does not necessarily solve the problem. Sec. 361 does not apply to an "F" reorganization since there would be no stock of a corporation (the parent) exchanged for property of a corporation (the subsidiary). One might argue that the language of sec. 361, requiring an exchange of property by the disappearing corporation for stock or securities of the survivor, only operates to preclude gain or loss and not to prevent the applicability of sec. 361 to sec. 368(a)(1)(F). This result, however, is not clear, and it is likely that sec. 336 would still apply to trigger deferred DISC income.

The committee reports do not offer any help in determining congressional intent with respect to this provision. Note that the '76 act also amended sec. 1248 by requiring the recapture of accumulated earnings and profits of controlled foreign corporations in certain nontaxable transfers.

The technical corrections bill, as now drafted, would rectify this problem by not triggering recognition of income on a sec. 332 liquidation. In the meantime, taxpayers may want to consider other solutions. It has been suggested that the problem might be solved by dropping the DISC down to a subsidiary before liquidation. *sec. 995*

Gain or loss on disposition of property

Swapping mortgage portfolios to recognize unrealized losses

Sec. 1001

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, sec. 1001 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.

On June 10, 1980, Congressmen Vanik (D-Oh.) and Rosenthal (D-N.Y.) introduced a bill in the House of Representatives, H.R. 7541, that would apply the "wash sale" rules to deny a loss deduction for noneconomic losses incurred in commodity straddles and other offsetting transactions in personal property. Although the bill would not apply to portfolio swaps (such swaps do not involve maintaining offsetting positions), it may be a good indicator of the current trend of thinking at the Treasury Department and in Congress towards limiting the deductibility of noneconomic losses.

It should be noted that neither the current "wash sale" rules nor the rules for nonrecognition of gains or losses from like-kind exchanges would apply to mortgage portfolio swaps. The wash-sale provisions of sec. 1091 apply only to losses from sales or exchanges of stock or securities. The nonrecognition provisions of sec. 1031, relating to like-kind exchanges, specifically exclude transactions relating to notes or other evidences of indebtedness.

sec. 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 sec. 1031 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.

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.

sec. 1031

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 applica-

sec. 1031 tion 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.

sec. 1033 Moving expenses of real property condemnation

The expenses of moving machinery and equipment from one location to another, as distinguished from improvements and new installations, have been held to be ordinary and necessary business expenses deductible in the year paid or incurred. Does the fact that the taxpayer receives reimbursement for such expenses either (1) cause the reimbursement to become taxable income or (2) cause the expenses to be disallowed?

The answers are that if the reimbursement is part of the proceeds received in connection with an involuntary conversion of property, the reimbursement is not taxable income and the expenses, nevertheless, are deductible. This conclusion is based upon two recent cases, *Graphic Press, Inc.*, and *E. R. Hitchcock Co.* In each case, the amount of the condemnation award specified the portion that was attributable to the moving and relocation expenses. The courts reasoned that the entire reimbursement was a result of the condemnation and was caused by, and attributable to, an involuntary conversion. Thus, the entire amount was eligible for nonrecognition provisions of sec. 1033.

In an earlier case, *Electric Tachometer*, the commissioner contended that the moving expense deduction should be disallowed because the expense should be considered an advance repaid through the condemnation settlement. The court rejected this argument since there was no binding agreement for the recovery at the time the expenditures were made. *sec. 1033*

Based upon these decisions, it appears that taxpayers may deduct moving expenses currently even though recovery of these expenses is included in amounts received in settlement of condemnation proceedings which, under sec. 1033, cause no tax impact if reinvested in similar property.

Suspension of sec. 1034 replacement rule has retroactive effect

sec. 1034

Sec. 206 of the Foreign Earned Income Act of 1978 (P.L. 95-615) added sec. 1034(k) to the code, which provides that the running of the 18- or 24-month period of sec. 1034 is suspended during the time a taxpayer has a tax home (as defined in sec. 913(j)(1)(B)) outside the United States, except that the suspension period cannot extend beyond the date four years after the sale of the old residence.

The amendment is effective for taxable years beginning after December 31, 1977. There was some question as to whether the effective date would preclude the new rule from applying to sales of residences made prior to 1978 but within the four-year maximum replacement period.

The general explanation prepared by the staff of the joint committee on taxation, issued on February 23, 1979, settles the question by noting that the provision is effective for taxable years beginning in 1978 even if the old residence was sold in an earlier year. The explanation gives an example of a taxpayer who sold his old residence on September 30, 1976, and had a tax home abroad from January 1978 to August 1980, and concludes that the latest date the taxpayer could purchase or construct a residence is September 30, 1980.

In view of this clarification, amended returns may be in order if a tax was paid on the sale of a residence in 1976 or 1977 by a taxpayer who went abroad.

However, one should be aware of the elective nature of the Foreign Earned Income Act as it applies to a 1978 taxable year. Section 209(c) of the act provides that a taxpayer may elect not to have the amendments made by the act apply with respect to any taxable year beginning after December 31, 1977, and before January 1, 1979. Thus, if for 1978 the taxpayer chooses the $15,000 exclusion of sec. 911 prior to its *sec. 1034* amendment by the act, rather than the five deductions allowed by the act in new sec. 913, sec. 1034(k) will not be effective until 1979. Therefore, if the taxpayer sold his residence in 1976 or 1977, he may run afoul of the 18- or 24-month period rule.

sec. 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. *sec. 1037*

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

Commodity futures contracts on Treasury bills

sec. 1221

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.

sec. 1233 Short sales after the '76 act

The '76 act has raised an interesting question for taxpayers who made short sales in 1976. Consider the following example:

> *A* purchased 1,000 shares of*ABC* Corporation stock on June 15, 1976, for $10 a share. On December 20, 1976, the stock was trading at $100 a share, which was as high as *A* believed the stock would go. *A* wanted to defer recognizing his $90,000 gain until 1977 and decided to sell short against the box. Thus, *A* sold 1,000 shares of*ABC* Corporation short on December 20.

Since *A* holds substantially identical property to that which is sold short, the character of the gain to be recognized is determined by reference to the holding period of the substantially identical property. For this purpose, the holding period ends on the date the stock is sold short. If the holding period test is made under law in effect in 1976, *A* has held substantially identical property for more than six months and his $90,000 gain will be long-term when the short sale is covered in 1977. On the other hand, regs. sec. 1.1233-1(a)(1) states that "a short sale is not deemed to be consummated until delivery of property to close the short sale." If *A* delivered his *ABC* Corporation stock in January 1977, to close his short position, and if the holding period test for determining the character of gain or loss is made using law in effect in 1977, he would realize short-term gain. This unfavorable result is possible since substantially identical property had not been held for more than nine months (increased for 1977, see amended sec. 1222) on the day the stock was sold short. This question will probably not be resolved until regulations are issued. However, a strict interpretation would deny *A* long-term capital gain treatment.

Readjustment of tax between years and special limitations

Income averaging: less is more or Congress giveth and the IRS taketh away

secs. 1301 -05

The purpose of the income-averaging provisions (secs. 1301-1305, added to the code by the Revenue Act of 1964) is to mitigate the harsh effect of a progressive rate tax structure upon taxpayers having widely fluctuating or rapidly increasing incomes. The statutory scheme and the legislative intent, both in the original act and subsequent amendments, include making adjustments to the "taxable income" of each base-period year in order to arrive at a "base period income" for such year that is comparable to the taxable income of the computation year.

With the introduction of the "zero bracket amount" (ZBA) concept by the Tax Reduction and Simplification Act of 1977, it was deemed appropriate to add to the taxable income of each pre-1977 base-period year an amount equal to the ZBA of the computation year in order to make such base-period years comparable to post-1976 years.

Since they were adopted in 1966, the sec. 1302 regulations have provided that "[b]ase period income for any taxable year may never be less than zero." Since that time, Schedule G has included as part of the line depreciation for "base period income" the words "if less than zero, enter zero." Furthermore, the instructions for line 1, "Taxable income," have also included the parenthetical phrase "(never less than zero)." The service, it is submitted, went beyond the regulations by providing in Schedule G that "taxable income" as well as "base period income" may never be less than zero.

In the case of a pre-1977 base-period year in which taxable income shown on a joint return is a negative figure, let's say ($2,000), the harsh effect is evident in the following illustration:

sec. 1301-05

	Per Statute	Per Sch. G
Taxable income	$(2,000)	0
Add zero bracket amount	3,200	3,200
Base-period income	$1,200	3,200

Before ZBA, relatively few taxpayers were actually affected by the use of "zero" for a negative figure on line one; however, the ZBA adjustment does actually affect many taxpayers. This same problem has existed since 1964 in connection with the sec. 911 exclusion for income earned abroad.

In the only case dealing with this issue, *Fablon Tebon, Jr.*, the Tax Court agreed with the taxpayer that there was no statutory authority for providing by regulation that "[b]ase period income for any taxable year may never be less than zero," let alone for Schedule G to extend the "not less than zero" concept to "taxable income" of each base-period year. Nevertheless, the court gave its blessing to the regulations. The court was concerned that since a base-period-year loss might result in a tax benefit by being carried back or over, a taxpayer might get a double benefit by being permitted to also use that negative figure for income-averaging purposes.

It is believed that the court, lacking statutory authority, usurped the prerogative of Congress by formulating "judicial legislation." It is not true, as implied by the court, that *all* negative income years result in NOL tax benefits for individuals. Before a NOL may be carried back, it must be decreased by the long-term capital gain deduction, the excess of nonbusiness deductions over nonbusiness income, and personal exemptions. The court's approach is to "throw out the baby with the bath water."

To avoid a double tax benefit from a loss year, the service should propose corrective legislation that would adjust base-period negative taxable income only to the extent that a tax benefit is received from a NOL deduction derived from such negative taxable income.

sec. 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

sec. 1348

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).

sec. 1348 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 ten-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.

sec. 1348 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.

Personal service income: payments under qualified plans and noncompete covenants

The '76 act changed the terminology of income eligible for the maximum tax rate under sec. 1348 from "earned income" to "personal service income," and broadened the eligible income to include deferred compensation payments received subsequent to the year following an employee's separation from service. Inclusion of deferred compensation prompts a new look at qualified plan distributions and payments under business sale agreements with noncompete covenants.

