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edited by Don J. Summa, CPA

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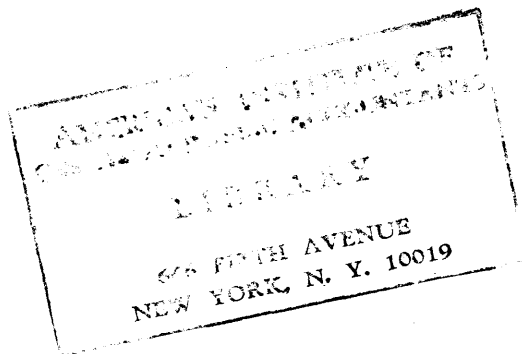
edited by

Don J. Summa, CPA
Arthur Young & Company



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FOREWORD

It has been a privilege and a pleasure to work with Mr. Don J. Summa of Arthur Young & Company, New York City. Mr. Summa is the new editor of *Working With the Revenue Code—1971*. He has devoted a substantial amount of time and effort to all aspects of this publication. His personal review and editing ensure that all the material contained in this edition reflects the latest thinking on current issues. I also want to thank Mr. Eugene A. Eberhardt of Arthur Young & Company who was Mr. Summa's liaison with my staff.

I would like to call your attention to the fact that this year's edition of the book is called the 1971 edition rather than 1970. This is not a lapse in sequence; it is merely a more appropriate way to date the book to better reflect the year in which it is put to greatest use.

As in past editions of this book, the current edition is a compilation of the most pertinent material that has appeared in the Tax Clinic in recent years. As many of you are aware, the Tax Clinic is a feature which originally appeared monthly in *The Journal of Accountancy*. Beginning in January 1970, this feature was incorporated into *The Tax Adviser*, the Institute's new monthly publication devoted exclusively to taxation. The material in this book includes Tax Clinic items through August 1970.

The items in the volume are categorized by Code section, providing an orderly approach for a reader going through the book for general information. It also enables a researcher analyzing a specific problem to determine quickly whether any comment has been included on the matter which interests him.

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

It is not my objective to encourage the use of this book as a source of basic research. Federal taxation changes so rapidly

that any bound volume cannot be completely current even at the instant of publication. It is, however, my hope that the book will provide a base from which common problems can be identified and the necessary research conducted.

This book continues to be a cooperative effort—the work of many minds and hands. The generous co-operation of the contributing editors and of numerous practitioners who have submitted articles over the years have made it possible to provide readers with specific information which I hope will be found worthwhile.

The contributing editors to the Tax Clinic Department of *The Tax Adviser* for 1970 are:

Mario P. Borini, CPA	T. Milton Kupfer, CPA
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Peter Elder, CPA	William E. Neuhauser, CPA
Paul Farber, CPA	Thomas C. Parsons, CPA
Walter C. Frank, CPA	Don J. Summa, CPA
Eli Gerver, CPA	Jerome Toder, CPA

I wish to express my thanks to my associates in the Institute's Tax Division for their assistance in research, editing and assembling the publication—notably Joel Forster, CPA, Manager, Special Projects.

I also want to acknowledge the efforts of the production department of our Publications Division.

Gilbert Simonetti, Jr., Director
Division of Federal Taxation

January 1971

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DETERMINATION OF TAX LIABILITY

Certain Married Persons May Qualify as Head of Household

Sec. 1

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

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

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

COMPUTATION OF TAXABLE INCOME

Sec. 61 Measuring Solvency Where Debt Is Cancelled

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

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

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

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

Cooperative Apartments and Condominiums

Sec. 61

Do cooperative apartments and condominiums have taxable income under the following circumstances:

1. When routine assessments for maintenance and operating expenses exceed the actual outlays in a given year and are refunded; or

2. When funds are contributed in accordance with FHA requirements to cover deductible amounts under insurance contracts?

In the first instance, Rev. Rul. 59-322, 1959-2 CB 154, provides for the exclusion of patronage dividends, rebates or refunds paid by nonexempt cooperatives in accordance with a pre-existing obligation. If the contract with the tenant-stockholders provides that any excess funds must be returned to the stockholders as soon as the amount was determinable, the conditions prescribed by Rev. Rul. 59-322 would appear to have been met and the cooperative would have a liability at the year-end in the nature of a patronage dividend. Although Rev. Rul. 56-225, 1956-1 CB 58 seems to be at variance, the absence of a pre-existing obligation makes it distinguishable. See *Lake Forest, Inc.*, 22 TCM 156(1963), for a discussion of these revenue rulings in a similar fact situation.

Where funds must be contributed to the corporation to satisfy FHA requirements for an insurance reserve or to finance capital improvements, it appears reasonable to argue that these contributions are made as additional paid-in capital under the rationale of *874 Park Ave. Corp.*, 23 BTA 400 (acq.), which cited I.T. 1469, 1-2 CB 191, as its authority. This same issue was also upheld in the *Lake Forest, Inc.* case. Although these cases involve contributions required to make mortgage amortization payments and I.T. 1469 refers to both mortgage payments and "any other capital expenditures," it seems that the principle could be extended to cover the FHA-required insurance reserve as well, so long as the contract provided that the amounts were to be accounted for as paid-in capital.

Gift Tax Trap With Life Insurance

Sec. 102

In estate planning, life insurance is often recommended as gift property because of its low value for gift tax purposes.

In this connection, the question arises as to who should be

Sec. 102 the donee. A gift tax trap can arise if thorough analysis is not made. For example, assume the insured transfers the ownership of a $100,000 policy to his wife. She then names her children as primary beneficiaries of the policy. When the insured husband dies, his wife may be deemed to have made a gift of $100,000 to her children.

The critical question in this area is the point in time of the completed gift. As long as a donor has retained the right to change beneficiaries, a gift is incomplete. In other words, such a transfer is subject to outright revocation by the donor and a completed gift only results when the donor either gives up or loses his power to revoke. In our example, the owner-wife had the power to revoke the beneficiary designations until the death of her husband, at which time she lost her power of revocation. Accordingly, the death of the husband causes the relinquishment of dominion and control and gives rise to a completed gift subject to gift tax (*Goodman* v. *Comm'r*, 156 F2d 218 (CA-2, 1946)).

This trap could arise in any number of factual settings whenever a policy owner is not the insured. Another example is where the owner designates a trust as the beneficiary. Once again, if the right to change beneficiaries is retained, the gift is incomplete until the death of the insured, at which time the gift is completed and the beneficiary's rights become vested.

Sec. 103 Exempt Interest on Sales to Municipalities

Taxpayers selling major items of equipment to municipalities or other nonfederal governmental bodies on a financial basis may be overlooking an opportunity to exclude interest so earned from gross income.

Interest paid by a governmental body on an installment obligation is tax-exempt interest and excludable from gross income. Sec. 103(a) provides that gross income does not include interest on the obligations of a state, territory or possession of the U.S., or any political subdivision of the foregoing. The exemption is not limited to interest on obligations evidenced by some particular form, such as a conventional bond or promissory note. The exemption is equally applicable to an obligation evidenced by an ordinary written agreement of purchase and sale entered into by duly constituted authorities empowered to enter into such an agreement, in which the governmental body agrees to

pay interest (*Newlin Machinery Corp.* v. *Comm'r*, 28 TC 837). *Sec. 103*
Note, however, that if the taxpayer must borrow to finance the construction and sale of the equipment, interest paid on such borrowings would not be deductible. Moreover, even if funds are borrowed only for the general needs of the business, Rev. Rul. 63-27, 1963-1 CB 57 would require the taxpayer to allocate part of the interest on such borrowed funds to the tax-exempt interest received.

Confusion May Exist Between Dependent and Dependency Exemption

Sec. 151-2

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

To qualify for the exemption, an individual (a) must have less than $625 ($650 in 1971, $700 in 1972 and $750 in 1973 and subsequent years) gross income for the year (except that the taxpayer's child who is a full-time student for five months in the year or is under 19 at the end of the year may have a gross income of any amount and still qualify as a dependent), (b) must not file a joint return, (c) must receive over half of his support from the taxpayer (except for the multiple-support rule), and (d) must live with the taxpayer as a member of his household or be of a qualifying relationship to the taxpayer.

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

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

There have been several novel court decisions construing the dependency provision. For example, Sec. 152(a)(9) does not

Sec. 151-2

require that the dependent be related to the taxpayer in any way. However, in *Leon Turnipseed,* 27 TC 758, the Tax Court denied the taxpayer, a single man, a dependency deduction for a married and undivorced woman with whom he lived as man and wife and whom he supported during the entire taxable year, since taxpayer's actions were deemed to be contrary to public policy. This decision was codified by the 1958 Technical Amendments Act.

In *Richard Farnsworth,* 25 TC 936, a case involving the 1939 Code, the taxpayer was denied an exemption for a dependent because he had given a prize ticket to his daughter who won $750. Since her gross income exceeded $600, the credit was disallowed. This would not have been the result under the 1954 Code as the gross income factor does not apply to children under 19 or over 18 who attend a full-time accredited school.

The Treasury has ruled (Rev. Rul. 57-561, 1957-2 CB 114) that a student is a "full-time" student during such time as he is working in a "co-op" job with private industry, placement having been made by the educational institution at specified intervals for practical experience in conjunction with his prescribed course of study.

However, if the child provides more than 50% of his support out of his earnings, or his support comes from other than the taxpayer, the deduction will be denied. This was emphasized in *Hicks,* 16 TCM 108 (1957), where a son attended college under the G.I. Bill and the father could not prove that he provided more than 50% of the son's support. On the other hand, a father who provides support for a child is entitled to the deduction even though the child finishes school during the year and becomes employed. Once status as a student has been attained (five months at school) it continues throughout the year (Rev. Rul. 56-399, 1956-2 CB 114). The foregoing highlights the importance of keeping adequate records to demonstrate that the child's income was not used to support him; e.g., a bank account showing that all or a substantial portion of the income had been deposited to the account of the child and had not been withdrawn would be ideal proof.

Sec. 162 Business Use of Home and Insurance

The standard personal liability policy covering home risks excludes the use of the home for business purposes. Suppose the

Sec. 162

home is used in part for business purposes and deduction is taken in the tax returns for the use. It is desirable to follow through and get a rider to the policy permitting the business use. Otherwise, awkward problems can arise with both the insurance company and the income tax authorities.

Deductions Paid in Stock

Payment of such items as salaries, bonuses and interest through the medium of unissued stock or treasury stock will give rise to corporate tax deductions (Rev. Rul. 69-75, 1969-1 CB 52). Furthermore, no gain or loss is recognized to the corporation for discharge of such liabilities through issuance of its own stock (Sec. 1032).

Payment in common stock, however, can present problems to the individual on subsequent redemption (Sec. 302). Payment in the form of negotiable notes, while effective to insure the deduction under Rev. Rul. 55-608, 1955-2 CB 546, would hurt the company's financial picture.

Use of preferred stock should be considered in this situation since it possesses the advantages inherent in both common stock and notes. That is, the preferred stock used for this purpose may avoid the ordinary income redemption problem which is a potential danger under Sec. 302. Unlike notes, the preferred stock would be reflected in the capital section of the financial statements. Thus, it would not hurt the corporation's financial picture. Lastly, it gives key employees an interest in the corporation without in any way diluting the ownership of the common stockholders.

Sec. 163

Deduction of Interest on Term Savings Accounts and Certificates of Deposit

Commercial banks and thrift institutions have increasingly used term savings arrangements and certificates of deposit in an effort to attract new or increased deposits. This has prompted numerous questions as to the tax treatment of the interest payable under such an arrangement as it affects the bank or thrift institution.

With respect to the issuing corporation or association, the

 time for, and amount of, the deduction for interest will depend upon the nature of the taxpayer, its method of accounting, and the terms of the deposit arrangement.

Commercial banks—cash basis. In the case of a commercial bank which uses the cash method of accounting, no deduction will be allowed until the interest is credited to the account of and made available for withdrawal by the depositor. (See Regs. Secs. 1.163-1(c) and 1.461-1(a)(1); also see *First National Bank of Braddock,* 38 BTA 1244, in which interest credited as of December 31, 1934 was held not deductible until the calendar year 1935, since the depositor could not withdraw the interest until January 2, 1935.) Further, interest on a time certificate of deposit will only be deductible in the taxable year when the certificate matures or when the interest is paid in the event of an early retirement.

Commercial banks—accrual basis. In the case of a commercial bank on the accrual basis, the deductibility of interest is governed by the "all events" test prescribed in Regs. Sec. 1.461-1 (a)(2). With respect to ordinary passbook accounts, an accrual basis bank may deduct interest for the taxable year in which the liability to pay interest is incurred, notwithstanding that the actual credit to the account occurs in a subsequent year.

In this connection, the accrual of interest on time certificates of deposit requires further consideration. Certificates of deposit issued by national banks are subject to the regulations of the Board of Governors of the Federal Reserve System. Regulation Q, issued by the Federal Reserve, provides in part:

"Payment in emergencies—In an emergency where it is necessary to prevent great hardship to the depositor, a member bank may pay before maturity a time deposit or the portion thereof necessary to meet such emergency: Provided, that before making such payment the depositor shall sign an application describing fully the circumstances constituting the emergency which is deemed to justify the payment of the deposit before maturity, which application shall be approved by an officer of the bank who shall certify that, to the best of his knowledge and belief, the statements in the application are true. . . . Where a time deposit is paid before maturity the depositor shall forfeit accrued and unpaid interest for a period of not less than three months on the amount withdrawn if an amount equal to the amount withdrawn has been on deposit three

months or longer, and shall forfeit all accrued and unpaid interest on the amount withdrawn if an amount equal to the amount withdrawn has been on deposit less than three months. . . ."

(Similar provisions are applicable under Regs. Sec. 329.4(d) of the Federal Deposit Insurance Corporation.)

With respect to the portion of accrued interest on such a certificate of deposit which is subject to forfeiture in the event of an emergency circumstance, there is uncertainty whether such amount is deductible by an accrual basis commercial bank. About two years ago, the National Office of the IRS issued favorable technical advice on this issue, concluding that the element of forfeitability in the unlikely event of an emergency circumstance would not, in and of itself, preclude the accrual of such interest where the commercial bank adhered to the requirements of Regulation Q.

Presently, however, the IRS has reconsidered the favorable conclusion and takes the position that the all events test is not met in view of the possibility that holders of the certificates may satisfy the emergency circumstance shortly after the close of the taxable year of the bank. This position is taken in such cases notwithstanding that the bank may never have experienced an early redemption, and the fact that the bank has effective control over whether the certificate holder will receive an early redemption. The current IRS position is the subject of a docketed Tax Court case, *North State Bank of Amarillo* (TC 1/19/68, No. 403-68). Until that case is decided, the IRS will not process advance rulings on this issue; nor will it process favorably that part of any application on Form 3115 or Rev. Proc. 64-16 (1964-1, Part 1, CB 576) with respect to forfeitable interest.

Savings institutions. In the case of mutual savings banks, domestic building and loan associations, and other thrift institutions described in Sec. 591, there are separate provisions with respect to the deductibility of interest (or dividends) on deposits (or share accounts) and on term savings certificates. Sec. 591 provides a deduction for such amounts paid to, or credited to the account of depositors or holders of such accounts, if the amounts paid or credited are withdrawable on demand, subject only to customary notice of intention to withdraw. A restriction on withdrawal until the first banking day in January will generally preclude a deduction in the preceding calendar year for an amount of interest credited on December 31.

However, Regs. Sec. 1.591-1(b) provides that if the thrift

Sec. 163

institution maintains a bonus plan, or issues shares or accepts deposits, subject to fines, penalties, forfeitures or other withdrawal fees, it may deduct under Sec. 591 the total amount credited as interest (or dividends), notwithstanding that as a condition of withdrawal the institution may recover a portion of the credit as a fine, penalty, forfeiture or other withdrawal fee. The IRS has taken the position that Regs. Sec. 1.591-1(b) only applies to long-term savings accounts or certificates issued by such thrift institutions. In their view, a one-year savings certificate is short term and therefore is not within this rule (Rev. Rul. 69-149, 1969-1 165); whereas a certificate for three or more years is subject to this rule. (Rev. Rul. 69-638, IRB 1969-51, 19). Further, under Sec. 591 no distinction is made for the treatment of cash or accrual basis thrift institutions. In the case of such plans, the thrift institution's deduction is claimed without regard to the forfeitability feature, and its gross income for a subsequent taxable year is increased to reflect the amount of any actual forfeitures. Accordingly, the deductibility of interest on long-term savings certificates issued by such institutions may be treated more favorably than similar time certificates issued by commercial banks, if the IRS view in *North State Bank of Amarillo* prevails.

Sec. 164

Ordinary Deduction for State Tax on Sale of Securities

Although conceded by the IRS and although it is frequently of insignificant consequence, many taxpayers are unaware that state stock transfer taxes, which are imposed on the seller of stock in certain states, are deductible against ordinary income and need not be deducted from the sales price for purposes of computing the capital gain. The authority for such a deduction is the last sentence in Sec. 164(a). Regs. Sec. 1.164-1(a) states ". . . Investors in securities . . . may deduct state stock transfer . . . taxes under Sec. 164, to the extent they are expenses incurred in . . . an activity for the production of income."

An example of the application of this deduction is with respect to the New York stock transfer tax. This tax applies to all transfers taking place through the New York or American stock exchange. Where the volume of transactions warrants, the transfer of this deduction to the status of a deduction against ordinary income may result in a valuable tax benefit.

Worthless Affiliate Stock And Historical Records

Sec. 165

The records of a subsidiary should be preserved from the beginning of its history. This includes the period of its life prior to the time the subsidiary was acquired. The importance of preserving the records stems from the provisions of Sec. 165(g). If the stock of a subsidiary becomes worthless, it is an ordinary loss, provided the parent owned directly at least 95% of the subsidiary's stock and the total aggregate receipts for all years from so-called nonpersonal holding sources exceed 90%. This 90% factor must be measured from the beginning of its time. Any gap can dislodge the ordinary loss provision, as a result of which the worthlessness becomes a capital loss unless the total receipts for the year of lost records, when considered as personal holding company income in their entirety, should be insufficient to bring the total aggregate receipts for all years from so-called nonpersonal holding sources down to 90% or less. Obviously, the only insurance is to get and keep the records covering the entire history of the subsidiary.

Loss on Worthless Shares Of Foreign Subsidiaries

The Code is replete with language the meaning of which is difficult to grasp. An example is found in Sec. 165(g)(3) pertaining to worthlessness of securities in affiliated corporations. It reads in part: "For purposes of paragraph (1) any security in a corporation affiliated with a taxpayer which is a domestic corporation shall not be treated as a capital asset." Experience demonstrates that readers tend to conclude from this language that a fully deductible loss may not be claimed in respect of worthlessness of the shares of a foreign subsidiary. As brought out clearly in the applicable regulations, the clause "which is a domestic corporation" modifies the term "taxpayer" and has no reference to the subsidiary.

When Is New Property Not New For Accelerated Depreciation?

Sec. 167

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

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

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

Royalty Payments Measure Patent Amortization Deduction

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

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

Let us suppose that an inventor, Mr. A, has a patent which he wishes to exploit, but for which he requires financing. He interests two individuals, B and C, in his patent, and they agree to finance production. One possible means to accomplish this would be for A, B and C to form a corporation with equal stock ownership, giving A stock in exchange for his patent. The organization of such a corporation would be accomplished tax free, but since A transferred his entire interest in the patent in exchange for stock, any payments by the corporation to A with respect to the patent would be dividend income to A and would

not constitute a deduction to the corporation. *Sec. 167*

If the proper conditions exist, it would be possible for B and C to form a corporation by investing money, and then to have the corporation purchase the patent from A, agreeing to pay A one-third of the corporate profits before income taxes. If the share of profits to be paid to A extended over the life of the patent, and if A had no stock ownership or would acquire no stock ownership in the corporation as a result of the agreement, the payments by the corporation would be capital expenditures for the purchase of the patent, with depreciation on the patent measured by the same payments. (*Associated Patentees, Inc.*, 4 TC 979, acq.) Thus, under this arrangement the corporation would secure a deduction for the share of profits going to A by reason of his transfer of the patent to the corporation. Thus, corporate federal income taxes on A's one-third share would be eliminated.

Application of New Depreciation Methods to Successor Owners

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

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

Recognition of Gain—Retirements From Multiple Asset Accounts

With the introduction of the depreciation guidelines and the ordinary income consequences of Sec. 1245, the use of multiple asset accounting for depreciation purposes has become more widespread. Consequently, whether gain or loss *must* be recognized when an asset carried in a multiple asset account is

Sec. 167 retired or otherwise disposed of can be important in effecting significant tax deferral benefits.

While the rules for recognition of loss resulting from a normal or abnormal retirement from a multiple asset account are quite specific, the rules for recognition of gain are not quite as clear. It generally has been assumed that any gain on a normal "retirement" from a multiple asset account could be deferred. This conclusion was based on the depreciation and Sec. 1245 regulations and Treasury Department releases relating to the depreciation guidelines. Specifically, Regs. Sec. 1.167(a)-7(b) provides, in the case of a normal retirement from a multiple asset account being depreciated over average useful lives, that "Amounts representing salvage ordinarily are credited to the depreciation reserve." Regs. Sec. 1.167(a)-8(e)(2) states, "Where multiple asset accounts are used and acquisitions and retirements are numerous, if a taxpayer, in order to avoid unnecessarily detailed accounting for individual retirements, consistently follows the practice of charging the reserve with the full cost or other basis of assets retired and of crediting it with all receipts from salvage, the practice may be continued so long as, in the opinion of the Commissioner, it clearly reflects income." Finally, Regs. Sec. 1.1245-6(c) provides that "Sec. 1245(a)(1) does not require recognition of gain upon normal retirements of Sec. 1245 property in a multiple asset account as long as the taxpayer's method of accounting, as described in paragraph (e) (2) of Regs. Sec. 1.167(a)-8 (relating to accounting treatment of asset retirements), does not require recognition of such gain."

A "retirement" is described as a "permanent withdrawal of depreciable property from use in the trade or business or in the production of income" which may be made in several ways; for example, by selling or exchanging the asset, or by actual abandonment. Whether a retirement is normal is determined in light of all facts and circumstances. Regs. Sec. 1.167(a)-8(b) provides that "In general, a retirement shall be considered a normal retirement unless the taxpayer can show that the withdrawal of the asset was due to a cause not contemplated in setting the applicable depreciation rate. For example, a retirement is considered normal if made within the range of years taken into consideration in fixing the depreciation rate and if the asset has reached a condition at which, in the normal course of events, the taxpayer customarily retires similar assets from use in his business." "Salvage" is defined in Regs. Sec. 1.167(a)-

Sec. 167

1(c) as "the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is retired from service by the taxpayer."

Notwithstanding the foregoing rules, the provisions of Regs. Sec. 1.167(a)-8(a) (1) and (2) apparently have been interpreted by some examining revenue agents as *requiring* the recognition of gain in cases of asset retirements by "sale at arm's-length" or by "exchange." Support cited for this position has been the provision dealing with gains and losses on retirements which states that the recognition of gain or loss will be subject to the provisions of Secs. 1002, 1031, 1231, *and other applicable provisions of law.*

A private technical advice memorandum clarified the position of the Service with respect to normal retirements from multiple asset accounts. The Service acknowledges that there are three methods of treating salvage proceeds. These are: (1) the predominantly used method of crediting any proceeds to the reserve for depreciation (Regs. Sec. 1.167(a)-7(b) and 1.167(a)-8(e)(2)) which defers recognition of taxable income; (2) the method of reporting all proceeds as ordinary taxable income (Regs. Sec. 1.167(a)-8(e)(2)); and (3) the method of recognizing gain on a sale or exchange (Regs. Sec. 1.167(a)-8(a) (1) and (2)). The memorandum further clarifies the circumstances which will be considered as "clearly reflecting income" under the method for deferring taxable income.

Although stated in a negative manner, it would appear that income is not distorted for any taxable year in which salvage proceeds from a normal retirement, when added to the depreciation reserve account, do not make the depreciation reserve account exceed the cost or other basis of the multiple asset account. Even if the addition of proceeds to the reserve should produce an "excess" reserve, a taxpayer apparently would not be required to change his method of treating salvage, but would be required only to report the excess as taxable gain, probably ordinary income under Sec. 1245.

Double Deduction for Subchapter S Losses

Sec. 170

Losses of a subchapter S corporation first reduce basis of stock and then the basis of indebtedness to stockholders. When

Sec. 170 the corporation has earnings, there is no restoration of basis for the indebtedness and the IRS has ruled that the repayment is a taxable event and may qualify for capital gain treatment (Rev. Rul. 64-162, 1964-1, CB 304).

Instead of receiving repayment, the stockholder might consider a charitable contribution. The effect would be no different from that of any gift of appreciated capital gain property—no tax on the difference between basis and value but the deduction measured by value. There is one difference; there is a double deduction, one for the losses which reduced basis and one for the reduction which was never restored to basis.

20% or 30% Charity

In a letter to Vice President Humphrey on June 30, 1967, the Commissioner of Internal Revenue advised that travel expenses in the course of rendering donated services to charity are deductible, but they come in the 20% rather than the 30% (50% under Sec. 170(b)(1)(A) as amended for taxable years beginning with 1970) category because they are "for the use of" rather than "to" the charity.

Taxpayers that have substantial expenditures of that character should consider increasing their cash contributions to the charitable organization to qualify for the 30% category. In turn, they can be reimbursed for their travel expenses.

Valuation of Art Objects Contributed to Charity

Before 1964 it was possible for a taxpayer to contribute an art object to charity and be entitled under Sec. 170 to a present income tax deduction for a charitable contribution *even though he retained the possession and enjoyment of the art object for some period, such as, for example, the remainder of his life.* The proper amount of the fair market value allowable as a deduction was computed on an actuarial basis.

Thus it was not unusual for a taxpayer to contribute a remainder interest in a valuable painting to a museum, keep the painting hanging in his own home to enjoy for life, and claim a present deduction for the actuarially computed value of the remainder interest.

Now, however, Sec. 170(a)(3) precludes a present charitable deduction for a contribution of a future interest in *tangible personal property*. It is aimed directly at art objects, although it covers all other tangible personal property.

Under Sec. 170(a)(3) the contribution to charity of tangible personal property is treated as made only when all intervening interests in, and rights to the actual possession or enjoyment of the property have expired or are held by persons other than the taxpayer or those standing in a relationship to the taxpayer described in Sec. 267(b).

It should also be noted that Sec. 170(f)(3) denies a deduction in the case of certain contributions of partial interests in property except where an individual portion of the taxpayer's entire interest is contributed.

In spite of Secs. 170(a)(3) and 170(f)(3) it is still possible for a taxpayer to obtain a present deduction for the contribution to charity of an art object even though he retains some possession and enjoyment of it.

A taxpayer can accomplish this result by creating a tenancy in common with the charity in the art object. For example, the taxpayer might by deed of gift transfer a present undivided one-third interest in a painting to a museum. The deed should provide that the museum is entitled to possession, dominion and control of the painting for four months out of each year and that the taxpayer is entitled to possession, dominion and control for the other eight months. The deed of gift should provide for liability for loss or damage and, if appropriate, for insurance coverage.

If handled properly, the taxpayer in the example would be entitled to a present charitable deduction of one-third of the fair market value of the painting.