Although the general explanation of the '76 act, prepared by the staff of the joint committee on taxation, at page 110, states that "[l]ump-sum distributions which are taxed under special rules . . . do not qualify for the maximum tax," it is believed that the maximum tax should apply to the portions of a lump-sum distribution defined in sec. 402(e)(4)(A) to which the ten-year averaging provisions of sec. 402(e)(1), or the capital gain provisions of sec. 402(a)(2), do not apply. Put another way, the distributee should be able to utilize the maximum tax if he does not elect under sec. 402(e)(4)(B).

Note that for a contributory plan, regs. sec. 1.1348-3(b)(3)(ii)(A) disqualifies from "personal service income" amounts attributable to earnings on employee contributions, even though the ten-year averaging or capital gain treatments do not apply.

Furthermore, normal distributions from an IRA under sec. 408(d)(1) should qualify as "personal service income," except to the extent of the portion of the distribution consisting of earnings attributable to employee contributions included in a rollover from a qualified corporate contributory plan and earnings excluded from income under sec. 402(a)(5) at the time of the rollover.

In regard to noncompete agreements, regs. sec. 1.1348-3(a)(1)(i), under the old law, states that "the term 'earned income' . . . does not include amounts received for refraining from rendering personal services or engaging in competitive activity or amounts received as consideration for the cancellation of an employment contract."

Consideration should be given to a combined consulting agreement/noncompete covenant that will provide for payments to former shareholder/officers of a purchased business, and that specifies that the payments are also made as additional compensation for services previously rendered to the business enterprise. It is believed that such an enlarged agreement might permit maximum tax treatment of the amounts received by the former shareholder/owners, except to the extent that the payments in substance represent additional proceeds from sale of their stock. *sec. 1348*

Election of certain small business corporations as to taxable status

Subchapter S trap: sale of partnership interest

sec. 1371

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.

Termination of subchapter S election—retroactively or prospectively?

sec. 1372

Taxpayers who wish to sell a subchapter S corporation should consider whether a retroactive or a prospective termination of sec. 1372 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).) *sec. 1372*

The IRS refused to recognize such a planned termination in IRS Letter Ruling 7928001. In the case addressed by the letter ruling, *X* corp. 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.

Subchapter S: IRS criteria in determining sham terminations

When a subchapter S corporation wants to terminate its small business corporation election, sec. 1372(e) provides a number of ways to do so. For planning purposes, it may well be desirable for the corporation's shareholders to have the election terminated retroactively to the beginning of the current taxable year. However, formal revocation of the election [sec. 1372(e)(2)] is only valid for future taxable years unless made in the first month of the current year, and termination for excess amounts of foreign or passive investment income [sec. 1372(e)(3), (4)] can be very difficult to control. Thus, a taxpayer is normally left with the options of adding a new—and nonconsenting—shareholder, or issuing a second class of stock that will be recognized as a valid second class and not as a de *sec. 1372* facto addition to the present one class of stock. (See sec. 1372(e)(1), (3).)

The service has had some success in attacking the transfer of stock to a nonconsenting shareholder. In *C. L. Hook*, a transfer of shares to the shareholder's attorney, for purposes of failing to consent to the subchapter S election, was ignored by the Tax Court as a sham where the attorney exercised no rights as a shareholder and surrendered his shares to the controlling stockholder for no consideration when he was asked to do so. The Tax Court held similarly in *William B. Wilson*, where one share out of 100,000 was held by the controlling stockholder's brother as a nominee, and state law required more than one incorporating shareholder. Failure to consent to the subchapter S election by the nominee shareholder was not sufficient, in this case, to invalidate the election.

The IRS has not published guidelines regarding the effectiveness of a nonconsent. However, some informal indications were given orally in an inquiry concerning a company that considered transferring stock to a key employee who would refuse to consent to the election. The situation presented was that the employee was a key part of corporate management and would exercise all shareholder rights including voting, receiving dividends, etc. The IRS national office representative said that, even so, the IRS would scrutinize the transfer of shares very carefully on the grounds that it might well be a sham. He pointed out that under the '76 act, the IRS would have every opportunity to do so since it is now required that an affirmative statement be filed by the new shareholder refusing to consent to the existing election.

In response to the question of what criteria IRS might use in making its determination of whether there was a sham or a bona fide transfer of shares that would be successful in retroactively terminating the election, the following suggestions were made. The purpose for making the change would be an important factor in determining the validity of the retroactive termination. A change in the corporation's financial status would be highly relevant here; for example, if the corporation had passed through losses to its shareholders in prior years, but it suddenly became apparent that the current year would produce substantial profits to be taxed at the shareholder level, the attempt to retroactively terminate subchapter S status by a transfer of shares to a nonconsenting stockholder would probably be challenged, particularly in light of the available alternative statutory remedy of revocation (which, of course, would only be effective for future years). Further, acquisition by the new shareholder of an "insignificant" percentage of corporation stock could also be evidence of a sham transaction. No "safe haven" figures were given, but it was stated that a 5 percent ownership would probably not be "significant." *sec. 1372*

Subchapter S: restoring basis of debt reduced by losses **sec. 1374**

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

sec. 1374

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

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:

sec. 1374

	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

sec. 1377

Sec. 280C allows tax-free distribution of accumulated E&P

Sec. 280C creates an opportunity for shareholders of subchapter S corporations that have accumulated earnings and profits. Assume that a subchapter S corporation has accumulated E&P because it had not always been an electing corporation. Also assume that its 1978 taxable income computed before the disallowance under sec. 280C will be $60,000 and that there will be a jobs tax credit of $40,000.

After application of sec. 280C, the taxable income of the corporation will be $100,000. So long as distributions made during 1978 (or by March 15, 1979) do not exceed $100,000, $100,000 will be the total amount includible in gross income of the shareholders, either as an actual distribution of current E&P or as an amount considered to be a distribution of undistributed taxable income under sec. 1373(b).

Thus, if the entire $100,000 were distributed, it would be out of 1978 current E&P. For subchapter S purposes, sec. 1377(b) and regs. sec. 1.1377-2 provide that *current* E&P for 1978 are considered to be $100,000, since the disallowance under sec. 280C does not reduce E&P. Thus, the entire $100,000 will be a distribution of 1978 current E&P.

However, the 1978 E&P for purposes of computing *accumulated* E&P will be only $60,000! Example (1) of regs. sec. 1.1377-2(a)(2), while dealing with a capital loss, clearly suggests that in this case accumulated earnings will be reduced by the $40,000. In ultimate effect, an additional $40,000 can be paid out without any additional tax, and accumulated E&P will be reduced by $40,000.

Even if not distributed, the $40,000 would cause a reduction in current E&P under sec. 1377(a) and an increase in undistributed taxable income pursuant to sec. 1375(d). The undistributed taxable income thus created could be paid out without tax in any succeeding year if a subchapter S election continues uninterrupted.

Cooperatives and their patrons

Pass-through to co-op apartment owners

sec. 1381

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

Consent dividend gives more flexibility than deemed dividend

sec. 1502

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: timing acquisition of loss corporation

When a corporation with a net operating loss carryover is acquired by another corporation that elects to file consolidated returns, or by an affiliated group that files consolidated returns pursuant to sec. 1501, close attention should be paid to the timing of the acquisition as it relates to the tax years of the corporations involved. Without proper planning, the carryover period for the acquired corporation's NOL may be shortened substantially. For example, assume the following:

P owns 100 percent of *S* and has filed consolidated returns on a calendar-year basis with *S* for several years. In 1976, *P* decides to acquire all of the stock of *T*, whose year end is March 31. *T* has a NOL carryover originating in the year ended March 31, 1973. If the purchase becomes effective between January 1 and March 31, 1976, the NOL will expire December 31, 1977 (under pre-'76 act rules), three months early, because *T* must adopt *P*'s year end, and the short period, April 1, 1975, to date of purchase, will count as a separate taxable year for which a separate return must be filed. If the purchase becomes effective anytime during the month of April 1976, the short period from April 1 to the date of purchase may be disregarded as a separate year of *T*, pursuant to regs. sec. 1.1502-76(b)(5). In this instance, as in the previous one, the NOL would expire on December 31, 1977. However, if *P* waits even one day longer than the last day of April to effect the purchase, *T*'s separate taxable year must terminate as of that day.

To illustrate, assume *P* purchased *T* on May 1, 1976. Since this is the thirty-first day of *T*'s taxable year, the provisions of regs. sec. 1.1502-76(b)(5) may not be utilized and the NOL will expire December 31, 1976. In this instance, April 1, 1976, through April 30, 1976, would constitute a short taxable year, which would nonetheless count as a taxable year for NOL carryover purposes. For any purchase between May 1 and December 1, inclusive, the carryover period would be shortened by 15 months. If we assume the purchase is effective between December 2 and December 31, *P* can choose not to include *T*'s short period ending December 31 in the group's December 31, 1976, return. In such case, *T* would be treated as becoming a member of the group on January 1, 1977, and having a short-period, separate return for the period April 1 to December 31, 1976. In this instance, as in the first two instances, the NOL would expire December 31, 1977.

Note that although the '76 act provides for an additional two years in which to deduct NOL carryovers of NOLs incurred in taxable years ending after 1975 [amended sec. 172(b)(1)(B)], the above problem still remains.

Notwithstanding the above rules, carryovers from separate return limitation years cannot be utilized unless *T* contributes separate income during consolidated return years.

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.

sec. 1502

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.

Consolidated returns and lifo inventories

The growing popularity of lifo has raised a number of interesting questions with respect to the effects of lifo upon intercompany profits in inventory in the context of a consolidated federal income tax return. Fortunately, there is specific reference to the lifo method contained in regs. sec. 1.1502-13(f)(1)(i), which states that the determination of whether inventory (with respect to which an intercompany profit had been realized) is disposed of outside the group shall be made "by reference to [the owning company's] method of inventory identification (e.g., first-in, first-out; last-in, first-out; or specific identification)." Further in this vein, regs. sec. 1.1502-18(a) includes this section by reference for the purpose of the operation of the rules with respect to the "initial inventory amount" and the "unrecovered inventory amount." It therefore seems reasonable to assume that the lifo assumptions as to what goods are on hand are applied to all situations in which the identification of inventories could be relevant.

Assume a situation in which an affiliated group has been in existence for many years. The group has filed separate returns up through 1974 but will file a consolidated return for 1975. One member (the "selling company") has for many years been selling goods to another member (the "owning company") at a profit. Comments with respect to the various possibilities follow. It is to be borne in mind that the entire focus of regs. secs. 1.1502-13 and -18 is upon the selling company, and, generally, it is by reference to the selling company that all computations are made. However, the inventory method employed by the owning company will determine the treatment by the selling company.

Addition of initial inventory amount to taxable income. Under regs. sec. 1.1502-18(b), a selling company is required to include in its income for any consolidated return year the intercompany profits attributable to goods upon which it had realized intercompany profits in years prior to the consolidated return. This inclusion takes place *when the related goods are disposed of outside the group* (or when the owning company becomes a nonmember). In a first-in, first-out situation, the intercompany sales usually, though not necessarily, occur in the most recent separate return year, and the disposition outside the group usually, though not necessarily, occurs during the first consolidated year. Application of this section in a lifo context results in the following observations:

- If the owning company adopts lifo for the first time for calendar year 1975, there will be no addition to the selling company's income for the initial inventory amount unless and until there is a reduction in the inventory quantity of the owning company from the level existing at January 1, 1975.
- If the owning company had employed lifo for several years, the initial inventory amount would be determined by reference to the profits realized in the year or years in which the owning company's lifo layers were built up, and there would be no inclusion of such initial inventory amount in income until those lifo layers were liquidated.

Recovery of initial inventory amount. The same principles would be applied under regs. sec. 1.1502-18(c). Notice, however, that when the owning company is using lifo, the inclusion of the initial inventory amount in taxable income of the selling company would always occur in the same taxable year in which an ordinary loss is allowable under regs. sec. 1.1502-18(c)(2)(i), by reason of the intercompany inventory amount for such taxable year being lower than the initial inventory amount. This lower inventory amount, as noted above, is necessary in order to require the inclusion in income of the initial inventory amount.

sec. 1502 *Deferral of gain from deferred intercompany transactions.* Intercompany profits realized by the selling company on sales to an owning company that uses the lifo method during 1975 or any future consolidated return year will not be deferred unless there is an increase in the owning company's inventory. Without such an increase, all goods purchased by the owning company are deemed, under the lifo method, to have been disposed of during the same taxable year. Only if there is an increase in the owning company's inventory could there be a deferred intercompany transaction that would result in the deferral or elimination of gain. In the simple case of computing lifo by reference to specific units of raw materials (e.g., pounds of copper) as described in regs. sec. 1.472-1(c), whether there is gain to be deferred will be dependent upon whether any purchases from the selling company were included in those purchases by reference to which the lifo inventory increases are valued (i.e., earliest purchases, latest purchases, or an average of all purchases for the year), pursuant to regs. sec. 1.472-2(d)(1)(i).

Special problems of statistical lifo methods. Assume that the owning company first made a lifo election in 1975 under the double-extension method of dollar-value lifo, as described in regs. sec. 1.472-8(e)(2). It appears logical that the results obtained should be similar to those obtained in the case of lifo by reference to specific units of raw material. Accordingly, there would be no addition to income of initial inventory amount unless there is a reduction in inventory quantity (expressed in base-year cost) of the owning company from the level existing at January 1, 1975, even though in fact the closing inventory contained no intercompany goods and the "base-year cost" and "current-year cost" extensions contained no intercompany purchases. Also under this approach, there would be no deferral of gain from intercompany sales during a consolidated return year when there was no increase in inventory expressed in base-year cost, even though significant intercompany goods may have been included in the owning company's closing inventory or intercompany purchases were taken into account in determining the "current-year cost" extension.

It seems appropriate to treat intercompany goods and profits thereon by a proportionate approach in the case of either additions to layers or liquidations of layers. For example, if 10 percent of a lifo inventory layer was liquidated, it seems appropriate to deem that there was also a 10 percent reduction in the intercompany profit contained in such layer. Similarly,

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if there was a new layer added, it seems reasonable to determine intercompany profit on the basis of the proportion of intercompany purchases to total purchases during the year. However, an alternative might be to use the proportion of intercompany goods included in the closing inventory, or even the proportion of intercompany purchases included in the determination of "current-year cost" in the case of the double-extension method.

In the case of either the link-chain method or the retail method, reference to the proportion of intercompany goods contained in the year-end inventory would seem appropriate to determine the amount of intercompany profit included in a new lifo layer. Liquidations of layers could be made on a proportionate approach as in the case of the double-extension method.

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,

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> 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 post-affiliation 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.

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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 preempts 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.

Consolidated returns: how will the CRCO rules now apply? And . . .

As a result of the changes in sec. 382(a) made by the '76 act, the question arises as to how the consolidated return change-of-ownership (CRCO) rules and other rules contained in regs. sec. 1.1502-1(g), -21(d), -21(e), and -22(d) will apply.

The definition of a CRCO contained in regs. sec. 1.1502-1(g) is geared to the conditions contained in the "old" sec. 382(a), except that a CRCO will occur without regard to whether any member of the group has continued to carry on a trade or business substantially the same as that conducted before the change in ownership. It appears obvious that this regulation should be updated since the changes made in sec. 382(a) seem to express the most recent congressional purpose. At a minimum, the portions of sec. 382(a) incorporated by reference have changed and the references themselves are outdated. However, the effective date of such updating, should it occur, creates still another uncertainty.

Since the CRCO was independent of (even though based *sec. 1502* upon the concepts of) sec. 382(a), the CRCO rules contained in regs. sec. 1.1502-21(d) and -22(d) could continue to apply in overall principle (with, of course, whatever definition of a CRCO is applicable under regs. sec. 1.1502-1(g)). In general, these latter two sections respectively limited the consolidated net operating loss carryovers and capital loss carryovers that were attributable to the "old members" of the group to the aggregate income (or capital gains) of such old members.

Regs. sec. 1.1502-21(e)(1)(ii) and (e)(2) appear to need no updating. These sections simply apply sec. 382(a) and (b), with all their changes (including effective dates), independently of CRCO considerations. However, regs. sec. 1.1502-21(e)(1)(i) is geared to the old sec. 382(a) and operates independently of the CRCO rule, even though it would most likely operate when a CRCO also occurs. Under this section if there is a 50 percent points-change in ownership of the parent, the NOL carryover of any member (including its portion of a consolidated loss carryover) is lost, if such member changes its business. Thus, a subsidiary that changed its business would lose its carryover even though it itself did not have a 50 percent points-change of ownership because, for example, the parent owned only 80 percent of its stock. It appears obvious that this section should be updated in the same manner as regs. sec. 1.1502-1(g).

It really seems as if the CRCO rules have lost their reason for existence as a result of the new statutory scheme of sec. 382(a). For example, if in the future there is a 55 percent change of ownership in the common parent corporation, the new sec. 382(a) will not apply. But the ability of the group to use a loss carryover from a consolidated return may be limited by the old CRCO rule so that the carryover may be utilized only against profits contributed by the "old" members of the group. As another example, if in the future there is a 70 percent change of ownership in the parent, there will presumably be a 35 percent loss of carryovers from a consolidated return and, in addition, there may be a requirement to use the remaining 65 percent only against the income contributed by the old members.

It will undoubtedly be some time before new regulations are proposed in this area. Although it can be argued that the old CRCO rules no longer serve congressional purpose, affiliated groups filing consolidated returns will have to watch very carefully not only the existing CRCO regulations but the CRCO regulations (if still retained) as they may be retroactively amended in the future.

. . . old member means old member for CRCO purposes

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When discussing the present status of CRCO problems, it is well to focus on the definition of an "old member" of the group. The term is defined in regs. sec. 1.1502-1(g)(3). It is limited to those companies that were in existence and members of the group immediately preceding the first day of the taxable year in which the CRCO occurs. It is interesting to note that there is no counterpart in that definition to regs. sec. 1.1502-79(a)(2). Under the latter section, net operating losses that are attributable to a new member created out of an old member of the group are not apportioned to such new member for carryback purposes but are apportioned to the member that formed the new member. However, the formation of a new member by an old member of the group would not cause the new member to be considered an old member for CRCO purposes.

This situation is most apt to occur where corporations are set up for the purpose of acquiring assets. For example, a new corporation may be established with funds provided by the common parent. The funds are to be used by the new company to buy stock of an existing corporation that will be immediately liquidated into the new corporation under sec. 334(b)(2). The new corporation will not qualify as an old member of the group for CRCO purposes. If, however, the parent had made the purchase directly, the purchased operations would now be in an old member of the group, and the carryovers, even under the CRCO rule, could be applied against the profits of the purchased operations.

A similar situation exists with respect to a new corporation formed for the purpose of effecting a triangular merger of the type described in sec. 368(a)(2)(D). The problem could also arise in the case of a new corporation simply formed for business purposes with assets and operations from any old member of the group. Tax practitioners should be extremely cautious in this area.

Personal holding companies filing consolidated returns

For some time, there has been considerable uncertainty about the proper treatment of dividends paid by one member of an affiliated group filing consolidated returns to another member where the group's personal holding company tax liability must be computed on a separate basis because of in-eligibility under sec. 542(b) for consolidated treatment. The specific question has been whether intercompany dividends, although eliminated entirely from consolidated taxable income by virtue of regs. sec. 1.1502-14, nevertheless constitute separate PHC income and undistributed income to the recipient member for purposes of computing a separate PHC tax.

In recent years the IRS has published several rulings that eliminate from PHC income those dividends paid to bank holding companies filing consolidated returns [Rev. Ruls. 71-531, 74-131, and 74-432]. Also, recently enacted sec. 542(b)(5) provides somewhat similar relief in the case of life insurance groups. (Cf. Rev. Rul. 76-320.) And, more importantly, the service has recently begun issuing private letter rulings that extend these relief principles to *all* affiliated groups filing consolidated returns. (See, for example, IRS Letter Ruling 7836070.)