Under Rev. Rul. 57-293, 1957-2 CB 153, division of the ownership and possession presumably does not affect the total fair market value. The Service apparently does not contend that the fair market value of a, say, one-third interest in an art object is any more or less than one-third of the total fair market value without regard to the division of title.

The real problem is still in determining the fair market value of the entire art object rather than in applying fractions to that value. The usual art object contributed to charity is unique—there is none other like it, although there may be some resembling it. Further, much of the valuation technique is purely subjective. The valuation problem is further aggravated

Sec. 170 by a mushrooming inflation in art values in recent years and the unpredictable effect on expert opinion of occasional extraordinary auction sales. Accordingly these and other factors can result in great disparity of opinion among even the most properly motivated and well-qualified experts in art valuation.

Contribution Deductions for Fractional Interests

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

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

Foundation: Corporation vs. Trust

A corporate foundation has an advantage over a trust when it comes to contributions by a corporation. If a corporation donates to a trust, the amount is deductible only if the money is to be used by the charitable trust in the United States. There is no similar requirement on contributions by a corporation to a charitable corporation.

Charitable Contributions of Note or Pledge

Rev. Rul. 68-174, 1968-1 CB 81, offers an interesting way around the charitable contribution limitation for a particular year. The ruling holds that a debenture bond or promissory note issued and delivered to a charitable organization is not

deductible as a contribution at the time issued. The deduction is allowable at the time the bond or note is paid off, regardless of whether it is then held by the charitable organization or a subsequent transferee. Thus, a taxpayer who wishes to make a charitable contribution, but is unable to claim a deduction because of the limitation, or who does not want to claim a deduction because of prior expiring carryovers can make the contribution in the form of a note or pledge. The charity can obtain the cash immediately by discounting or borrowing against the note or pledge. The charity deduction, however, will be available to the taxpayer only when the note or pledge is paid off.

Charitable Contributions by Closely Held Company

In Rev. Rul. 68-314, 1968-1 CB 101, the IRS held that charitable contributions made by a closely held company were nondeductible to the company and construed to be a dividend to the company's sole shareholder. Subsequently, Rev. Rul. 68-658, 1968-2 CB 119, was issued and substantially liberalized the previously announced IRS position although not reversing the conclusion of nondeductibility and dividend treatment. The distinguishing feature of the new ruling is the inclusion of additional facts.

In the revised example in Rev. Rul. 68-658, it is emphasized that the fair market value of the transferred assets (inventories and appreciated securities) was in excess of 50% of the net assets of the corporation, which did not have significant liabilities. In addition, the contribution was in excess of 5% of the corporation's taxable income. The Service held that the transfer by the corporation was made for the sole purpose of carrying out the charitable intentions of its only shareholder. It is important to note the Service now recognizes explicitly that the exercise of control by a shareholder does not convert the corporate contribution into that of the shareholder unless the facts and circumstances establish that the transfer served only the personal objectives of the shareholder. The second example set forth in Rev. Rul. 68-314 is carried forward intact to Rev. Rul. 68-658 with only slight adjustment for grammatic changes. In that example, much emphasis is placed on the business motives to justify the deduction to the corporation for the transfer to a public charitable donee.

Sec. 170 In summary, it may be concluded that the severe restrictions previously announced by the Service no longer exist although one might still question the legal basis for a business purpose requirement for any charitable contribution. If the transfer to a charity by a closely held corporation (a) is not a substantial portion of the corporation's assets, (b) does not exceed substantially the 5% deduction limitation and (c) other factors exist (such as outsiders on the foundation's board), the likelihood of the charitable deduction's being denied and a dividend deemed distributed to the controlling shareholder now appears remote.

Contributions Carryover for Individuals

The provision for carryover of contributions applies only for those contributions which qualify for the 50% limitation or 30% in the case of capital gain property. Thus, anyone facing the prospect of a carryover should plan, in the year of contribution, to make only gifts qualifying for the carryover, deferring other types of gifts to the following year. This secures the maximum carryover and hence the maximum ultimate aggregate charity deductions possible.

Sec. 172

Avoidance of Net Operating Loss Carryover Expirations

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

Sec. 174

R&D Expenses— First Year Split Election

Since the regulations under Sec. 174 were issued, there has been some doubt that a split election (partly expense and partly deferment) for research expenditures was permissible in the

first year such expenditures are incurred without IRS permission. *Sec. 174*

Rev. Rul. 68-144, 1968-1 CB 85, in part reads, "A taxpayer had *properly* elected to currently expense all research and experimental expenditures *with the exception* of those on two particular projects relating to new product development as to which the deferred expense method was elected. In a later year, the taxpayer undertook new research projects relating to *new* product development and in its return included a written statement described as an 'election' to use the deferred expense method for these new projects." (Emphasis added.)

The ruling concluded that "where the taxpayer *originally elected* to expense all research and experimental expenses *except* as to two particular projects, if it desired to use the deferred expense method for any *subsequent* project or projects, permission of the Commissioner is necessary." (Emphasis added.)

In the light of the above, it appears that a split election can be made in the first year research and experimental expenditures are incurred, but thereafter all new projects must be currently expensed, unless permission is obtained to use a different method.

Because of past uncertainties it is recommended that the initial election be made in writing, great care being exercised to make clear the basic intent to be on the expense method. If the amounts capitalized exceed those expensed, and the amounts are large, a ruling should be considered.

In planning, especially for new corporations, the use of the split election should be considered. The deferral of expenses on specific projects could substantially reduce initial net operating losses and thereby reduce the possibility of NOL's being unused due to the five-year carryforward limitation.

85% vs. 100% Dividend-Received Deduction

Sec. 243

The 1964 Revenue Act introduced the 100% dividend-received deduction by adding new paragraph (3) to Sec. 243(a) of the Code. Prior to such addition, most intercompany dividends were eligible for only the 85% dividend-received deduction under paragraph (1) of Sec. 243(a). Now, intercompany dividends fall into the 85% category in paragraph (1) unless the taxpayer elects the 100% (between 87.5% and 97.5% for corporations described in Sec. 1564(b) for the "transitional period" through December 31, 1974) deduction in paragraph (3).

Sec. 243

If the election is made under Sec. 243(b)(2) the members of the affiliated group may be subject to certain restrictions regarding the number of surtax exemptions the group may claim, elections concerning foreign tax credits, accumulated earnings credits, exploration expenditures, and the computation of estimated taxes.

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

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

The "effective" rate of the "85% dividend deduction can thus go below the 85%, depending on the results of other operations. However, since the 100% deduction is not subject to these limitations, but is subject to other limitations mentioned above, any decision involving a choice between the two should consider these important differences.

Dividends-Received Deduction for Sec. 356(a)(2) "Boot"

The IRS has long maintained that, given the necessary earnings and profits, boot received in connection with exchanges in tax-free reorganizations is a dividend pursuant to Sec. 356(a)(2). This position is based on the decision in *Estate of Edward Bedford* (325 U.S. 283). However, the IRS considers this type of dividend to be something other than that which is contemplated by Sec. 243, and therefore not eligible for the dividends-received deduction provided for by that section. This position appears to be dependent on the assumption that Sec. 356(a)(2)

constitutes a dividend test outside the provisions of Secs. 301 and 316. *Sec. 243*

In the case of *King Enterprises, Inc.,* 418 F2d 511, Ct. Cls. (1969), the court held that when Sec. 356(a)(2) is invoked to treat boot as a taxable dividend to a corporate shareholder, it is entitled to the dividends-received deduction under Sec. 243 (a)(1). Presumably, the rationale of *King Enterprises* would extend to corporations electing the 100% dividends-received deduction under Sec. 243(a)(3) and also qualify for elimination in a consolidated tax return.

The IRS did not contest this issue. However, it is probably safe to assume that the IRS will not change its position, but rather, may avoid further direct confrontation in the Court of Claims while continuing to press the issue elsewhere.

Quirk in Limitation on Dividend Deduction

Sec. 246

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

An astounding situation apparently can result from this quirk. An illustration of this follows:

1970	
Dividends received	$100,000
Other income	300,000
	400,000
Deductions (other than dividends-received deduction)	315,001
Taxable income (before dividends-received deduction)	84,999
Dividends-received deduction under the general-rule limitation is $72,249 or 85% of taxable income before the dividends-received deduction. However, inasmuch as the dividends-received deduction computed without reference to the general-rule limitation creates a net operating loss, the general-rule limitation does not apply.	
Dividends-received deduction = 85% × $100,000 =	$85,000
Net operating loss	$ 1

Sec. 246

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

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

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

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

Sec. 263

De Minimis Rule for Minor Equipment Purchases

Some taxpayers have arbitrarily set their own rules for expensing purchases of minor equipment. Writeoff minimums generally range from $50 to as high as $500. To date there has not been a pronouncement on this type of procedure by the IRS either through a regulation, ruling or internal memorandum.

In a recent Court of Claims Commissioner's decision, *The Cincinnati, New Orleans and Texas Pacific Railway Company* v. *U.S.*, Ct. Cls. Comm. Rpt., No. 91-63 (1969), however, a deduction for purchases of property costing less than $500 was allowed. The court indicated that items costing less than $500 were not of such nature or character in relation to the company's business to constitute permanent improvements or betterments made to increase the value of property (Sec. 263(a)(1). Perhaps more important, the court concluded that the minimum rule constituted a method of accounting under Sec. 446(a) and 446(c). Since that method of accounting clearly reflected the income of the taxpayer, the IRS could not make an arbitrary change—that is, require the taxpayer to capitalize and then depreciate the items in this minor property account.

Assuming the Court of Claims adopts the recommendations, it will be the first official pronouncement on this question of expensing minor equipment which admittedly has a useful life extending beyond one year. Such an approach certainly makes sense from an administrative and accounting point of view in

that it eliminates substantial paper work. In short, a *de minimis* rule for minor equipment certainly seems to have a lot to recommend it.

Sec. 263

Interest Paid by Employee To Carry Life Insurance

Sec. 264

A corporation maintains key-employee insurance on the lives of selected officers and executives. When an insured employee retires, the company offers him the right to take over the policy for its then cash surrender value. The policy was purchased by the company in 1950. In 1967 the employee takes over the policy and borrows the funds in order to pay the cash surrender value to his former employer.

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

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

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

Temporary Investment of Borrowed Funds

Sec. 265

A taxpayer who borrows for the purpose of financing a construction program frequently finds it impracticable to time the borrowing with the need for the funds. Therefore, excess funds are on hand for a period of time following the borrowing and prior to the expenditure for construction. Code Sec. 265(2)

Sec. 265 provides that no deduction shall be allowed for interest on indebtedness incurred or continued to purchase or carry tax-free obligations. Does Sec. 265(2) operate to prevent a deduction of interest on the borrowing when the excess funds are temporarily invested in tax-free obligations?

Apparently not. Sec. 265(2) is directed toward the purpose of the borrowing and not toward the temporary use of the funds borrowed. This position is made clear in Rev. Rul. 55-389, 1955-1 CB 276. Informal discussions with the IRS in Washington indicate that this is still the feeling of the Service, but the length of time the tax-free bonds are held is considered to be a persuasive indication of the purpose of the borrowing. Should the tax-free bonds be liquidated in the year following the borrowing, chances are that no questions would be raised. On the other hand, if no commitments were entered into in connection with the expansion or construction program during the year subsequent to the borrowing, the taxpayer's position as to the purpose of the borrowing is considerably weakened. The vague intention of building sometime in the future certainly does not justify the investment of borrowed funds in tax-free obligations. For court decisions involving the question as to whether an investment was temporary, see *F. W. Drybrough*, 42 TC 1029 and *Wisconsin Cheeseman, Inc.* 388 F2d 420 (CA-7, 1968).

Deduction of Trust Expenses

Expenses allocable to tax-exempt income other than interest and Sec. 212 expenses allocable to tax-exempt interest are not deductible. (See Sec. 265(1).)

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

Apparently, there has been no clear-cut decision by the Service or the courts as to when a trust is in business and its expenses are deductible as business expenses under Sec. 162, and when they are deductible under Sec. 212 for the production of income. In the preparation of fiduciary returns, no allocation of expenses to tax-exempt interest income should be necessary whenever the activities of the trust are sufficient to constitute the conduct of a business. Sec. 162 of the Code, which requires no allocation, would then apply. It may ultimately develop that the activities of a trust, per se, would be regarded as the conduct of a busi-

ness, in which case Sec. 212 would not be applicable. Only Sec. 162 would then govern, and the expenses would be fully deductible.

Sec. 265

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

Bargain Sales to Close Corporations

Sec. 267

When a shareholder sells property to his close corporation at a price clearly in excess of fair market value, the constructive dividend possibilities for the amount in excess of fair value are obvious. But what about a sale by the same shareholder to his close corporation for an amount less than fair market value? Here the tax consequences are more complicated. Any difference between the sales price and the shareholder's adjusted basis which would constitute a loss will be disallowed under Sec. 267 where the other shareholders are family members or the selling shareholder owns more than 50% of the corporation's stock. In addition to the possibility of losing the loss deduction, other tax effects on the donor and on the other corporate shareholders must be considered.

Our selling shareholder, by virtue of his "bargain sale," has caused property to be placed in the corporation in excess of the value of assets being distributed. In other words, he has made a capital contribution equal to the difference between what the corporation paid him and the fair market value of the asset. The IRS may well contend that by selling the property to the corporation at less than its fair value the selling shareholder has made a gift to the other shareholders. This is in accordance with Regs. Sec. 25.2511-1(h)(1), which provides that "a transfer [for inadequate consideration] by B to a corporation generally represents gifts by B to the other individual shareholders of the corporation to the extent of their proportionate interests in the corporation."