These new letter rulings hold that, except in the case of dividends paid by a subsidiary availing itself of a sec. 562(d) dividends-paid deduction, intercompany dividends will be eliminated in determining the separate PHC tax status of companies included in a consolidated return. The complete absence of regulations in this area gives these recent letter rulings significant importance in judging the IRS position in this area.

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):

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$$\frac{\begin{array}{c}\$100{,}000\\ \text{depletion}\end{array}}{\begin{array}{c}\$1{,}000{,}000\\ \text{basis}\end{array}} \times \$1{,}000{,}000 \text{ deferred gain} = \$100{,}000 \text{ income}$$

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 multi-tier disposition

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A member of an affiliated group that owns stock in a subisidiary 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]

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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).

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

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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.*

sec. 1502 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.

sec. 1504 Pledged subsidiary includible in consolidated return

An insurance company guaranteed borrowings of *P* Corporation under a line of credit that *P* has with a bank. The insurance company required that *P*'s investment in its subsidiary be pledged as security for the guarantee. This required transfer to the insurance company of title to the subsidiary's stock. *P* retained all voting and dividend rights except in the case of default. The dividends were to be applied to the bank loan.

P owned 80 percent of the subsidiary's only class of voting stock. (The subsidiary's cumulative nonvoting preferred stock is owned 100 percent by *P*.) The question is whether *P*, for consolidated return purposes, retains ownership of 80 percent of the voting power of the subsidiary's stock, the nominal title to which is transferred to the guarantor. *sec. 1504*

In Rev. Rul. 55-458, the acquiring corporation purchased for cash, payable in installments, all of the outstanding stock of a second corporation. The purchase agreement provided that the stock would be transferred in escrow to a trust company as security for the purchase price of the stock, and that the stock would be transferred to the trust company's name as escrow agent. The purchaser retained the right of voting the stock and the right to receive dividends unless a default occurred and continued.

The ruling noted that all the outstanding stock was purchased and, although legal title was in the escrow agent, the beneficial ownership remained in the purchasing parent corporation. The ruling distinguished between the existing right of ownership and the possibility that ownership rights might be forfeited upon default. The ruling held that where all of the outstanding stock is purchased and placed in trust as security for the purchase price, the fact that all the stock is held in escrow will not deprive the purchasing parent corporation of the right to include the purchased corporation in the consolidated return of the affiliated group.

Nevertheless, *P* requested a ruling that it owns stock possessing 80 percent or more of the voting power of the subsidiary's stock and that the subsidiary will be an includible corporation for consolidated return purposes within the meaning of sec. 1504(a) and (b).

Factually, the differences between the published ruling and *P*'s case are that *P* purchased 80 percent and not all the voting stock, and that dividend payments are to be applied towards payment of *P*'s bank loan.

The IRS did not consider the difference in the percentage of stock purchased (80 percent and 100 percent) to be a material distinction. (Under the regulations cited in the ruling, 95 percent direct control was required.) In Rev. Rul. 55-458, the purchasing corporation retained voting and dividend rights. It was the retention of both rights in the ruling that resulted in the finding that the entire beneficial or equitable ownership remained in the purchaser. Rev. Rul. 55-458 stands for the proposition that where beneficial ownership is retained, the right to existing enjoyment rather than a contingent divestiture of enjoyment controls ownership. *P*'s application of the dividends to the bank loan was apparently also considered the retention of dividend rights.

Accordingly, the IRS held that *P* and its subsidiary constitute an affiliated group under sec. 1504(a) and, subject to the exceptions in sec. 1504(b), the subsidiary is an includible corporation which must join in the consolidated return filed by the *P* group.

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 subsidary 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

Consolidated returns: tax allocation agreements and . . .

sec. 1552

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, 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 finan-

sec. 1552 cially troubled. For a recent example, see *Jump* v. *Manchester Life & Casualty Management 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.

sec. 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. *sec. 1561*

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 *sec. 1561* 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.

sec. 1563 Multiple surtax exemptions through partnership

From a business standpoint, the ownership of multiple operating corporations by several individuals may be more desirable through a partnership rather than a corporation. Also, under certain circumstances, the ownership of a group of corporations by a small number of investors may be more advantageous from a tax standpoint if the ownership is through a partnership rather than through a corporation. For example, assume a group of individuals plans to purchase all of the stock of a number of retail outlets, each separately incorporated. The initial reaction is to have the individuals form a corporation and have the newly formed corporation acquire all of the stock of the retail corporations. It may be more advantageous, however, to have the individuals form a partnership (or use an existing partnership) and have the partnership acquire all of the stock of the retail corporations.

For taxable years beginning with the calendar year 1975, the privilege of a controlled group of corporations to elect multiple surtax exemptions has been repealed. All parent-subsidiary and brother-sister controlled groups are now limited to one $50,000 surtax exemption, as well as one $150,000 accumulated earnings credit. (See sec. 1561.)

If a corporation were used to acquire the retail corporations, the parent company and the retail subsidiaries would be members of a controlled group and would be entitled to only one surtax exemption. This is true regardless of the number of shareholders of the holding company parent. However, if a partnership is used instead of a corporate holding company to hold the stock of the retail corporations, it may be possible to obtain multiple surtax exemptions. The result depends upon the number and ownership interests of the partners. The ownership of the underlying corporations is attributed to the partners (having an interest of at least 5 percent in capital or profits) through the partnership. (See sec. 1563(e)(2).) If five or fewer individuals own stock (directly or indirectly) possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and if this group owns more than 50 percent taking into account the stock ownership of each person only to the extent such stock ownership is

sec. 1563

identical with respect to each corporation, then the corporations constitute members of a brother-sister controlled group. (See sec. 1561(a)(2).) Note that both tests must be met. If the 80 percent test is not met, the corporations are not a controlled group and are entitled to multiple surtax exemptions.

Thus, to meet the test would require at least seven partners, with the top five holding partnership interests totaling no more than 79 percent.

It is interesting to note that if the recent case, *Fairfax Auto Parts of Northern Virginia, Inc.*, is good law, regs. sec. 1.1563-1(a)(3) with respect to ownership of brother-sister corporations is more restrictive than Congress intended. Hence, some brother-sister controlled groups that were precluded from using multiple surtax exemptions under the regulations may be eligible to do so.

Editors' note: The pressure for corporations to adopt a position contrary to regs. sec. 1.1563-1(a)(3) has been increased due to the broadening of the surtax exemption as of January 1, 1979. Fairfax *was reversed by the fourth circuit; the eighth and second circuits have followed the fourth in* T.L. Hunt, Inc., of Texas *and* Allen Oil Co., Inc. *respectively. The Tax Court, however, remains convinced that the regulations are "plainly inconsistent with the thrust of the statutory language." (See* Charles Baloian Co., Inc., *on appeal to the ninth circuit;* Davidson Chevrolet Co., *on appeal to the sixth circuit, and* Delta Metalforming Co., Inc.*)*

Estate and gift taxes

Estate tax: '76 act can reduce benefits of Clifford trusts

sec. 2001

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 ten-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 ten-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).

sec. 2001 *Tax planning*. The tax adviser should consider maximizing the annual exclusions available by using a trust for a period greater than ten 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 ten years and one month or longer. However, note that the value of the gift is increased by the length of the trust.

sec. 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 ten 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 ten 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. sec. 2013

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 ten 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.

Private annuity clauses in wills

sec. 2031

The recent 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 *sec. 2031* 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.*)*

sec. 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. sec. 2032

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
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) income	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.

Estate tax: scrutinize income tax files for contributions made within three years of death

sec. 2035

Tax practitioners may be overlooking one step in the process of preparing estate tax returns, possibly unduly increasing tax liabilities and decreasing assets passing to heirs. In the preparation of an estate tax return, an essential step is to determine all charitable gifts made within three years of death.

sec. 2035 Sec. 2035 provides that gifts—including gifts to charitable organizations—made within three years of the decedent's death must be included in the gross estate. An exception is provided for gifts (other than life insurance) for which a gift tax return did not have to be filed—e.g., a gift not exceeding $3,000 per year to a donee.

For computation of the taxable estate, sec. 2055 allows a deduction for qualifying charitable transfers. However, such transfers do not reduce the adjusted gross estate, which is the base for the 50 percent limitation on the marital deduction [sec. 2056(c)]. The proper inclusion of all charitable transfers made within the three-year period will have the net effect of increasing the maximum marital deduction by 50 percent of the sum of the transfers. The gross estate, adjusted gross estate, and total deductions are increased by the sum of the charitable transfers, and the maximum allowable marital deduction is increased by 50 percent of the charitable transfers. In short, if an increase in the maximum marital deduction can be beneficial, it is desirable to "gross up" qualifying charitable transfers made within three years of the decedent's death. The following example illustrates this.

D made $40,000 of charitable gifts to one organization in the year prior to his death. *D* bequeathed all his property to his wife. By grossing up the charitable gifts, *D* reduced the taxable estate by $20,000.

	With charitable gifts	Without charitable gifts
Adjusted gross estate	$1,040,000	$1,000,000
Less marital deduction for property passing to spouse	(520,000)	(500,000)
Charitable deduction	(40,000)	—
	$ 480,000	$ 500,000

Making "charitable gifts in contemplation of death" can be extra beneficial in the case of a terminally ill taxpayer whose will includes charitable bequests. By converting the completed testamentary charitable transfers into deathbed transfers, the taxpayer can also achieve income tax savings.

A simple review of prior years' income tax returns on their face may not disclose all the gifts made, for at least the following reasons:

- Contributions to foreign charities are not deductible for income tax purposes, but they may be deductible for estate tax purpose.

- The income tax rules may limit a deduction for a contribution of appreciated property, but the estate tax rules do not. *sec. 2035*
- There are percentage limitations on contribution deductions for income tax purposes but not for estate tax purposes.

Therefore, it may be necessary to scrutinize the income tax files to avoid overlooking a qualifying charitable transfer made within three years of death.

Estate tax exclusion and income tax deferral for lump-sum distributions from qualified plans

sec. 2039

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 ten-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 ten-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 sec. 2039 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).

sec. 2041

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 appiontment 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

sec. 2041

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 sec. 2041 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.

sec. 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 produced 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. *sec. 2053*

Election of the sec. 2053 deduction option under sec. 642(g) will reduce the adjusted gross estate and the marital bequest if a marital deduction formula has been used in the will.

The marital deduction will be reduced, whether or not a sec. 163 or sec. 2053 deduction is taken, in the case of an intestate estate where local law treats administrative expense as chargeable to corpus rather than income. (See Rev. Rul. 55-225.)

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.

Charitable remainder trusts: unitrust vs. annuity trust

sec. 2055

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 *sec. 2055* invaded to pay the annuity, the service had no trouble in ruling 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.

sec. 2056 Creating a marital deduction from community property

In determining the limitation on the marital deduction, the value of community property is excluded from the adjusted gross estate. As a result, when the decedent spouse leaves only community property, the adjusted gross estate is zero and there is no marital deduction. But there is still an opportunity to reduce estate taxes of decedents domiciled in community property states.

Rev. Rul. 67-171 raises the possibility of creating separate property from community property, thereby giving rise to a marital deduction that would not otherwise be available. The ruling deals with a conversion of community property (stock) to separate property by agreement between the spouses. From the time of partition, the converted stock paid cash dividends and was the subject of several stock splits and stock dividends. Under the applicable state law, the income derived from converted property constitutes separate property. After an analysis of sec. 2056(c)(2)(B) and (C), the ruling holds that the income from the converted community property as well as other property acquired with, or derived from, such income constitutes separate property for purposes of computing the adjusted gross estate.

Under the holding, a marital deduction can be deliberately generated by partitioning income-producing community property.

The tax savings that might be achieved are illustrated in the following example.

Example. Mr. and Mrs. Smith, who are domiciled in a community property state, have the following estate which is all community property. It is Mr. Smith's desire to leave Mrs. Smith the residence outright. All other property will be placed in a testamentary trust with income to Mrs. Smith and remainder to the children.

Residence	$ 200,000
Preferred stock—6% dividend rate	300,000
Other investments	500,000
	$1,000,000

Alternative 1. Mr. Smith dies 10 years hence. The only change in the estate is the accumulation of $180,000 dividends on preferred stock.

Total community estate	$1,180,000
Mr. Smith's one half interest	590,000
Specific exemption	60,000
Taxable estate	530,000
Estate taxes before state death tax credit	$ 156,200

Alternative 2. Mr. and Mrs. Smith partition the preferred stock now. The facts are otherwise the same as in alternative 1.

Total community estate		$700,000
Mr. Smith's one half interest		350,000
Separate property		
Preferred stock (subject to partition)		150,000
Reinvested dividends on preferred stock		90,000
Gross estate		590,000
Marital deduction		
(see computation below)	$45,000	
Specific exemption	60,000	105,000
Taxable estate		485,000
Estate taxes before state death tax credit		$140,900

In computing the marital deduction, the preferred stock actually partitioned is excluded under sec. 2056(c)(2)(C) but the reinvested dividends are not. The limitation is therefore computed as follows:

Gross estate		$590,000
Less:		
Community property [sec. 2056(c)(2)(B)(i)]	$350,000	
Converted community property [sec. 2056(c)(2)(C)]	150,000	(500,000)
Adjusted gross estate		90,000
50% thereof		$45,000

Above, the estate assets and testamentary plan are identical. However, the creation of separate property results in a $45,000 marital deduction and a tax saving of $15,300.

While deliberate use of this technique may not have been contemplated by the statute, it is endorsed by Rev. Rul. 67-171. In the proper set of circumstances (i.e., a large community estate, a contemplated qualifying bequest to the spouse, and time to accumulate income), the partition may be used to sec. 2056 advantage as an estate-planning technique. It should be noted, however, that the '76 act allows $250,000 to be transferred to the surviving spouse free of estate taxes and therefore increases the effect of the above.

Editors' note: Although the tax liability would differ if post-'76 act rates are utilized, the principle remains the same.

Marital deduction: the code loveth a cheerful giver

In addition to any other benefits that may result, a taxpayer's annual generosity to his spouse can also save taxes, and it may be advantageous to give more than the $3,000 annual exclusion.

Under the '76 act, taxpayers under sec. 2523 were granted a full gift tax marital deduction for the first $100,000 of gifts, no marital deduction for gifts between $100,000 and $200,000, and a 50 percent marital deduction for further gifts in excess of $200,000. On the other hand, sec. 2056(c)(1)(B) requires that the estate tax marital deduction be reduced to the extent that the gift tax marital deduction exceeds 50 percent of the gifts. Before the '78 act, all gifts to a spouse up to $200,000 could have served to decrease this reduction of the estate tax marital deduction. In addition, gifts of $3,000 or less could have been used for this purpose. However, the '78 act provides that only gifts required to be included in a gift tax return enter into the computation [sec. 2056(c)(1)(B)(ii)].

If a husband has made substantial gifts to his wife, such as a gift of their residence or the severance of a joint tenancy, and has used the $100,000 full marital deduction, he still has the opportunity to lessen the resulting reduction of his estate tax marital deduction. This may be accomplished by making current gifts large enough (over $3,000) to require their inclusion on a gift tax return. Substantial savings can be accomplished by sufficiently increasing small annual gifts to require their inclusion in a gift tax return.

Assume individuals *A* and *B* each make a gift to their spouse of $100,000 (ignoring the annual exclusion). *A* makes subsequent gifts of $2,000 each year, and *B* makes gifts of $3,030 each year, for the next ten years. If each were to die at the end of ten years, their estates would compute the marital deduction as follows:

Gifts to Spouse	Estate A	Estate B
1. Initial gift	$100,000	$100,000
2. Subsequent gifts reported	None*	30,300
3. Total gifts reported	100,000	130,300
4. Gift tax marital deduction	100,000	100,000
5. 50% of gifts	50,000	65,150
6. Excess gift tax marital deduction that reduces estate tax marital deduction	$ 50,000	$ 34,850

*Gifts of $3,000 or less are not required to be included in a gift tax return [sec. 6019(a)].

The estate of *B* has an additional estate tax marital deduction of $15,150 resulting from additional gifts of only $10,300 and taxable gifts of only $300. Thus, although it requires 33 years at $3,030 per year to obtain a full estate tax marital deduction, each gift that is reported reaps some benefit.

The reasoning of Congress is sometimes difficult to understand. In explaining the reason for the change, the Senate Finance Committee stated that "[b]ecause no gift tax return is required to be filed . . . the committee wishes to relieve executors of the administrative difficulties in determining the amount of these small gifts for purposes of computing the allowable marital estate tax deduction" [*Senate report on HR 6715*, p. *88*]. This "relief" is of dubious value to an estate. Rather than giving the executor a chance to compute the gifts that may have been made by a decedent to his spouse, it abolishes the opportunity entirely.

A remedy is available even if the husband does not want to increase his gifts to his spouse. The mere timing of the gifts can help. For example, if he is accustomed to giving approximately $2,000 a year and is unwilling to give more, by giving slightly more than $3,000 for two years and skipping the third year he has succeeded in requiring two gift tax returns to be filed and having an additional $6,000 included with his previous gifts. By grouping these gifts, he receives a tax benefit not otherwise available.

In making substantial gifts to a spouse, the donor has everything to gain and nothing to lose, at least taxwise. Under pre-'78 law, a gift made within three years of death and includible under sec. 2035 nevertheless affected the computation of the marital deduction and could cause its reduction even though estate tax benefit was not received from the gift. This result is prevented under the '78 act. Sec. 2056(c)(1)(B) specifically provides that if a gift is includible under sec. 2035, it is not taken into account in computing the adjustment to the sec. 2056 marital deduction. However, this favorable adjustment to the estate tax marital deduction resulting from gifts required to be included in a gift tax return is the opposite of the result under sec. 2035, where gifts made within three years of death are not added back to the gross estate only if a return was *not* required to be filed for those gifts. If the donor was generous and dies within three years of having made a gift for which a gift tax return was required, the gift is required to be added back to his gross estate.

sec. 2057 Orphan's exclusion—a Tax Reform Act sleeper

The '76 act tightened up many aspects of estate taxes, eliminated some benefits, and added other benefits. One of the new benefits can be found in a little-noticed provision in the act that, under certain circumstances, could add up to a considerable estate tax saving.

Under new sec. 2057, a deduction is provided for amounts left to orphaned children.

The maximum deduction cannot exceed the lesser of (*a*) $5,000 multiplied by the excess of 21 over the child's age on the date of the decedent's death or (*b*) the value of property passing from the decedent to the child and included in the gross estate.

For example, take a case where both parents die in a common disaster, perhaps an auto or plane crash. Their minor children would obviously need all the funds they could get, undiminished by estate taxes. If the will (or living trust) meets the requirements of sec. 2057, the estate is entitled to a deduction of $5,000 times the number of years each child is under the age of twenty-one. Perhaps this doesn't sound like much, but it could be. Assume for example that there are three children, ages one, three, and five. The estate could get a deduction of $270,000.

The deduction, however, is not automatic. Wills (or living trusts) should be reviewed to make certain the amounts to be transferred to minor children meet the requirements of sec. 2057 for this new deduction. For example, interests terminable under sec. 2056(b) generally do not qualify. (See sec. 2057(c).)

It should be noted that the Technical Corrections Act contains several proposed amendments which, if enacted, would liberalize the orphan's exclusion and make it easier to use.

sec. 2057

Editors' note: The Revenue Act of 1978 amended sec. 2057 retroactively to January 1, 1977, to permit the use of a single minor's trust to benefit all children as a group and raised from 21 to 23 the beneficiary's age by which the property may pass to someone other than the child's estate in the event of the child's death. See the following item.