The cases in this area are far from clear as to the correct gift tax treatment, assuming that the sale to the corporation has resulted in a gift. In the case of *S. F. Heringer* (235 F2d 149 (CA-9, 1956)), modifying 21 TC 607 1954), cert. den. 352 U.S. 927, the Tax Court, following the holding in *Frank B. Thompson* (42 BTA 121 (1940)), held that a donor was entitled

to just one exclusion for a gift to a corporation (notwithstanding there were several stockholders), despite the rule that a gift to a trust is deemed to be a gift to the trust beneficiaries. The Ninth Circuit, in *Mary M. Hutchings* (312 U.S. 393), skirted this point by denying any additional exclusions if the gifts are deemed to the shareholders and not to the corporation on the grounds that the gift would be of a "future interest." The other circuit courts have not specifically ruled on this point. The Third Circuit, however, in the case of *A. J. Diebold* (194 F2d 266 (1952)) has indicated in dictum that a gift to a corporation was a gift to the individual shareholders and subject to separate exclusions.

The Court of Claims, in the case of *Irwin S. Chanin*, 393 F2d 972, (1968) has agreed with the Third Circuit that the gift to the corporation was a gift to the stockholders, but is also in agreement with the Ninth Circuit that the gifts were future interests. Both the taxpayer and the government agreed that the various stockholders and not the corporate entity were the donees. The question was whether the gifts were future interests as defined in Regs. Sec. 25.2503-3. The taxpayer's argument in *Chanin* was that each stockholder-donee received as a result of the gifts a definite amount of increase in net worth of his stock, but the argument was rejected.

Thus, the "bargain sale" by a shareholder to his close corporation could result in both undesirable income tax consequences and in a taxable gift. The same effect as the "bargain sale" can be accomplished by selling the asset for full value and then making individual gifts to the stockholders. These gifts in cash will qualify for the $3,000 per donee annual exclusion. The stockholders then can contribute the money to the corporation. In the end, the corporation winds up in the same position as if it had made a "bargain purchase."

Bonds Held by Related Taxpayer

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

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

The specific situation in which application could be easily overlooked is the one relating to bond interest payable more than two and one-half months after the close of the corporation's taxable year. See Rev. Rul. 68-114, 1968-1 CB 100. *Sec. 267*

Report Unaccounted for Entertainment Expense on Employee's W-2, Not Form 1099

Sec. 274

On Sept. 12, 1969 a memorandum was issued to all District Directors in the North Atlantic Region by the Assistant Regional Commissioner (Audit) stating that an employer can avoid a disallowance of entertainment expense under Regs. Sec. 1.274-2(f)(2)(iv)(b) only if he meets one of two conditions:

1. The employer demands and receives an adequate accounting from his employee, or
2. The employer treats the entertainment expense allowance or reimbursement as compensation subject to withholding.

The accountability requirement (1) can be met at any time. Accordingly, there should be no disallowance if there is adequate substantiation furnished at the time of the examination.

With respect to (2), compensation treatment does not include the filing of an information report on Form 1099. However, inclusion of an expense allowance on Form W-2 should be accepted as compensation treatment even if tax had not been withheld on such items. This position is considered to be correct, although Regs. Sec. 31.3401(a)-1(b)(2) provides that traveling and other bona fide ordinary and necessary expenses incurred or reasonably expected to be incurred in the business of the employer are not wages and therefore are not subject to withholding. This is not inconsistent with the regulations under Sec. 274. In short, employers should report the allowance on Form W-2, not on Form 1099, whenever they do not receive an adequate accounting from the employee.

Repayment of Disallowed Corporate Expenses

Where the IRS, upon examination, disallows a deduction for expenses such as travel and entertainment, salary, etc., paid to a shareholder/employee of a closely held corporation, the disallowed deduction can result in being taxed—once to the share-

Sec. 274 holder and once to the corporation. One way to avoid this problem was to have an agreement requiring the shareholders to reimburse the corporation for the amount of the disallowed expense. However, until recently, there was no assurance that the IRS would recognize such an agreement.

The IRS in *Oswald* (49 TC 645, acq.) reversed its position as to those situations involving a repayment agreement regarding disallowed disbursements or excess compensation entered into between a corporation and its shareholder/employees. In the *Oswald* case, though, the so-called "hedge agreement" was legally binding and timely made (i.e., executed before the corporate tax year was under examination). The effect of this change in the IRS position is that disallowed corporate expenses can now be deducted by the shareholder/employees as ordinary and necessary expenses when they are repaid to the corporation. A number of important points, however, should be noted regarding the case; the agreement was incorporated in the bylaws, it covered future events, the particular shareholder/employee had been advised by the corporation's counsel that the agreement incorporated in the bylaws constituted a valid and enforceable corporate claim, and the agreement applied to all corporate shareholder-employees.

The advisability of using "hedge agreements" should be considered in certain instances in light of the IRS acquiescence in *Oswald*. In addition, these agreements are equally applicable to the officer-stockholders of a closely held corporation (Rev. Rul. 69-115, 1961-1 CB 50).

CORPORATE DISTRIBUTIONS AND ADJUSTMENTS

Sec. 301 Distributions of Property by Foreign Corporation

Distributions of property in kind from a foreign corporation to a domestic corporation are now taxable at the fair market

Sec. 301

value of the distributed property to the extent the distribution is treated as coming from foreign-source income. However, in determining the effect on earnings and profits of the distributing corporation, the provisions of Sec. 312 apparently still apply. Therefore, it appears that earnings and profits of the distributing corporation are generally decreased only by the adjusted basis of the property distributed.

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

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

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

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

Lack of E&P No Bar to Taxing Cash Flow

Generalizations are dangerous—particularly if they relate to tax rules. There are at least two situations which may result in taxable income due to the loose application of the principle that a lack of current or accumulated earnings and profits insulates actual or constructive corporate distributions from tax.

A rather common situation is that of a real estate corporation which has a positive cash flow and a negative taxable income. Generally, it is assumed that a cash distribution by this type of corporation will be treated first as a return of capital to the investor. Any distribution in excess of the tax basis for the investment results in capital gain (Sec. 301(c)(3)(A)). However, if the real estate corporation fits the definition of a collapsible corporation, this excess will be treated as ordinary income and not capital gain (Sec. 341(a)(3)). Here, it would be advisable to delay making distributions until more than three years have elapsed since the property was purchased or its construction completed (Sec. 341(d)).

Sec. 301 What to Do With Due From Shareholders

When loans are made by a corporation to its stockholders, the intent to create bona fide indebtedness (and not a distribution of a dividend) can be proved by pointing to a history of significant repayments together with a consistent treatment of the transaction on the books and tax returns of both borrower and lender. In addition, an attempt generally is made to point to a bona fide business (corporate) purpose for the loan together with the financial ability on the part of the borrower to repay the amounts advanced to him.

What happens if the creditor corporation is liquidated before the shareholder's indebtedness is repaid? In this event, the shareholder receives in the liquidating distribution the corporate assets, including the receivable representing the advances which have been made to him by the corporation. Is this a constructive dividend to him on the theory that the corporation has canceled or forgiven the shareholder's indebtedness by making the distribution? (It is assumed that the shareholder is solvent and the corporation has earnings and profits at least equal in amount to the indebtedness.)

Fortunately for the shareholder, the courts have not equated the liquidation distribution of the receivable to the shareholder with a constructive dividend to the shareholder, if the corporation has not, in fact, formally canceled this indebtedness. The distribution of the receivable and its treatment as an item of the liquidation proceeds represents a recognition of the substance of the indebtedness and not a constructive forgiveness (see, for example, *The Estate of Helen Gilmore,* 40 BTA 945; *Sam Weisberger,* 29 BTA 83; *Fred T. Wood,* 27 BTA 162; *James J. Gravley,* 44 BTA 722).

The lesson in planning is clear. Practitioners should make certain that shareholder indebtedness to controlled, closely held corporations is not forgiven either prior to or incident to a liquidation of these entities.

Sec. 302 Substantially Disproportionate Redemption of Voting Preferred Stock

To qualify as a substantially disproportionate redemption under Sec. 302(b)(2), the ratio of voting stock owned by the shareholder after the redemption to all the voting stock then out-

standing must be less than 80% of the ratio which the shareholder's voting stock immediately before the redemption bore to the outstanding voting stock at that time. In addition, the shareholder's ownership of *common* stock, both before and after redemption, must meet the same 80% requirement.

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

Attribution Rules in Redemptions Terminating an Interest

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

In order to insure capital gains treatment for Sec. 302(b)(3) redemptions it is important that the agreement be filed as required by Regs. Sec. 1.302-4. In *Archbold* v. *United States,* 311 F2d 228 (CA-3, 1963) the Court of Appeals affirmed a New Jersey District Court decision sustaining the refusal of the Commissioner of Internal Revenue to permit Archbold to file the required agreement at a later date with an amended return. As a result the entire distribution received by Archbold was held not to qualify as a sale or exchange entitled to capital gains treatment and instead was taxed as a dividend.

Subsequent to the decision in *Archbold,* in *U.S.* v. *Van Keppel,* 321 F2d 717 (CA-10, 1963), the Tenth Circuit distinguished the former case. On somewhat similar facts, it held that inadvertent failure to file the agreement under Sec. 302(c)(2)(A)

(iii) with the returns for the year of redemption did not foreclose capital gains treatment when it was subsequently filed after the defect was discovered upon an audit of the return, but before the director had made a deficiency assessment. The court held that Van Keppel had "substantially" complied with the provisions of the Code requiring the filing of the agreement. Accordingly, the constructive stock ownership rules did not apply for purposes of determining whether the taxpayer's interest had been terminated and the redemption was taxed as a capital gain.

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

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

Using Corporate Funds To Finance Sale of Stock

The use of a close corporation's assets to help its stockholders finance the sale of their stock is made much safer taxwise as the result of the Treasury's acquiescence in the *Zenz* decision (*Zenz* v. *Quinlivan,* 213 F2d 914 (CA-6, 1954)).

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

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

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

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

Thus, a sole stockholder may dispose of his stock in a combina-

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

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

Redemption of Stock of a Marital Deduction Trust

A corporation proposed to redeem stock held by a marital deduction trust. The widow of one of the founders of the corporation was life beneficiary of the trust, over which she had full power of appointment. Her sons likewise owned stock in the corporation and it was not proposed to redeem their stock. The question arose as to whether the sons might be held to have an actuarial interest in the marital deduction trust. If such an interest were held to exist, the stock of the sons as beneficiaries of the trust would be attributed to the trust. If so attributed a disproportionate redemption of the stock owned by the trust under the provisions of Sec. 302(b)(2) would not be possible.

The question has been discussed with the National Office of the IRS which has advised that if the widow has complete power of disposition of the trust remainder and if the trust qualified for the federal estate tax marital deduction, the sons would not have an actuarial interest in the trust. The opinion was that this would hold true even though there was a provision, in the will establishing the marital deduction trust, that the trust remainder should be distributed to the sons in the event the wife should fail to exercise her power of appointment.

Stock Redeemed for Notes of Redeeming Corporations

The National Office of the IRS scrutinizes very carefully requests for rulings as to the tax status of proposed stock

Sec. 302

redemptions under Sec. 302 where a portion of the redemption price consists of notes of the redeeming corporation. The purpose of the careful review is to assure that the so-called notes represent indebtedness of the redeeming corporation and not a continuing equity interest. Taxpayers are requested to submit draft copies of the proposed note or notes. In addition, detailed information regarding the notes is requested as follows:

1. Rate of interest. (Normally the interest rate should be the "going rate" for notes involving similar circumstances. It should appear that the rate of interest was determined on an arm's-length basis.)
2. Maturity date. (The note must mature within a reasonable period after the date of the stock redemption in order to obtain a favorable ruling. For this purpose, a reasonable period has been held to mean within 15 years after the date of redemption.)
3. A statement as to whether payments on the note (of either principal or interest) are dependent upon the earnings of the corporation.
4. A demonstration of the corporation's ability to pay the notes.
5. A statement as to whether the note is subordinated to the debts of other creditors to any extent and, if so, details of such subordination.
6. A description of the rights of the noteholder in event of default. (It should be shown particularly whether the noteholder, in the event of default, will have voting rights or any other rights normally associated with the ownership of stock.)
7. Profit and loss statements of the redeeming corporation for the three most recent years prior to the proposed redemption.

Apart from the character of the note, consideration must also be given to whether the stock redeemed had been issued as a dividend and the impact, if any, of a redemption on Sec. 531.

Requirements in Connection With Sec. 302(b)(3) Redemptions

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

Sec. 302

1. There must be a contract, note or other evidence of indebtedness to the retiring shareholders. A simple account payable is not sufficient.

2. The retiring shareholders must surrender all their shares at the time of the redemption. If they hold their shares as collateral, the Service will not treat the transaction as a termination of interest under Sec. 302(b)(3).

3. If the transaction is arranged in such a way that the retiring shareholders will be permitted to recover their stock upon a default of the redemption payments, this again will prevent the transaction from qualifying as a Sec. 302(b)(3) redemption. The debt to the retiring shareholders may be secured, however, by a mortgage on the property of the corporation.

4. After a Sec. 302(b)(3) redemption, the retiring shareholders may be creditors of the corporation only as a consequence of the redemption. If they loan money to the corporation or become creditors of the corporation for any other reason, this will also disqualify the redemption.

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

Redemption of Stock Held by An Estate in Related Corporations

Sec. 303

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

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

A decedent owned 50% of Corporation A and all the stock of Corporation B. On the basis of estate tax valuation, the stock of Corporation A qualifies for Sec. 303 treatment but the stock of Corporation B does not. Pursuant to a contract, Corporation A purchases the stock of Corporation B. Under Sec.

Sec. 303 304 the decedent and the estate are considered to be in control of both corporations and, accordingly, the purchase by Corporation A of the stock in Corporation B is considered to be a redemption of Corporation A stock.