Estate tax orphan's deduction—potential tax costs of using a single "qualified minors' trust"

The Tax Reform Act of 1976 added sec. 2057, which provides a deduction for estates of decedents making transfers to their orphaned minor children. The deduction is limited to $5,000 per year per child for each year a child is under age 21. As originally enacted, sec. 2057 required a separate gift to each minor to meet the terminable interest requirements of sec. 2056(b). The Revenue Act of 1978 added new subsection 2057(d), which provides an exception to the terminable interest rule for a "qualified minors' trust." Using a qualified minors' trust, a deduction may now be allowed for multiple interests in a single trust. However, the use of a single trust (with separate shares), as compared with a separate trust for each child, can result in loss of a portion of the orphan's deduction otherwise allowable.

Assume that the decedent is survived by three minor children (*X*, *Y*, and *Z*), ages 18, 16, and 8, respectively. The children have no surviving parent. The maximum orphan's deduction allowable under sec. 2057(b) is as follows:

X	21 − 18 =	3 × $5,000 =	$ 15,000
Y	21 − 16 =	5 × $5,000 =	25,000
Z	21 − 8 =	13 × $5,000 =	65,000
			$105,000

This maximum deduction could be obtained by providing a total of $105,000 to be allocated among three trusts: $15,000 to the *X* trust, $25,000 to the *Y* trust, and $65,000 to the *Z* trust.

For the purpose of calculating the amount that passes to each minor child upon the formation of a qualified minors' trust, each child will be treated as receiving a pro rata portion of the trust. (Sec. 2057(d) provides in general that in order to be a qualified minors' trust, all distributions must be pro rata to each beneficiary.) Thus, if this same $105,000 were instead sec. 2057 placed into a single qualified minors' trust for *X*, *Y*, and *Z*, the allowable orphans' deduction would be limited to $75,000 as follows:

Amount passing to each child: $105,000 ÷ 3 = $35,000
Allowable deduction per sec. 2057(b) and (d):

X	[limited per sec. 2057(b)]	$15,000
Y	[limited per sec. 2057(b)]	25,000
Z	[limited per sec. 2057(d)]	35,000
		$75,000

Therefore, by using a single qualified minors' trust rather than three separate trusts, $30,000 of the orphan's deduction is lost. To receive the maximum allowable orphan's deduction of $105,000 using a single qualified minors' trust, it would be necessary to place $195,000 in the trust as follows:

Amount of property passing to each child: $195,000 ÷ 3 = $65,000
Allowable deduction per sec. 2057(b):

X	$ 15,000
Y	25,000
Z	65,000
	$105,000

While the cost of administering three separate trusts may be larger than the cost of administering one trust with three beneficiaries, the additional costs should be weighed against the potential additional estate tax that may be incurred if a single trust is used.

sec. 2505 Beware of the "exemption equivalent"

The '76 act, which provided for unification of estate and gift taxes, introduced the term "unified credit." Commentators were quick to translate the credit to the "exemption equivalent" amount, which many understood to mean the value of gifts (or estate) that would pass tax-free. But this amount is not always the same. A donor will *not* have a credit that is the equivalent of $120,667 (or greater amount as the credit is phased in) if he has made taxable gifts before December 31, 1976, or used any part of his $30,000 lifetime gift exemption between September 8, 1976, and December 31, 1976.

If the donor has made prior gifts, his current gift tax will consist of the difference between the theoretical tax on all of his prior gifts at the new rates and the total gifts to date at the new rates less the unified credit. The true "exemption equivalent" will vary depending on the tax bracket the gifts fall into and cannot be translated into an amount of tax-free gifts unless the taxpayer's gift tax history is known. An example of this potential problem follows: sec. 2505

T, a widower, decides that he is going to give his daughter and son-in-law a gift of a sufficient amount of cash to purchase a ranch in 1978. The cost of the ranch is approximately $126,000. The tax on this gift is zero, assuming that *T* had never given a taxable gift in the past.

Gift	$126,000
Less exclusions	6,000
Taxable gift	120,000
Tax before credit	29,800
Less available credit	34,000
Tax	$ 0

Assuming that *T* had already made prior taxable gifts of $100,000, the computation of his gift tax would be the following:

Prior taxable gifts		$100,000
Plus current gift	$126,000	
Less exclusions	6,000	
		120,000
Total taxable gifts		220,000
Total tax		61,200
Less tax on prior gifts		23,800
Tax before credit		37,400
Less credit		34,000
Tax to be paid		$ 3,400

Thus, the same gift will produce a different tax result because of the donor's prior gifts. The "exemption equivalent" will be accurate for estate tax purposes before the credit for state death taxes when there is no prior gift history to enter into the computation.

If *T*, in the second case above, wishes to know how much he can currently give tax-free, the following computation can be used:

Prior taxable gifts	$100,000
Tax at current rates	23,800
Add 1978 credit	34,000
Total	57,800
Amount that produces $57,800 tax*	209,375
Less prior taxable gifts	100,000
Current tax-free gifts	$109,375

*$57,800 − 38,800 (tax on $150,000) = 19,000; 19,000 ÷ 32% = 59,375; 150,000 + 59,375 = $209,375.

sec. 2513 Gift-splitting by spouses in disparate gift tax brackets

Gift tax returns need not be filed on a quarterly basis until cumulative *taxable* gifts for that calendar year for which a return has not been filed exceed $25,000. A quarterly return must be filed, however, for the fourth quarter for any taxable gifts not previously required to be reported during the calendar year, regardless of the $25,000 requirement for the first three quarters [sec. 6075(b)].

How are these filing requirements affected by the gift-splitting provisions of sec. 2513? When a husband and wife consent, a gift made by one is deemed to be given one-half by each. The consent is effective for *all* gifts made within a calendar quarter to third parties, i.e., the spouses cannot pick and choose among gifts. Furthermore, cross-consents are mandatory if spouses elect to gift-split in a given quarter [regs. sec. 25.2513-1(b)(5)].

The facts that the gift-splitting election is available on a quarter-by-quarter basis and that cross-consents are mandatory present an important planning opportunity where (1) the "first" spouse has previously made substantial taxable gifts, (2) the "second" spouse has previously made a negligible amount of taxable gifts, and (3) both spouses plan to make substantial gifts. The second spouse should make gifts in a quarter during which the first spouse makes no taxable gifts and gift-splitting is not elected for that quarter. The first spouse may make gifts in a later quarter when gift-splitting is elected and the benefits of a lower combined tax accrue. The following example illustrates the advantage of alternating the spouses' gifts (II, below) rather than making all gifts in the same calendar quarter (I, below).

Facts:

	Wife	Husband
Prior taxable gifts—all made in 1977	$500,000	None
Gifts to be made in 1978 to the same individual	$100,000	$200,000

I. Gifts made in same quarter with gift-splitting:

	Wife	Husband
Gift	$100,000	$200,000
Less split gift to spouse	(50,000)	(100,000)
Plus split gift from spouse	100,000	50,000

Less annual exclusion	(3,000)	(3,000)
Taxable gift	147,000	147,000
Previous taxable gifts	500,000	None
Cumulative taxable gifts	647,000	147,000
Tax on cumulative gifts	210,190	37,900
Tax on previous gifts	155,800	None
	54,390	37,900
Unified credit (1978) ($30,000 used in 1977 by *W*)	(4,000)	(34,000)
Gift tax payable	$ 50,390	$ 3,900

II. Gifts made in different quarters with gift-splitting only for wife's gift:

Husband's earlier gift (no gift-splitting)

Gift	$200,000
Less annual exclusion	(3,000)
Taxable gift	197,000
Previous taxable gifts	None
Cumulative taxable gifts	197,000
Tax on cumulative gifts	53,840

	Wife	Husband
Tax on previous gifts		None
		53,840
Unified credit (1978)		(34,000)
Gift tax payable		$ 19,840

Wife's subsequent gift (gift-splitting)

	Wife	Husband
Gift	$100,000	None
Gift-split—from *W* to *H*	(50,000)	$ 50,000
Less annual exclusion	(3,000)	None
Taxable gift	47,000	50,000
Previous taxable gifts	500,000	197,000
Cumulative taxable gifts	547,000	247,000
Tax on cumulative gifts	173,190	69,840
Tax on previous gifts	155,800	53,840
	17,390	16,000
Unified credit—unused portion	(4,000)	None
Gift tax payable	$ 13,390	$ 16,000

III. Comparative summary of taxes payable:

	Wife	Husband
Alternative I		
Wife	$50,390	
Husband	3,900	$ 54,290

sec. 2513

Alternative II		
Wife	13,390	
Husband	19,840	
Husband	16,000	(49,230)
Saving		$ 5,060

Where a return has not been filed for a given quarter(s), spouses can elect to split gifts for that period on a return filed for a subsequent quarter. The consent for such previous quarter(s) is made by completing question 2 on Form 709. This election for a preceding quarter(s) is effective only for gifts made in such quarter that are reported on the gift tax return for that subsequent quarter [regs. sec. 25.2513-2(a)(2)].

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

sec. 2513

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.

Inter vivos marital gifts by moderate-sized estates

sec. 2523

Fully deductible marital gifts under sec. 2523(a) (i.e., the first $100,000) are not included in the donor's gross estate (subject to sec. 2035), nor added back in the taxable gift category of the donor's estate tax computation [sec. 2001(b)]. Because fully deductible marital gifts may shift assets that would be taxed in the donor's estate into the shelter of the donee spouse's unified credit, an estate plan might provide for $100,000 in inter vivos gifts to a spouse. Gifts in excess of $100,000 are often unwise because they may be subject to tax in the donee spouse's estate and are included in the taxable gift category of the donor's estate tax computation. However, gifts in excess of $100,000 might be appropriate where the tax imposed on the estate of the surviving spouse is a secondary concern or where a charitable bequest may eliminate tax in the survivor's estate.

sec. 2523 Lifetime gifts to a spouse are usually predicated on the possibility of the donor being the surviving spouse. If the donor is not the surviving spouse, it might be assumed that the benefits of lifetime gifts will be neutralized in the computation of the estate tax marital deduction. The sec. 2056(c)(1)(B) "marital adjustment" reduces the maximum estate tax marital deduction to the extent the donor is allowed to deduct more than 50 percent of post-1976 marital gifts.