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

Gifts May Adversely Affect Sec. 303 Redemptions

One of the most valuable provisions in the Code for stockholders in closely held companies is Sec. 303. It permits an estate and its beneficiaries to get money out of the corporation equal to the estate taxes and funeral and administration expenses. This can be done through stock redemption on a capital gain basis, rather than through tax consuming dividends.

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

Practical Problems in Applying Sec. 303

Sec. 303 permits a corporation to redeem shares held by the estate of a deceased shareholder, without danger of ordinary dividend consequences, up to the estate's total federal and state death taxes, plus its funeral and administrative expenses. Such a

redemption must occur no later than 90 days after the statute of limitations expires for assessing additional federal estate tax. If questions of valuation are being argued with the IRS, the normal three-year statute may well be extended for a considerably longer period by filing a petition in the Tax Court. In such case the application of Sec. 303 may give rise to interesting accounting as well as tax problems.

Assume a father owns 200 shares, one-half of a corporation's stock. His two sons, active in the business and in high personal tax brackets, own the other half. The father dies in 1960. His stock is the major asset in his estate and qualifies percentagewise for Sec. 303 treatment. It is reported for estate tax purposes at $1,000 per share. In 1961, the two sons acting as executors have the corporation redeem, for taxes and expenses, 30 shares at the reported $1,000.

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

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

Two problems present themselves. First, the 1961 redemption was made at $1,000 per share on the assumption that the estate would thereby incur no gain or loss. However, now that a $1,200 per share fair market value at date of death has been conceded, thus establishing $1,200 as the correct tax basis, did the estate have a $6,000 (30 shares times $200) capital loss? And if so, what can be done about it now that the statute of limitations on the fiduciary income tax return has expired?

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

The answers to these problems seem to be as follows:

1. The corporation may properly pay $6,000 to the estate as additional purchase price of the shares acquired in 1961. Assum-

ing it was always intended that the 1961 redemption be at the estate tax basis, the theory has to be that for five years the estate has been carrying a $6,000 account receivable from the corporation. On this assumption, the company should consider this payment as additional cost of its 30 shares of treasury stock purchased in 1961. This approach would eliminate the estate's "lost" 1961 capital loss. In this connection, it appears to be both desirable and practical, when the sale is made in the first instance by the estate to the corporation, for the selling price to be named and agreed upon with an open-end provision that any adjustment upwards or downwards by the IRS is to result in a corresponding adjustment of the selling price. This eliminates the need for assuming the intention that the redemption should be at the estate tax basis by spelling it out in clear-cut terms. A reasonable period after the final determination either by the IRS or, if appealed, by the courts, is allowed for the payment of the adjustment in price.

2. The 1966 redemption must take into account the present fair market value of the shares. Since it is assumed that a total of $42,000 can be paid within Sec. 303 limits, and $36,000 has already been received ($30,000 in 1961 plus the additional $6,000 in 1966), only $6,000 more in fair market value of the shares can now be surrendered. At $1,500 fair market value per share, this means four shares. Four shares have a basis of only $4,800, so the estate realizes a $1,200 capital gain. The estate should not elect to turn in five shares and thus argue that $6,000 of basis should be offset against the redemption price, thereby resulting in no taxable gain.

Compare the last paragraph of Rev. Rul. 57-334 (1957-2 CB 240) discussing partial liquidations under Sec. 346(a). It holds that regardless of the actual number of shares surrendered for redemption, the number "deemed" to have been surrendered is a percentage of total shares outstanding before redemption equal to the fair market value of assets distributed, divided by the fair market value of the entire corporation immediately before the redemption.

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

Let us assume ten more shares are redeemed from the estate

Sec. 303

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

Paying this "dividend" in the form of a stock redemption makes it unnecessary to pay a similar amount on the corporation's other shares, which in our example are held by the high-bracket sons. The estate loses no tax basis from having surrendered 15 shares of its stock. Regs. Sec. 1.302-2(c) calls for transferring the $12,000 basis of the stock surrendered to the estate's remaining shares.

Flexibility Under Sec. 303

One of the interesting things about Sec. 303 is the lack of restrictions regarding its use in certain instances. Although it was enacted to provide a method for financing payment of estate taxes, it does not require:

- That there be a federal estate tax liability against the estate
- That the estate be lacking in liquid assets that could be used to pay taxes or other expenses
- That the redemption of stock be made only from the estate
- That the stock be stock of a closely held corporation.

Appreciated property could be distributed by a corporation without realization of gain and avoid the capital gains tax. If appreciated land or other nondepreciable property is distributed, Secs. 1245 and 1250 are avoided.

The estate planner should also not overlook the advantages of recapitalizing closely held corporations with preferred stock. The preferred stock may be Sec. 306 stock, but loses the taint at death. Preferred stock is easy to value, and redemption will not disturb equity ownership.

"Widely Held" Recently Defined For Sec. 306 Purposes

Sec. 306

If preferred stock issued to common shareholders meets the definition of "Sec. 306 stock," sale or other disposition of the

Sec. 306 stock generally results in ordinary income for the owner. However, if it can be shown that neither the original distribution of the preferred stock nor its ultimate disposition were in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax, ordinary income treatment will not follow. One situation in which the purpose is considered by the IRS not to exist is where the stock of the issuing corporation is "widely held," and certain other conditions are present.

We understand that in the past the IRS considered the "widely held" test to be met if no more than 5% of the voting stock was owned by any individual stockholder, and not more than 20% was held by a related group of stockholders.

However, the National Office has indicated that it will apply the lower 5% test to the aggregate ownership of stock by a family group. Conceivably the Service would apply this strict test only in specialized situations, such as where stockholders who may individually own less than 5% are represented on the board of directors, or where the aggregate shares held by a family group constitute the largest block of stock owned in the issuing company.

Sec. 316 Tax-Free Corporation Distributions

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

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

Example: The Upright Corporation is a seasonal business on a September 30 fiscal year. As of September 30, 1966, the company had an earnings and profits accumulation since February 28, 1913, of $50,000. Due to unfavorable business and climate conditions, the company anticipates at least a $10,000 loss for the fiscal year ending September 30, 1967. Since its business

season begins in April and lasts through August, Upright Corporation had a six months' operating deficit of $100,000 on March 31, 1967. A $40,000 dividend was paid to stockholders on March 31, 1967.

The taxability of the distribution is determined after the close of the company's year on September 30, 1967. Let us assume that the company did, in fact, lose $10,000 for the year ($100,000 loss during the first half year and $90,000 profit during the second half).

Since there were no current earnings and profits, the earnings and profits accumulated as of March 31, 1967, would have been the only source of a taxable distribution. However, as noted above, in a loss year the accumulated earnings and profits must be adjusted to the date of distribution. On March 31, 1967, the adjusted figure was a $50,000 deficit—the $50,000 beginning balance less the $100,000 net loss for the six months ended March 31, 1967. Since there were no current or accumulated earnings and profits on March 31, 1967, the $40,000 distribution is treated as a return of capital to stockholders, tax free to the extent of basis in the stock.

What happens to Upright Corporation's earnings and profits balance as a result of the distribution? The $40,000 distribution does not reduce earnings and profits since a distribution out of capital can't create or increase a deficit in earnings and profits. Therefore, Upright's September 30, 1967, earnings and profits balance is $40,000 (September 30, 1966, balance of $50,000 less $10,000 operating loss for the fiscal year).

If the $40,000 had been distributed on September 30, 1967, instead of March 31, 1967, it would have been fully taxable.

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

Taxability of Dividends

A listed client having a large deficit in accumulated earnings wishes to adopt a method of paying dividends in alternate years in order to have a portion of the dividends tax free since the dividends would be in excess of the earnings for the year. However, the client desires to continue to declare a dividend in

Sec. 316 each year to avoid a possible deleterious effect on the price of the stock which may be caused by an omission of the declaration.

In Rev. Rul. 62-131 (1962-2 CB 94), the IRS indicated that the payment date was to be used for purpose of determining the source from which dividends were paid and that the declaration date was of no consequence. This means that the client may declare dividends on the usual or historic declaration days but the dividends themselves will be paid in alternate years. This will achieve the desired objective.

Sec. 332

Sale by Parent Corporation of Assets Received From Subsidiary

When a parent company is considering disposing of the business of its wholly owned subsidiary, a question often arises as to whether the parent or the subsidiary should sell the assets. Inasmuch as the subsidiary could be liquidated tax free with a carryover of basis and the parent could effect the sale, it may appear at first blush that the tax result would be the same regardless of which company sells the assets. However, this is not necessarily so.

In a case of first impression, *The Acro Manufacturing Company*, 334 F2d 40 (CA-6, 1964), taxpayer caused its subsidiary which was engaged in an unrelated business, to be liquidated and immediately sold the assets distributed to it to a third party at a loss. The court held that the inventory, accounts receivable and real estate received by the parent upon the liquidation of its subsidiary were capital assets. Consequently, the loss incurred upon their sale was a capital loss. The rationale for the decision was that the assets were not used in the parent's business.

In view of this reasoning, sound tax planning would seem to dictate that if a loss is to be realized on the sale of Sec. 1231 assets, inventory and receivables, such loss being fully deductible against ordinary income, the subsidiary should realize this loss since, if it were realized by the parent company immediately after the liquidation and before the assets were used in the parent's business, the Treasury would treat it as a capital loss.

The result is doubtful where there is the possibility of a gain being realized on the sale of the assets. The problem here is whether it is possible to convert what would be ordinary income to the subsidiary on the sale of, say, inventory to capital gain by first liquidating the corporation and having the parent effect the

sale. A close reading of the *Acro* case may leave that impression. The court specifically states that it cannot ignore the separate corporate entities. Consequently, if the sale of the inventory is negotiated and actually consummated by the parent after a tax-free liquidation, there is room for argument that the inventory is a capital asset in the hands of the parent. Of course, the corporation may run afoul of the *Court Holding* doctrine and that determination would be a factual one.

Sec. 332

Step-Down in Basis in One-Month Liquidation

Sec. 333

There is a delayed-action trap in Sec. 333. It results from the loss of basis in the hands of the stockholders of ordinary income-type assets received in the one-month liquidation. The case of *Garrow* v. *Comm'r* (43 TC 890) illustrates the danger as follows.

Upon liquidation of his corporation—Diablo Development Co. —under Sec. 333, Garrow recognized an $18,000 gain. Since his basis for Diablo's stock was $6,800, his total basis for the assets received was $24,800. The assets among which this amount had to be allocated were:

Asset	*Book Value*	*Fair Market Value*
Receivables	$20,000	$20,000
Real estate	8,000	80,000

Regs. Sec. 1.334-2 requires an allocation of basis in accordance with fair market values. Therefore, the $24,800 basis must be allocated 80%, or $19,840, to the real estate and 20% or $4,960, to the receivables. The loss in basis of the receivables meant that when the taxpayer collected the proceeds he had ordinary income of $15,040 ($20,000 minus $4,960). The corporation already had reflected in income the sales which generated the receivables.

In effect, the same income was taxed twice—once to the corporation when it was earned and once to Garrow when he collected it. Of course, the taxpayer had the advantage of avoiding tax in the course of the liquidation on the increment in value of the real estate ($72,000).

If Garrow had been able to make a preliquidation sale of the receivables for face value less a discount and reinvested in assets other than stock and securities (such as additional real estate), he could have avoided $15,040 of ordinary income without in-

 creasing his gain in the Sec. 333 liquidation. Note that the reinvestment should not take the form of stock or securities because if the total cash, stock and securities exceed the corporation's accumulated earnings and profits, the excess is taxed as capital gain.

Another asset that would also enter into the allocation and which may be overlooked in planning the liquidation is goodwill. This nondepreciable asset does not yield any tax benefit until the business is sold. In *Garrow* this was not a factor because the corporation was a real estate concern with no goodwill. However, as Rev. Rul. 66-81, 1966-1 CB 64, illustrates, the requirement of allocation can cause a loss of basis for other assets when the business liquidated under Sec. 333 is of the type that has goodwill or other nonamortizable intangibles.

The *Court Holding Company* Rule and Sec. 333

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

Potential Tax Traps in One-Month Liquidation

Under Sec. 333 of the Code, recognition of gain upon liquidation of a corporation may be postponed in part or completely. However, noncorporate shareholders recognize dividend income to the extent of their ratable share of earnings and profits.

The election under the provisions of Sec. 333 is most beneficial when recognition of dividend income is kept to a minimum. The amount of the earnings and profit, which limits the amount of dividend income to be recognized, cannot be easily ascertained by quick review of retained earnings because Sec. 312(c)(3) indicates that earnings and profits must be increased by the amount of the gain resulting from depreciation recapture under Secs. 1245 and 1250. What may appear on the surface

to be a deficit in the earnings and profits can turn out to be accumulated earnings and profits when the gain from recapture is determined net of income taxes.

If this should be the case, tax may be due not only at the corporate level on the income from recapture but also at the shareholder level as a result of the increase in earnings and profits from such recapture.

Because the basis of the assets received in liquidation by the shareholders is not determined by reference to the basis in the hands of the transferor, under Regs. Sec. 1.47-3(f)(1)(ii)(d) investment credit recapture would also appear to be applicable.

When Must Sec. 334(b)(2) Liquidations Be Completed?

Where one corporation purchases all the stock of another corporation at a premium, it may obtain a stepped-up basis for the acquired corporation's assets by liquidating it under Sec. 334(b)(2). This section gave statutory authority to the principle earlier enunciated in *Kimbell-Diamond Milling Co.*, 14 TC 74, aff'd 187 F2d 718 (CA-5, 1951). Thus, if the requirements of that section are met, the assets take the same basis as the cost of the stock to the purchasing corporation. It should also be noted that the *Kimbell-Diamond* rule remains applicable even though the statutory requirements of Sec. 334(b)(2) are not met (*American Potash & Chemical Corp.*, 399 F2d 194, Ct. Cls., 1968).