The marital adjustment will ordinarily do its job of neutralizing lifetime gifts to a spouse. A $600,000 estate reduced to $500,000 by a $100,000 marital gift is limited to a $200,000 estate tax marital deduction (the greater of (*a*) $250,000 or (*b*) 50 percent of $500,000, less the $50,000 marital adjustment). The donor's taxable estate is $300,000, the same as if there had been no marital gifts, and only the maximum estate tax marital deduction had been claimed.

However, the marital adjustment is not completely effective when lifetime gifts reduce the estate below $500,000. An estate of $500,000 reduced to $400,000 by a $100,000 marital gift is still entitled to a $200,000 estate tax marital deduction (the greater of (*a*) $250,000 or (*b*) 50 percent of $400,000, less the $50,000 marital adjustment). Thus, the maximum fully deductible marital transfer possible for a $500,000 estate is $300,000, the same as an estate of $600,000 (i.e., $100,000 gift tax marital deduction plus $200,000 estate tax marital deduction). Absent lifetime gifts to a spouse, the $500,000 estate is limited to an estate tax marital deduction of $250,000. The following table demonstrates the ability of a $100,000 marital gift to significantly reduce the tax on the first estate with only a modest increase in the couple's combined tax.

	No gift		$100,000 gift	
	Decedent	Survivor	Decedent	Survivor
Estate	$ 500,000	—	$ 400,000	$100,000
Marital deduction	(250,000)	$250,000	(200,000)	200,000
Taxable estate	250,000	250,000	200,000	300,000
Post-1980 estate tax	$ 23,800	23,800	$ 7,800	40,800
		23,800		7,800
Combined taxes		$ 47,600		$ 48,600

The table assumes the survivor's estate consists only of assets received from the other spouse and that the nonmarital bequest bears the estate tax burden.

The effect of marital gifts that reduce the estate below $500,000 should be appreciated. It may be appropriate to review will provisions of moderate-sized estates to determine whether any adjustment to the marital bequest for lifetime gifts to a spouse is consistent with the estate plan. However, when the donor is survived by the donee spouse, the range in which there will be a significant tax incentive for such gifts may be rather limited. The estate tax marital deduction and post-1980 equivalent exemption make it possible to eliminate any tax in the first estate where the estate is $425,000 or less ($250,000 estate tax marital deduction plus $175,000 post-1980 equivalent exemption). As pointed out above, an estate of $600,000 making a $100,000 gift is not affected by the gift. Nevertheless, there is a range where a moderate-sized estate may gain additional marital deductions as a result of inter vivos gifts even when the donor is survived by the donee. *sec. 2523*

This discussion does not consider the $3,000 annual exclusion or gifts within three years of the donor's death.

Use of gift tax marital deduction can result in higher estate taxes

The Tax Reform Act of 1976 has modified the gift tax marital deduction of sec. 2523 to allow an unlimited marital deduction for the first $100,000 of gifts to a spouse. It is important to note that the gift tax marital deduction will in many cases limit the amount of the allowable estate tax marital deduction. (See sec. 2056(c)(1)(B).) Many questions have been raised concerning this interplay, particularly when the gift to the spouse is less than $200,000. The effect should be closely evaluated.

The donor decedent's estate tax burden can be reduced under certain circumstances by using a program of lifetime giving; however, the combined estate tax of both spouses will be higher in most instances, assuming that the maximum marital deduction and "unified transfer credit" are fully utilized and that the assets passed on to the spouse are included in her estate at the same value.

This may seem to make any gift plan disadvantageous; however, the value of the use of funds in the limited situations where the donor decedent's estate tax can be reduced, the removal of the assets from the donor's estate to avoid further appreciation, the use of the unified transfer credit by the donee spouse should such spouse predecease the donor spouse, and other factors may cause the advantages of a gift plan to outweigh the overall potential estate tax disadvantage.

The effect of programs of lifetime giving may be illustrated sec. 2523 by the following examples. Assume that all the provisions of the new law, effective in 1981, are effective in the following situations and that the decedent's transfer of property at death will be in the amount necessary to provide his estate with the maximum estate marital deduction. Neither spouse has made any lifetime gifts other than gifts to a spouse noted in these examples, and such lifetime gifts to the spouse were not made within three years of the death of the donor spouse. The donee spouse has no separate property of her own.

Assuming that the program of gifts is deemed beneficial, however, an adjusted gross estate (before any gifts) of up to $601,250 can be transferred to a spouse tax-free through the use of lifetime and testamentary marital deductions and the $47,000 unified transfer credit. The computation follows:

Computation of estate tax upon death of donor spouse

Adjusted gross estate (before lifetime gift to spouse)	$601,250
Gift (not within three years of death)	(351,250)
Adjusted gross estate	250,000
Marital deduction	(250,000)
Taxable estate	0
Adjusted taxable gifts	175,625
Total taxable estate	175,625
Tax	47,000
Credit	(47,000)
Estate tax	$ 0

Again, it should be emphasized that the estate tax on the subsequent death of the donee spouse would be approximately $146,000, whereas the combined estate tax on both estates, assuming no gift program, would be approximately $82,000.

Although these examples present a general trend of the interplay of the estate and gift tax marital deductions under the Tax Reform Act of 1976, all facts and circumstances must be considered because of the complexity of the new rules.

sec. 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

sec. 2601

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. Fur-

sec. 2601

thermore, 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.

Whether or not the IRS has gone beyond the intent of the law in drafting this portion of the proposed regulations is debatable, but the mere proposal of this rule on December 22, 1978, may have surprised many tax advisers. Since trustees, in certain circumstances, are personally liable for the generation-skipping tax, the need for professional tax guidance becomes even greater as a result of this proposal.

sec. 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):

sec. 2613

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.

Death of donor spouse

	$500,000 AGE			$600,000 AGE			$1 million AGE		
	No gifts	Post-1976 gift of $100,000 to spouse	Post-1976 gift of $150,000 to spouse	No gifts	Post-1976 gift of $100,000 to spouse	Post-1976 gift of $150,000 to spouse	No gifts	Post-1976 gift of $100,000 to spouse	Post-1976 gift of $150,000 to spouse
Adjusted gross estate (before lifetime gift to spouse)	$500,000	$500,000	$500,000	$600,000	$600,000	$600,000	$1,000,000	$1,000,000	$1,000,000
Gift	—	100,000	150,000	—	100,000	150,000	—	100,000	150,000
Adjusted gross estate (AGE)	500,000	400,000	350,000	600,000	500,000	450,000	1,000,000	900,000	850,000
Estate marital deduction—higher of:									
$250,000 or		(250,000)	(250,000)			(250,000)			
half of AGE	(250,000)			(300,000)	(250,000)		(500,000)	(450,000)	(425,000)
Less difference between									
nontaxable gifts to spouse		100,000	100,000		100,000	100,000	—	100,000	100,000
and half of FMV of gift		(50,000)	(75,000)		(50,000)	(75,000)		(50,000)	(75,000)
Taxable estate	250,000	200,000	125,000	300,000	300,000	225,000	500,000	500,000	450,000
Adjusted taxable gifts	—	—	50,000	—	—	50,000	—	—	50,000
Total taxable estate	250,000	200,000	175,000	300,000	300,000	275,000	500,000	500,000	500,000
Tax	70,800	54,800	46,800	87,800	87,800	79,300	155,800	155,800	155,800
Credit	(47,000)	(47,000)	(47,000)	(47,000)	(47,000)	(47,000)	(47,000)	(47,000)	(47,000)
Estate tax (paid from non-marital remainder)	$ 23,800	$ 7,800	$ 0	$ 40,800	$ 40,800	$ 32,300	$ 108,800	$ 108,800	$ 108,800

Subsequent death of donee spouse

	$500,000 AGE			$600,000 AGE			$1 million AGE		
	No gifts	Post-1976 gift of $100,000 to spouse	Post-1976 gift of $150,000 to spouse	No gifts	Post-1976 gift of $100,000 to spouse	Post-1976 gift of $150,000 to spouse	No gifts	Post-1976 gift of $100,000 to spouse	Post-1976 gift of $150,000 to spouse
Gifts from predeceased spouse	$ —	$100,000	$150,000	$ —	$100,000	$150,000	$ —	$100,000	$150,000
Distribution from estate of spouse	250,000	250,000	250,000	300,000	250,000	250,000	500,000	450,000	425,000
Adjusted gross estate	250,000	350,000	400,000	300,000	350,000	400,000	500,000	550,000	575,000
Marital deduction	—	—	—	—	—	—	—	—	—
Taxable estate	250,000	350,000	400,000	300,000	350,000	400,000	500,000	550,000	575,000
Tax	70,800	104,800	121,800	87,800	104,800	121,800	155,800	174,300	183,550
Credit	(47,000)	(47,000)	(47,000)	(47,000)	(47,000)	(47,000)	(47,000)	(47,000)	(47,000)
Estate tax	23,800	57,800	74,800	40,800	57,800	74,800	108,800	127,300	136,550
Combined estate tax	$ 47,600	$ 65,600	$ 74,800	$ 81,600	$ 98,600	$107,100	$217,600	$236,100	$245,350

Employment taxes

Avoiding employment taxes on nonresident aliens working for nonresident employers

sec. 3121

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/her 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 *sec. 3121* 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 sec. 3121 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: sec. 3121

- 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.
- Fifty percent or more of one corporation's officers are concurrently officers of the other corporation.
- Thirty 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. (See regs. secs. 31.3121(a)-1 and 31.3306(b)-1.) 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 sec. 3121 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.

Employment taxes of related corporations

Under the social security amendments of 1977, related corporations concurrently employing individuals may be treated as one employer for purposes of social security taxes and federal unemployment taxes. Section 314 of the Social Security Act of 1977 amends sec. 3121 of the code by adding new sec. 3121(s), which states: *sec. 3121*

> [I]f two or more related corporations concurrently employ the same individual and compensate such individual through a common paymaster which is one of such corporations, each such corporation shall be considered to have paid as remuneration to such individual only the amounts actually disbursed by it to such individual and shall not be considered to have paid as remuneration to such individual amounts actually disbursed to such individual by another of such corporations.

This subsection is effective for wages paid after December 31, 1978. Although the act was passed in December 1977, the proposed regulations necessary for section 314 were not issued by the IRS until December 1978. (See prop. regs. secs. 31.3121(s)-1 and 31.3306(p)-1.)