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

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

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

There is no requirement in Sec. 332(b) that the first dis-

tribution be made within the year in which the plan of liquidation is adopted. Accordingly, it appears that the liquidation of a subsidiary may come within the exception provided for in Sec. 334(b)(2), even though the liquidation is completed within a period of five or more years after control was acquired. Of course, the status of liquidation must continue after the plan of liquidation is adopted.

Stepped-Up Basis on Liquidation of Subsidiary

Prior to 1966, Sec. 334(b)(2) did not apply to stock purchased from a corporation in which the acquirer owned an interest of 50% or more.

In 1966 Sec. 334(b)(3) was amended to treat such stock acquisitions as "purchases" for 334(b)(2) purposes, provided that the original interest of 50% or more was acquired by purchase.

Therefore, if Corporation A wishes to liquidate Corporation B, which in turn owns Corporation C (also to be liquidated), does the order in which the corporations are liquidated have any effect on the application of Sec. 334(b)(2)? By reason of the 1966 amendment to the law, it would appear that the order of liquidation should have no effect.

However, it is our understanding that the Revenue Service will not issue an advance ruling with a 334(b)(2) result where Corporation B is liquidated before Corporation C.

As in so many technical matters, a simple change in mechanics may eliminate a problem. Any question as to the loss of stepped-up basis may be avoided in such cases if the purchaser arranges for the subsidiary of the purchased company to be liquidated before it liquidates the purchased company.

Beware: Sec. 334(b)(2) Requires a "Purchase"

In situations where a proposed acquisition coupled with a Sec. 334(b)(2) liquidation involves stock already held within the "family," tax advisers should proceed with caution. The following example illustrates a trap for the unwary:

Suppose X Corporation owns 50% of Z Corporation and 80% of Y Corporation. Suppose also that Y Corporation wants to acquire all the assets of Z Corporation, but it is impossible to

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

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

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

Planning for Intercompany Debt in Sec. 334(b)(2) Liquidation

Rev. Rul. 69-426 (IRB 1969-33, 13) illustrates the IRS position that in the liquidation of a subsidiary under Sec. 334(b)(2), where appreciated assets are used to satisfy debt owned to the parent corporation, a carryover of basis is required with respect to such assets. The balance of the subsidiary's assets would be assigned an allocated basis under Sec. 334(b)(2). The satisfaction of indebtedness to the parent corporation with appreciated assets would not result in gain to the subsidiary under the provisions of Sec. 332(c). This ruling may be useful to some clients who are willing to "stretch" their tax planning. By identifying certain assets intended to satisfy intercompany debt, such as appreciated personal property, recognition of Sec. 1245 income may be avoided.

If zero basis goodwill is used for this purpose, it is arguable that the potential detriment of allocating basis to such an in-

Sec. 334 tangible under Sec. 334(b)(2) could be avoided. In any event, it would be desirable to document the taxpayer's choice of assets to be used in satisfying the intercompany debt, since where all the assets are transferred at one time, it is not clear which assets would be attributable to the settlement of debt and which would be considered liquidating distributions. This problem of identification might be avoided by making an initial distribution pursuant to the plan specifically in satisfaction of the intercorporate debt, followed by the final liquidating distribution.

Sec. 337

Sec. 337—Formal Action Not Required

Suppose a corporation sells assets prior to taking any formal action to liquidate. Does this prevent the use of Sec. 337 to avoid tax on any gain realized by the corporation on this asset sale? Answer: not necessarily so.

The express language of Sec. 337 requires that a plan be adopted before making a sale in order to obtain the benefits of the section. However, the regulations and case law recognize that facts and circumstances may fix the date of adoption of a plan. In *Mountain Water Co. of La Crescenta*, 35 TC 418, the court said: "The existence of a plan of liquidation . . . does not require the formal adoption of a resolution by the directors or stockholders, and is dependent on the facts in each case."

The case of *Alameda Realty Corporation*, 42 TC 273, is pertinent. No formal plan of liquidation was ever adopted by the shareholders, and there was no dissolution prior to revocation of the corporation's charter for nonpayment of franchise taxes. No Form 966 was filed. The corporation had owned only one operating asset, a building which it sold. No business was done thereafter. The court held that the sale was the equivalent of an informal plan of liquidation. The Service has acquiesced in *Alameda* in 1964-2 CB 3.

Also of interest is Rev. Rul. 65-235 (1965-2 CB 88), where the Service states that under certain circumstances the Service will apply Sec. 337 to a closely held corporation in advance of the formal adoption of a plan of liquidation or formal approval by the shareholders. Unfortunately, the ruling does not state what the "certain circumstances" are.

On the other hand, the existence of an informal plan can be a two-edged sword. The IRS can claim that a plan was adopted

informally at a date prior to the date of the formal adoption of the plan and thus disallow a loss incurred between the two dates or unexpectedly shorten the 12-month period of Sec. 337.

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

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

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

If the corporation sells these securities, will this gain be recognized to the corporation? Will the Sec. 337 benefits of the real estate sale be lost?

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

In *Frank Verito,* 43 TC 429, acq., the Tax Court held that profit on the sale of such securities was not taxable to the corporation.

Court Holding Principle Is Not Entirely Dead

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

Code Sec. 337 was intended to jettison the *Court Holding Company* principle. It provides that gain or loss will not be recognized to a corporation upon the sale of its assets (except

 certain inventory and installment items) after a resolution to liquidate, if forthwith fully liquidated.

However, the *Court Holding Company* principle may *still* apply in cases of *partial* liquidation or redemption. Thus, where a contract made by a corporation to sell part of its assets at a gain is rescinded, and is followed by the stockholders obtaining the assets by partial liquidation or redemption of shares and completing the sale, the double tax still could apply. See also *Waltham Netoco Theatres, Inc.* (49 TC 399, aff'd 401 F2d 333, CA-1, 1968), which holds that the principle may be applied in a Sec. 311(a) situation.

Timing Important in Applying Sec. 337 to Condemnations

One of the requirements for nonrecognition of gain from the sale of property during the liquidation of a corporation under Sec. 337 is that the sale take place after the plan of liquidation is adopted.

The condemnation of property is considered a sale for the purposes of a Sec. 337 liquidation. The sale takes place when title to the property passes to the condemning authority. This is independent of when the sale price is agreed upon or paid (Rev. Rul. 59-108, 1959-1 CB 72).

The following case points out how this works. In *Covered Wagon, Inc.* (369 F2d 629, CA-8, 1967), a piece of property was condemned by the federal government. A plan of liquidation was adopted six months after the property was actually condemned but before compensation for the property was fixed. Under the Federal Declaration of Taking Act, title passes immediately upon the government's instituting condemnation proceedings. Accordingly, the court held that the sale took place at the time the property was condemned and the gain could not be excluded under the provisions of Sec. 337.

Possible Thin Corporation Attack

A 1966 case, *John Town, Inc.* (46 TC 107, aff'd CA-7, 1967), points out another area where the thin corporation concept may present a pitfall to the unwary taxpayer. In this particular case, nonrecognition treatment under Sec. 337 was denied for the

gain that was realized on the sale of assets during the 12-month liquidation period. The rationale was that the corporation retained assets beyond the 12-month period for the purpose of satisfying the remaining unpaid balance of a promissory note which was in reality an equity investment rather than a true debt. Therefore, the requirements of Sec. 337 were not met in that all corporate assets, other than those retained to meet claims, were not distributed to the shareholders within the 12-month period.

The moral of this case would seem to be that, in a liquidation under Sec. 337, whenever there is a possibility of attack under the thin capitalization concept, care should be taken to satisfy within the 12-month period all obligations purporting to be debt but which might be classed by the IRS as equity investment. Encumbering assets with a mortgage to secure the debt and then distributing the assets in liquidation, as encumbered, would also seem to avoid the problem.

Assets Other Than Cash May Be Retained in Sec. 337 Liquidation

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

Sec. 337 requires the distribution in liquidation of all assets, less assets retained to meet claims. Regs. Sec. 1.337-2(b) contains the statement that "a corporation will be considered to have distributed all of its property other than assets retained to meet claims even though it has retained an amount of cash equal to its known liabilities . . . plus an amount of cash set aside under arrangements for the payment after the close of the 12-month period of unascertained or contingent liabilities and contingent expenses."

Suppose a corporation liquidating under the provisions of Sec. 337 possessed certain non-cash assets which it wished to retain to meet certain claims since the assets would be converted into cash before or at the time payment of the claims was required. Under the wording of the regulation cited above, must the retained assets be in the form of cash?

The IRS has informally indicated that *any* assets owned by the corporation may be retained for the payment of claims as long as the amount retained is reasonable.

Sec. 337

Qualifying Corporate Liquidations Under Technical Limitations of Sec. 337

If a corporation distributes all its assets in complete liquidation within 12 months after the adoption of a plan of liquidation, no gain or loss is recognized from the sale of its property (with certain exceptions) during such 12-month period. If, after selling off the bulk of its assets, the corporation retains long-term receivables or other properties which cannot be converted into cash except at prohibitive discounts, practical difficulties may preclude the distribution of fractional shares in such unliquidated assets among a large number of stockholders.

Under the circumstances, it should be possible for the corporation to comply with the technical limitations of Sec. 337 by transferring the assets to a liquidating trustee. In making the transfer, the trustee is specifically empowered by the shareholders to act for them and, in lieu of fractional interests in the properties, the shareholders receive certificates of beneficial interest issued by the trustee. If the sole purpose of the trust is a liquidation of assets through collection and sale and distribution of the proceeds to the shareholders, with no power to engage in any trade or business or to invest or reinvest money, a favorable ruling that the corporation has "completed" its liquidation within the 12-month period should be obtainable from the Treasury. Compare Rev. Rul. 63-245, 1963-2 CB 1944.

Twelve-Month Liquidation—Sell or Abandon?

In a liquidation pursuant to Sec. 337, gain or loss from the sale or exchange of property during the 12-month period is not recognized. However, all other gains or losses of the liquidating corporation are subject to the usual tax treatment.

Where a sale at a loss during the 12-month period is contemplated, the proceeds of the sale should be measured against the tax benefit that would occur if the entire adjusted basis of the asset could be claimed as a loss. Certain losses, such as those from abandonment of property, appear to be deductible even though occurring during the 12-month period following the adoption of a plan of liquidation.

In order for the loss to be deductible, there must be no element of a sale or exchange. The fact that the asset had a sale value might also prevent deduction of the loss under Sec. 337. A loss

on the sale of property for scrap value, for example, evidently would be nondeductible under Sec. 337. An example of a deductible loss is the loss on abandonment of an asset, when the asset was permanently affixed to a building which was being demolished.

Sec. 337

Sec. 337 Election in Taxable Merger Should Not Be Overlooked

An excellent way to acquire properties of another corporation is by means of a proceeding under a state merger statute which does not qualify as a Sec. 368 transaction. Since title to the properties transfers by operation of law, it is not necessary to transfer title to each specific item of property. This eliminates a mass of paper work. The necessity for making a proper election under Sec. 337 to avoid recognition of gain to the transferor corporation should therefore not be overlooked.

A private ruling involved such an acquisition. The acquiring company issued convertible debentures and preferred stock in a statutory merger, with the debentures representing about 92% of the consideration. A ruling was requested and received to the effect that the transaction was taxable, since the requisite continuity of interest was lacking. The acquiring corporation represented that it would not redeem the debentures for a period of two years from the date of issuance, and that it did not presently plan to call the debentures.

Since this transaction essentially involved a sale of assets negotiated by the transferor corporation, the difference between the value of the debentures received and the basis of the transferred assets was taxable income to the transferor. A timely election by the transferor corporation to liquidate under the provisions of Sec. 337 was necessary to limit the taxable income from this transaction to those items recognized under Sec. 337. The acquiring corporation's transferee tax liability would then be restricted to such items as depreciation and investment credit recapture.

Disposal of Collapsible Corporation Stock

Sec. 341

Can a nontaxable merger of a collapsible corporation with a publicly held corporation be effected which would give the

Sec. 341 shareholders in the collapsible corporation a marketable security, with the possibility of capital gain upon a subsequent disposition thereof?

A representative of the Reorganization Branch of the IRS was of the opinion that a merger of a collapsible corporation with a larger company may be accomplished without tax consequences to the shareholders of the collapsible corporation. His thought was that Sec. 341 applies only when the shareholders have a recognized gain on their stock and since gain is not recognized in a reorganization, the section should not be applicable. Of course, the reorganization must have a valid business purpose.

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

Collapsible Corporations—Caveat Emptor

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

The buyer, however, may be less than happy with the effect of the consent on his newly acquired company. By filing the consent, a new category of assets is created called "Subsection (f) assets." In general, this includes all noncapital assets, land and any interest in real estate. Gain is to be recognized upon any disposition of these assets, except in certain tax-free transactions where basis carries over. This recognition-of-gain rule can have substantial adverse effects. If the buyer liquidates the company in order to step up the basis of the assets under Sec. 334(b)(2), gain is recognized on the Subsection (f) assets. If Subsection (f) assets are distributed as a dividend or in partial liquidation, gain is recognized. This taint exists as long as the assets are owned by the company or a tax-free transferee. Proving that the

company was not a collapsible corporation at the time of the sale of its stock doesn't help; the taint exists by virtue of the consent. *Sec. 341*

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

Distributions in Partial Liquidation

Sec. 346

The X Company, a closely held corporation, has been in business since 1900. Until 1960 it operated two plants, one in C city and one in M city. Its business has been declining, and since 1950 it has realized $1,400,000 from the disposition of assets. This amount includes proceeds of the sale of its plant in M city. Further, it has reduced its inventories, and has funds available from this source of $3,475,000. Working capital needs have also decreased, and $3,720,000 is available in cash from this decrease. The directors of the company have projected the cash and other requirements for the conduct of the company's business, and have concluded that $7,700,000 should be distributed.

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

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

On the basis of the foregoing facts, the IRS ruled that the redemptions would qualify for capital gain treatment.

Other interesting aspects of this ruling are:

1. A holding that in determining how much can be distributed in partial liquidation under Sec. 346 no reduction need be made for distributions which qualify as disproportionate redemptions or terminations under Sec. 302(b).
2. A statement that only the amount received by each share-

Sec. 346 holder which is not in excess of the fair market value of his stock redeemed will be entitled to capital gain treatment.

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

Sec. 351

Tax-Free Incorporation

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

Permitted Diversification of Investment Assets

Sec. 351 was amended by PL 89-809 (November 13, 1966) so that transfers to an "investment company" no longer result in gains or losses which are not recognized. Under Regs. Sec. 1.351-1(c), gain or loss is now recognized in a transfer which formerly qualified under Sec. 351 if the transfer is in diversification of the transferor's interest *and* if the transferee is either:

1. A regulated investment company.
2. A real estate investment trust.
3. A corporation more than 80% of whose assets (excluding cash and debt obligations from consideration) are held for investment and are readily marketable stocks or securities, or interests in regulated investment companies or real estate investment trusts.

On their face, the law and these regulations appear to end the organization of "swap funds," which was the object of

PL 89-809. Also ended are the formation of a real estate investment trust by means of the "swap" process and the formation of mere investment corporations for marketable securities, even though held by a relatively few shareholders.

What possibilities, then, remain for the diversification of investment-type assets? It seems clear that the transfers of interests in real property to a corporation will be tax-free, regardless of the number of participating transferors, provided that the corporation does not plan to convert itself into a real estate investment trust. Securities may be transferred to a corporation, provided more than 20% of its assets (as defined) are represented by stocks or securities which are not readily marketable, and provided further that the corporation does not intend to be taxed as a regulated investment company.

Perhaps most important, especially in light of the rapid growth of investment partnerships, is the fact that transfers to a partnership are not affected by the recent change in Sec. 351. Diversification by means of a transfer of appreciated marketable securities or real estate to a partnership has been, and continues to be, tax free by reason of Sec. 721.

Problems to Consider in Setting Up A 50% Owned Corporate Affiliate

Corporations which are owned 50% each by two other unrelated corporations seem to be increasing in number. Where the jointly owned corporation has been successful, not too many tax problems arise. However, in many instances the jointly owned corporation has not been successful, and a dissolving of the joint ownership usually becomes a business necessity.

If an unsuccessful jointly owned corporation is simply liquidated, each corporate owner sustains a capital loss on his stock investment, which usually is either nondeductible or deductible against preferentially taxed long-term capital gains. In view of this, consideration should always be given to forming a joint venture or partnership at the inception of a joint operation instead of a jointly owned corporation. The partners could be the two corporations which would have been the stockholders; in such case, one-half of the total loss of the venture would flow through to each corporate partner. Alternatively, the two corporations could form two separate wholly owned subsidiaries to

Sec. 351 become partners of the joint operation; then the loss could be utilized in a consolidated return, or the subsidiaries could be subsequently liquidated with ordinary loss deductions to their parents under either Sec. 381 or Sec. 165(g)(3).

Where there is a buy-out of one stockholder, the purchaser must consider many matters, including those reviewed below.

Sec. 382(a) may operate to disallow the net operating loss carryover of the unsuccessful corporation. This would apply if there is a change in stock ownership of *at least* 50 percentage points resulting from a "purchase" and if the unsuccessful corporation does not continue substantially the same trade or business as that conducted before the ownership change until the end of the taxable year following the year in which the change occurred. The change in ownership test is met by an increase in ownership from 50% to 100%.

Sec. 269(a)(1) appears to have no application in this situation because there was never a lack of "control" of the jointly owned company. In contrast to the above, "control" under Sec. 269 is defined as *at least* 50% of voting power or value.

Liquidation after acquiring 100% ownership. The liquidation of the subsidiary immediately after the stock acquisition does not seem to permit the parent to "inherit" the subsidiary's net operating loss carryovers under Sec. 381(a). Sec. 382(a), referred to above, requires that the pre-existing business be conducted by the same corporation which has been jointly owned. (See the words "such corporation" in Sec. 382(a)(1)(C) and the words "[t]he loss corporation" in Regs. Sec. 1.382(a)-1(b)(3).) Accordingly, it appears that liquidation should not be effected during the period of time that the business must be continued under Sec. 382(a), that is, before the close of the taxable year following the year in which the change of ownership occurred.

Contribution of income-producing assets. This possibility does not seem too desirable in view of Sec. 269(a)(2). Although Sec. 269(a)(1) does not seem to apply, as explained above, the example contained in Regs. Sec. 1.269-3(c)(2) indicates that the IRS believes Sec. 269(a)(2) can apply to deny the use of the carryovers.

From the above analysis it is apparent that great care must be used when the other corporate shareholder of an unsuccessful jointly owned corporation is bought out. For tax purposes, it may have been better if the jointly owned corporation had never been formed; but business considerations may make unattainable the most desirable tax position.

Sec. 351 Applies Though Control May Be Lost in Contemplated Public Offering

A favorable private ruling was recently issued in a Sec. 351 transfer where a family group transferred 100% of the stock of corporations *X* and *Y* to newly formed corporation Z in exchange for all the stock of Z. The transferors contemplated a secondary public offering of Z stock subsequent to the transfer (concurrent with a proposed "primary" public offering by Z of its unissued stock). Discussions with an underwriter concerned such possible public offering which would have reduced the transferors' interest in Z below 80%. However, no contractual arrangement or written or oral commitment was made with the underwriter at the date of the proposed transfer to Z.

The National Office of IRS ruled that the proposed transfer to Z qualified for tax-free treatment under Sec. 351. The ruling stated that registration with the SEC was in process and that a public offering was contemplated, but stressed the absence of any binding agreements at the time of the transfer to sell the Z stock. The IRS required a representation, however, that the Sec. 351 transfer would be consummated regardless of whether the subsequent public offering was effected.

Sec. 351 Transaction and Immediate Public Offering

The public sale of a new issue is often preceded by the incorporation of the business interest under Sec. 351. The potential effect of the public offering upon the tax-free nature of the incorporation must be carefully considered.

Sec. 351(a) requires that the transferor(s) have control of the transferee corporation immediately after the transfer, which means ownership of at least 80% of the total combined voting power of all classes of stock and 80% of the total number of all other classes of stock. If the public offering reduces the ownership of the transferors below "control," as defined, perhaps the IRS might allege that "control" was not present "immediately after" the transaction so as to make the incorporation a taxable event. Loss of control could result by a secondary offering by the shareholders and/or a primary offering of additional stock by the corporation.

Sale of stock by the shareholders might disqualify the Sec.

Sec. 351 351 transaction, if it can be proved the incorporation would not have been effected but for the public offering. In *American Bantam Car Co.* (11 TC 397 (1948), aff'd. *per curiam* 177 F2d 513 (3rd Cir. 1949), cert. den. 339 U.S. 920), the Tax Court found that there was no underwriting agreement committing the shareholders to dispose of shares as part of the Sec. 351 transaction. While it would seem that, absent a legally enforceable agreement at the date of incorporation, the subsequent offering should not affect the Sec. 351 transaction, it is difficult to reconcile the conclusion with the "step transaction" doctrine. In order to avoid application of the doctrine, incorporation should be completed before any negotiations begin with the underwriter.

If a public offering of additional stock is to be made by the corporation and the underwriter has a "firm" commitment to purchase a specified number of shares, but has no commitment to dispose of such shares, the requirements of Sec. 351 would seem to be satisfied since the underwriter is deemed to be a member of the group of transferors (*Hartman Tobacco Co.*, 45 BTA 311 (1941) acq.). However, if the underwriter has a firm commitment to dispose of shares, so as to disqualify the 80% control test, Sec. 351 has not been satisfied.

A "best efforts" underwriting agreement—under which the underwriter is not obligated to purchase shares but agrees to sell shares for the corporation if in existence at the date of the Sec. 351 transaction—may disqualify the Sec. 351 transaction. In *The Overland Corporation* (42 TC 26 (1964) nonacq.), a "best efforts" underwriting agreement was fatal to the tax-free aspects of Sec. 351. It would seem that the holding is questionable since the purchasers of shares would transfer cash to the corporation simultaneously with the other transfers. However, that such persons are unknown at the time the plan originates may be the basis of the Court's opinion.

Since the above results are quite restrictive, it is advisable that there be no binding commitment to dispose of stock at the time the Sec. 351 transaction is consummated.

Sec. 351 Transfer—Allocation of Boot

Sec. 351 transfers should be carefully reviewed to avoid inadvertent realization of taxable gain. When several assets are transferred to a controlled corporation in a Sec. 351 exchange,

gains and losses can't be netted in determining the recognized gain according to Rev. Rul. 68-55, 1968-1 CB 140. In a Sec. 351 transaction the transfer of appreciated property results in taxable gain to the extent of "boot" received but loss is not recognized under Sec. 351(b). The IRS's new approach may cause recognition of gain on individual assets even though there is not a net gain when gains and losses are netted on assets transferred.

Example: "A" transfers two assets to his wholly owned corporation in a Sec. 351 exchange. He receives $8,000 fair market value of common stock and $2,000 cash "boot" from the corporation. The results of this transaction are summarized below.

	Total	*Asset No. 1*	*Asset No. 2*
Fair market value of assets transferred	$10,000	$7,000	$ 3,000
Per cent of total value	100%	70%	30%
Fair market value of stock and cash received	$10,000	$7,000	$ 3,000
Basis of assets transferred	10,000	4,000	6,000
Gain (loss) realized	$ –	$3,000	$(3,000)
Allocation of "boot" received	$ 2,000	$1,400	$ 600
Gain recognized	$ –	$1,400	$ –

Each category of consideration received is separately allocated to the transferred assets in proportion to the relative fair market values of the transferred assets. Seventy percent of the stock ($5,000) and 70% of the cash ($1,400) are allocated to Asset No. 1 for a total of $7,000 consideration. The $3,000 gain on Asset No. 1 is recognized for tax purposes only to the extent of the "boot" which is allocated to that asset. Therefore, a $1,400 gain is recognized. The asset-by-asset approach prevents the offsetting of loss on Asset No. 2 against the gain on Asset No. 1. According to the above ruling this is the correct interpretation of Sec. 351(b) which provides for recognition of gain but not loss. In the example, "A" has realized no overall economic gain on the transfer to his controlled corporation but must report a $1,400 gain for tax purposes. No case in point on Sec. 351 transactions could be located to support the asset-by-asset approach

Sec. 351 but practitioners should be aware of the position of the Service on such transfers. In concept, it would appear that the Service might have difficulty in supporting its position. However, to avoid the problem, practitioners should attempt to plan proposed Sec. 351 transactions so that the consideration received is solely stock or securities with no "boot" involved.

Incorporation of Cash Basis Taxpayer

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

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

Sec. 354 Merger in Lieu of Sec. 333 Liquidation

Sec. 333 liquidation is not desirable where the corporate assets consist substantially of money or stock or securities acquired by the corporation after December 31, 1953, and when there are substantial undistributed corporate earnings and profits. In a case where the parent owned over 50% and less than 80% of the stock of a subsidiary, the Service ruled that a reverse merger of the parent into the subsidiary qualified as a tax-free exchange to the parent's stockholders under Sec. 354(a)(1). Significantly, the subsidiary was required to retire its stock owned by the parent and to draw on unissued stock in issuing new stock to the parent's stockholders in the exchange.

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

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

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

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

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

1. Income statements for the owner and for any subsidiaries which may have occupied the property during the past five years.
2. Complete description of the property showing dates of acquisition, manner of acquisition, location, tax basis, square footage of rental space and the square footage of space occupied by the owner or its subsidiaries.
3. For each of the preceding five years the total rental value of the property and the rental value of the space occupied by the owner and/or its subsidiaries.
4. Balance sheets for each business at the beginning and end of the five-year period. (These are used in determining whether

Sec. 355 the earnings of one business have been used to finance the operations of the other business. If that is found to be the case, the ruling may be denied.)

5. A business purpose for the proposed spin-off.

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

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

The decision in *Appleby*, 296 F2d 925 (CA-3, 1962), throws further light on the tax effects of this type of transaction. A corporate real estate and insurance brokerage agency owned a building and occupied 50% of the space (70% of the rental value) and rented out the remainder. This continued for over five years. It then transferred the building to a separate corporation and distributed the stock to its stockholders. The Tax Court ruled that this did not qualify as a spin-off but was a dividend distribution.

For a more recent case on this point, see *Bonsall, Jr.*, 317 F2d 61 (CA-2, 1963).

Obtaining a Ruling With Respect to a Spin-off

The IRS has advised that the following information is required:

1. A brief history of the company or companies involved in the spin-off.
2. A copy of the latest available balance sheet before the spin-off.
3. Copies of pro forma balance sheets as they would exist after the spin-off.
4. A summary of the earnings of the company or companies for each of the past five years.
5. A statement of the business reasons for the spin-off.
6. A statement from the stockholders that they have no pres-

ent intention of selling any of the stock of either company (i.e., either the principal company or the spun-off company).

7. A statement that there is no present intention of liquidating either company involved in the spin-off.

Spun-off Subsidiaries Grouped for Five-Year Test

The spin-off of numerous subsidiaries engaged in operating one type of business has been the subject of a favorable ruling. Interestingly, the five-year active trade or business test under Sec. 355(b) was applied to the spun-off subsidiaries as a group, thereby avoiding the problem of qualifying separately certain subsidiaries which had not been in business for five years.