Crucial to determining the applicability of sec. 3121(s) to a particular case is a correct understanding of the terms "common paymaster" and "concurrent employment." The common paymaster must be a corporation that is a member of the group of related corporations for which the common employee performs services. A group of related corporations may have more than one common paymaster, either for separate categories of employees or for separate categories of related corporations. Concurrent employment is presumed to exist among a group of related corporations if those corporations use a common paymaster to remunerate employees.

Once the existence of a common paymaster and concurrent employment has been established, one needs to determine the allocation of employment taxes and liability for these taxes. The common paymaster has primary responsibility for remitting the employment taxes with respect to remuneration it disburses as the common paymaster. If the common paymaster fails to remit these taxes, it remains liable for any unpaid portion. In addition, each other related corporation is jointly and severally liable for a share of these taxes, in the amount of the liability that, but for sec. 3121(s), would have existed with respect to the remuneration from that related corporation, up to the amount of the liability of the common paymaster. Specifically, the common paymaster computes these employment taxes as though it were the sole employer of the concurrently-employed individuals. Further, the portion of taxes previously paid by the common paymaster that is allocated to each related corporation is determined by multiplying the amount of taxes paid by a fraction, the numerator of *sec. 3121* which is the portion of the amount of employment tax liability of the common paymaster under sec. 3121(s) that is allocable to an individual related corporation, and the denominator of which is the total amount of the common paymaster's liability under sec. 3121(s). These rules apply whether or not the tax on employees was withheld from the employee's wages.

sec. 3402

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: *sec. 3402*

- 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

ERISA update: investment in customer notes

sec. 4975

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 con-

sec. 4975 sider 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

Notification to the field of IRS national office adverse decisions

sec. 6013

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

sec. 6013 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.

sec. 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.

sec. 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, care-

sec. 6152

less 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. secs. 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 ex-

sec. 6152 tended 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.

sec. 6166

Estate planning with sec. 6166

Sec. 6166, added by the '76 act, authorizes extension of the time for paying estate tax for up to 15 years.

If an estate qualifies for sec. 6166 deferral, interest accrues at a modest 4 percent, and principal payments need not begin until five years and nine months after the decedent's date of death. (See secs. 6601(j) and 6166(a)(3).)

In general, an estate qualifies for this 15-year deferral if the value of an interest in a "closely held business" exceeds 65 percent of the adjusted gross estate. A decedent is considered to own an interest in a "closely held business" with respect to an interest in a partnership or corporation that is "carrying on a trade or business" if the partnership or corporation had 15 or fewer partners or shareholders, respectively, or if the decedent's gross estate included a 20 percent or more capital interest in the partnership or was 20 percent or more in value of the voting stock in the corporation. (See sec. 6166(b)(1).)

It is difficult to qualify sole proprietorship assets for sec. 6166 treatment, although it is not impossible. (See Rev. Ruls. 75-365, 75-366, and 75-367, relating to investment assets.) Since the IRS does not issue advance rulings on estate tax matters, IRS rules to distinguish sole proprietorship assets from personal assets cannot be predicted with certainty. However, the regulations under sec. 6166 (now sec. 6166A) suggest that the *entire* gross estate value of a decedent's stock in a corporation will qualify as an "interest in a closely held business"; regs. sec. 20.6166-2(c)(1) prevents the IRS from allocating the decedent's stock interest between "active business" assets and nonoperating assets of the corporation.

Example. Individual *A*, a widower aged 75, owns assets as follows:

	FMV	Annual income
Rental property	$10,000	
Debt securities	10,000	
Equity securities	30,000	5,000
Residence and personal property	$ 500	($ 20)

Individuals *B* and *C*, his sons, aged 50 and 45, together own assets as follows:

	FMV	Annual income
Interests in BC partnership, a retail seller of goods	$20,000	1,500
Residence and personal property	$ 750	($ 100)

If *A* were to die, the entire estate tax liability of his estate would be payable in nine months since none of his assets would qualify as an "interest in a closely held business."

If *A*, *B*, and *C* transfer all their assets, other than residences and personal property, to a new corporation (Newco) (which will continue the BC retail business), in exchange for Newco voting common stock issued to *B* and *C* and cumulative preferred stock issued to *A*, the transfer would be tax-free under sec. 351. The individuals' current receipts after the transfer (preferred dividends to *A* and salaries to *B* and *C*) can be set up to approximate their receipts prior to the transfer.

And, if *A* dies *after* this sec. 351 transfer, he will have left an estate comprised almost exclusively of an "interest in a closely held business," thereby qualifying the estate for the 15-year deferral of estate taxes. Further, if *B* and *C* inherit the preferred stock of Newco, it will not be sec. 306 stock because it will have been issued upon the original incorporation of Newco. (See sec. 306(c)(1)(B)(iii).)

If *A* in our example does not have sons with a business to incorporate, he could still transfer *his own* trade or business assets *and* investment assets to Newco, which transfer would also result in virtually all his assets being converted into an interest in a "closely held trade or business."

Deferral of estate tax for closely held business interests

The Tax Reform Act of 1976 added new sec. 6166 to the code and redesignated the existing sec. 6166, which remains effective, as sec. 6166A. Both sections provide a ten-year installsec. 6166 ment payment privilege for an allocated portion of estate tax where a major asset of an estate is an interest in a closely held business. Compared with sec. 6166A, the new sec. 6166 contains higher percentage thresholds for qualification, but provides an additional five-year deferral of estate tax payment before the installments begin and imposes a lower rate of interest on a portion of the deferred amount. Both sections are designed to soften the blow of estate taxes on closely held businesses where the owner dies. Without such relief, many businesses in such circumstances would have to be sold or heavily mortgaged to meet the cash requirements for immediate payment of estate tax. These sections, however, are useful not only in hardship cases, but may provide planning opportunities for very liquid estates as well.

Sec. 6166 requires that the value of an interest in a closely held business must exceed 65 percent of the adjusted gross estate. Under sec. 6166A, it must exceed either 35 percent of the gross estate or 50 percent of the taxable estate. Regs. sec. 20.6166-2(c) provides that where the business is a proprietorship, only the assets "actually utilized" in the business are considered. However, where the business is operated by a partnership or corporation in which the decedent owned at least a 20 percent interest (or there were ten or fewer partners or shareholders), all of the corporate or partnership assets are considered (to the extent of the taxpayer's interest) for purposes of the test. The regulation states, "[I]t is not necessary that all the assets of the partnership or the corporation be utilized in the carrying on of the trade or business."

A taxpayer who owns a business proprietorship that would not meet the percentage tests for use of either section may be able to form a corporation that owns the proprietorship together with other investments, thereby enabling the estate to qualify for one of the ten-year installment payment privileges. Similarly, a taxpayer who owns a business corporation that meets the tests of either sec. 6166 or sec. 6166A may be able to maximize the amount of tax his or her estate can defer by placing additional assets in the corporation before death.

These tax-planning steps should pass IRS scrutiny regardless of the relative amounts of business and nonbusiness assets held by the corporation or partnership as long as an active business is carried on. (See Rev. Ruls. 75-365, 366, and 367.) This conclusion is confirmed by IRS Technical Advice Memorandum 75041970A, dated April 14, 1975, which requested the IRS to determine whether a corporation was engaged in a trade or business within the meaning of sec. 6166A. According to the memorandum, the corporation in question owned assets with a total value of approximately $8 million, of which $7 million represented marketable securities. The $1 million balance consisted of various operating assets of a hotel—primarily land valued at $500,000 and property and equipment of $400,000. The memorandum concluded that the corporation in question was carrying on a trade or business, and, therefore, the federal estate tax attributable to the value of the corporation's stock could be paid in installments if the other provisions of sec. 6166A were met. *sec. 6166*

Although regulations have not yet been promulgated for new sec. 6166, it seems *unlikely* that this IRS position will change since the statutory language of sec. 6166 is very similar to that of its predecessor. Furthermore the legislative history suggests that new sec. 6166 was enacted to provide additional relief for estates with liquidity problems. (See HR Rep. no. 1380, 94th Cong., 2d Sess. (1976).) Consequently, any attempt by the IRS through regulation or other administrative interpretation to narrow the scope of sec. 6166 from that of sec. 6166A would appear to be inconsistent with congressional intent.

Sec. 6325(b)(3): liberalized IRS procedure on tax lien sale of property

sec. 6325

Sec. 6325(b)(3) provides that in the event of a dispute between the IRS and other lienors concerning their respective rights to real or personal property, the property may be sold and the proceeds of the sale held in escrow subject to the same liens and claims that the parties had in respect to the property sold. This provision is intended to provide a means for disposing of property as to which there is a dispute among lienors, so that the disputed property will not sit idle. It is believed that this provision is most often used to expedite the sale of real estate on which there is a claim of an IRS lien.

In the past, the IRS insisted that the entire proceeds of a sale had to be put into escrow in order to enter into an agreement as described in sec. 6325(b)(3). This interpretation worked an extreme hardship in cases where the proceeds of the sale substantially exceeded the amount of the IRS lien. For example, the IRS may have a questionable claim against property that is very small in comparison to the total value of the property. Typically, a competing lienor might be prej-

sec. 6325 udiced by tying up the entire proceeds of sale merely to determine whether some small part of the proceeds were subject to an IRS lien.

The IRS has recently informally disclosed that it has revised its procedures that formerly insisted that the entire proceeds be put into escrow. The service apparently now insists only that an amount equal to its claim be escrowed. This will enable wider use of the provisions of sec. 6325(b)(3).

sec. 6654 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.

sec. 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.

sec. 6655

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 underestimation 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 sec. 6655 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. *sec. 6655*

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

sec. 6655 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 annualiza-

tion exception of sec. 6655(d)(3) to avoid making any quarterly payments of estimated tax whatsoever for the first *three* quarters.

sec. 6655

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 towards 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.

Penalties—failure to include taxpayer's identifying numbe: on information returns

sec. 6676

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 *sec. 6676* 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.

sec. 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. *sec. 9100*

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 appli-

cation 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-'80 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. *sec. 9100*

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.

sec. 9100 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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