The transaction involved a parent company, *P*, engaged in one type of business activity. Since 1962, *P* developed a separate group of subsidiaries (S group) which was engaged in another business. *P* formed a new subsidiary for each new location; the number grew rapidly. For good business reasons, it was decided to transfer the *S* group stock to a new subsidiary (Z) and thereafter spin-off the stock of *Z* to the shareholders of *P*.

Each member of the *S* group separately satisfied the "group of activities" requirement described in Regs. Sec. 1.355-1(c), so that multiple businesses were involved. Further, Regs. Sec. 1.355-4(b)(1) requires that, in the case of a holding company, substantially all its assets must consist of the stock of a corporation or corporations controlled by it after the distribution, "*each* of which is engaged in the active conduct of a trade or business." Although the *S* group's business had been actively conducted for more than five years, this was not true for the majority of the *S* group subsidiaries. Moreover, in view of the very rapid growth rate of the *S* group, it was likely that the less than five-year subsidiaries would constitute a majority of the group on a continuing basis.

In what appears to be a recognition of the economic realities of a case such as this, the IRS ruled consistently with the holding in *Estate of Lockwood* (CA-8, 350 F2d 712, rev'g 23 TCM 1233). The IRS argued in *Lockwood* that the geographically separate branch business had to be viewed as a separate entity for purposes of the five-year active trade or business test. In reversing the Tax Court, the Court of Appeals stressed that there was no basis for applying a geographical test so as to separate,

Sec. 355 for trade or business purposes, two elements of the same business.

A factual difference between this private ruling situation and that in *Lockwood* was the form of the operation—subsidiary vs. branch. In approving the spin-off ruling described above, the IRS realistically applied Sec. 355(b), despite the difference in form.

Sec. 367 Failure to Obtain a Ruling Under Sec. 367

Sec. 367 of the Code of 1954 provides among other things that gain will be recognized to a domestic parent upon the exchange of stock for assets of a foreign subsidiary under a Sec. 332 type exchange unless the parent corporation receives an advance ruling from the Commissioner. However, Rev. Rul. 64-177, 1964-1 CB 141 states the Treasury's position to be that a taxpayer may not use its failure to obtain a Sec. 367 ruling to defeat the nonrecognition provision of Sec. 332 and the basis provision of Sec. 334(b)(1).

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

The request for a ruling raised the question as to whether *A* could obtain a stepped-up basis, for depreciation and other purposes, for *B*'s assets because of its failure to secure a Sec. 367 ruling.

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

Capital Contribution Does Not Require Sec. 367 Clearance

The main issue in a Tax Court case involved a liquidation-reincorporation problem. On another issue, however, the Court held that a capital contribution to a controlled corporation was not a Sec. 351 transaction unless stock or securities were received in exchange. Therefore, no advance clearance under Sec. 367 was required when capital was contributed to a foreign corporation in this manner.

In *Werner Abegg* (50 TC 145), the taxpayer, an individual, was the sole stockholder of Corporation *X* (incorporated in Delaware). In 1957 Corporation *X* adopted a Sec. 337 plan of liquidation, thereby avoiding tax at the corporate level on a capital gain of about $932,000, and distributed its assets to Mr. Abegg. Among the assets so distributed there were certain properties with unrealized appreciation of about $267,000. Immediately upon receiving these properties, Mr. Abegg transferred them to Corporation *Y* (a foreign corporation) in exchange for all its stock.

Upon examination, the IRS held that the transfer of *X*'s assets through Mr. Abegg to *Y* was in substance a "D" reorganization under the "liquidation-reincorporation" theory. According to the IRS, the net effect of the transaction was an exchange by *X* of its assets for all *Y's* stock, which was then distributed by *X* to its shareholders. The Tax Court upheld this view. This meant that *X*'s capital gain of $932,000 did not escape recognition in the Sec. 337 liquidation; instead, it was taxable to the corporation under the provisions of Sec. 1002. Moreover, the Court held that *X* was taxable on the $267,000 unrealized appreciation included in the assets transferred to *Y*. Such gain would not ordinarily be recognized in a reorganization, but this transaction involved a foreign corporation and no advance clearance under Sec. 367 had been requested or obtained. The tax burden arising from these adjustments fell on Corporation *Y*, as the transferee of *X*'s assets.

Nine months after the original transaction, Mr. Abegg also transferred to *Y* some investments which he had held personally. He received no stock or securities for these assets, which included both unrealized gains of $64,000 and unrealized losses of $851,000. The IRS attacked this transaction also, taking the position that it constituted a Sec. 351 exchange since Mr. Abegg owned all *Y's* stock both before and after the transfer. It again proposed to treat the unrealized appreciation ($64,000)

Sec. 367 as being realized on the transfer since no advance Sec. 367 clearance had been obtained. No offset was permitted by the IRS for the $851,000 in unrealized losses, since Sec. 367 provides for the recognition of "gain" rather than "net gain."

In considering this issue, the Tax Court observed that the transfer could not qualify as an "exchange" within the specific statutory language of Sec. 351, since Mr. Abegg had received no stock or securities from *Y* for the assets. This being the case, the Court held that no advance clearance under Sec. 367 was required, and no taxable income resulted from the transaction. The Court further noted that the transfer was clearly unrelated to the earlier transactions, and that this situation was therefore distinguishable from the *Louise B. King* case, 79 F2d 453 (CA-4, 1935), where a capital contribution within one month of a Sec. 351-type transaction was held to be part of the original plan.

This decision is clearly contrary to Rev. Rul. 64-155 (1964-1 CB (Part 1) 138) and apparently upsets that ruling. The IRS there ruled that a transfer of appreciated property by a U.S. parent to a foreign subsidiary constituted a Sec. 351 transfer, even though no shares or securities were received in exchange; this transaction was therefore considered subject to advance Sec. 367 clearance. Thus, it appears a major *tax* barrier to transfers of property to foreign corporations has been eliminated.

Sec. 368 Reorganization Followed by Prearranged Sale of Stock

Plans for a tax-free reorganization need not falter because the shareholders of the company to be acquired insist on receiving some cash.

For example, assume that Company *X*, a publicly held company, plans to acquire the stock or assets of *Y*, a closely held company, in a merger qualifying as an A-type reorganization. The stockholders of *Y* wish 20% of the consideration to be cash but do not want to incur any dividend consequences.

The solution to this problem would be for *X* to issue stock for either the assets or the stock of *Y*. The former shareholders of *Y* could in turn sell 20% of the stock which *X* issued to them in the reorganization. There would be no dividend to the shareholders since neither the acquiring nor the acquired company would have purchased the stock.

In such a situation it is our understanding that the IRS would not regard the sale as affecting the tax-free nature of the transaction. Apparently the only requirement is that there be a continuity of interest (at least 50%), whether or not there is a prearrangement to sell. (Similar reasoning might also apply to proposed B- or C-type reorganizations.) Any ruling request should contain full disclosure of any prearrangements for the stock sale.

Preferred Stock to Discharge Bond Interest Arrearages

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

It was considered that this rearrangement qualified as a tax-free recapitalization under Sec. 368(a)(1)(E). *William Bernstein Estate,* 22 TC, 1364, acq. is authority for the proposition that the bondholder's claim for accrued interest is not severable from his claim for the principal amount due on the bond, and where other securities are received no interest income is realized by the recipient. Sec. 354(a)(2) does not apply, since there is no increase in principal amount of the bonds. Sec. 305(b) does not apply, since no accumulation of preferred dividends is being satisfied. Sec. 306 should not apply, since there is no "receipt by a shareholder" of preferred stock.

Reorganization to Provide Different Classes of Stock

The T Corporation is owned by approximately 25 stockholders. Forty-nine per cent of the stock is owned by a management group, and 51% by persons not presently connected with management.

The corporation has arrived at what may prove to be a turning point in its history. There has been a substantial decline in two lines of the corporation's business. The management shareholders

 believe that under these circumstances the corporation should venture into new fields, and they are willing to face the risks inherent in such action. On the other hand, the nonmanagement shareholders are interested primarily in a steady income, and are reluctant to have their investment endangered by any change in the operations of the corporation.

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

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

Rulings Emphasize Importance of "Form" of Reorganizations

Rev. Rul. 69-294, 1969-1 CB 110, describes a transaction which was held not to be a "B" reorganization, possibly because of the form in which it was consummated, rather than because of the end result.

Corporation *X* owned all the outstanding stock of Corporation *Y*. Corporation *Y* owned in excess of 80% of the outstanding stock of Corporation Z. Since *X* wished to own 100% of the outstanding stock of Z, it liquidated *Y* under Sec. 332 and immediately acquired the remaining outstanding Z shares held by the minority stockholders in exchange solely for *X* voting common stock.

The ruling held that part of the stock of Corporation Z received by Corporation *X* was in exchange for Corporation *Y* stock. Only the minority stock interest of Corporation Z was acquired by Corporation *X* solely in exchange for its own voting stock. Therefore, the transaction did not qualify as a reorganization under Sec. 368(a)(1)(B) which states that an exchange

must be solely for voting stock of the acquiring corporation or for voting stock of a corporation in control of the acquiring corporation.

Regs. Sec. 1.368-2(c) indicates that it is immaterial that the acquiring corporation already controls the acquired corporation. Therefore it would appear that the problem in the above ruling could be overcome by Corporation *X*'s contribution to the capital of Corporation *Y* of sufficient shares of its stock for Corporation *Y* to acquire the minority interest in Corporation Z. This would allow the acquisition of Corporation Z stock to be solely for voting stock of a corporation (*X*) in control of the acquiring corporation (*Y*) and thus fit the literal requirements of Sec. 368(a)(1)(B).

Sleepers in Assumptions of Stock Options in Triangular "C" Reorganizations

Rev. Rul. 70-107 (IRB 1970-10, 12) illustrates the care that must be given in the case of a "C" reorganization, where the assets are acquired directly by a subsidiary for voting stock of its parent corporation. It was there held that the assumption of liabilities of the acquired corporation, in part by the subsidiary and in part by the parent corporation, did not satisfy the "solely for voting stock requirement," because only an assumption of liabilities by the "acquiring" corporation is disregarded for that purpose. Since the parent corporation was not the acquiring corporation, its assumption of part of such liabilities is not to be disregarded.

There is a "sleeper" problem presented by the interplay of Rev. Rul. 70-107 and other published rulings regarding the assumption of outstanding stock options in connection with a "C" reorganization. Rev. Rul. 68-637 (1968-2 CB 158) holds that the solely for voting stock requirement in a "C" reorganization is not violated where pursuant to the plan of reorganization the acquiring corporation (in that case, the parent corporation) substitutes its stock for that of the acquired corporation under the terms of outstanding stock warrants and statutory stock options. The IRS views the arrangements under which the acquired corporation was obligated to issue its stock to the holders of such warrants and options as constituting contractual liabilities of the acquired corporation. Accordingly, the undertaking by the acquiring corporation to discharge such obligations by sub-

Sec. 368 stituting its own stock for that of the acquired corporation is no different from the assumption of any liabilities under any executory contract by the acquired corporation, and such assumption is to be disregarded as provided in Sec. 368(a)(1)(C).

It is now clear, however, that the assumption of statutory stock options of the acquired corporation, in a "C" reorganization where a subsidiary uses its parent stock as consideration for the asset acquisition, may not be done by a direct assumption of the obligation by the parent corporation. The problem may be obviated in one of the following ways:

- Have the parent corporation enter into a "C" reorganization agreement, whereby the assets are transferred to a subsidiary as designated by the parent (Rev. Rul. 70-224, IRB 1970-19);
- Have the parent corporation acquire the assets directly and drop them down to a subsidiary;
- Immediately prior to the reorganization, have the acquired corporation transfer all its assets down to a new subsidiary in exchange for the stock of the latter, and then merge with (or transfer its assets to) the acquiring corporation, consistent with Rev. Rul. 58-93 (1958-1 CB 188); or
- If a subsidiary is to be the acquiring corporation, have it assume the obligation to issue its parent's stock in satisfaction of outstanding stock warrants and options.

To be sure, it would be more convenient for the parent corporation to assume the obligation directly, but this would present squarely the problem dealt with in Rev. Rul. 70-107.

The published ruling also indicates the desirability of securing an advance ruling on a proposed "C" reorganization. In many advance ruling situations, the IRS will agree to (or suggest) restructuring a reorganization transaction on an "as if" basis for ruling purposes to reach a desired end.

Cash in a Statutory Merger

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

Contingent Pay-Outs in a Reorganization—Avoid the Trap

In this day of the popularity of mergers and conglomerates, a corporation that is an acquiring corporation in one reorganization may shortly thereafter be the acquired corporation in a second reorganization. In such cases, the shareholders of the acquired corporation in the first reorganization may have serious tax problems as a result of the second reorganization if there was a contingent stock pay-out in connection with the first reorganization and such pay-out had not been completed by the time of the second reorganization. The problem arises because the stock of the acquiring corporation in the second reorganization will be issued to the shareholders of the acquired corporation in the first transaction as the contingent pay-out is earned. Since the acquiring corporation in the second reorganization was not a party to the first reorganization, the receipt of the stock of such acquiring corporation by the shareholders of the acquired corporation in the first reorganization will not be pursuant to a reorganization exchange and will be taxable. If the first reorganization was pursuant to Sec. 368(a)(1)(B) or 368(a)(1)(C), there is the possibility that the first reorganization may become taxable because of the second reorganization, whereas if the first reorganization were pursuant to Sec. 368(a)(1)(A), the contingent pay-out by the second acquiring corporation in its own stock may be treated as boot.

To avoid the aforementioned problems, the shareholders of the acquired corporation in the first reorganization involving a contingent pay-out could insist that the agreement state that if the first acquiring corporation enters into a later reorganization where it will go out of existence, then prior to such reorganization the contingent stock should be placed in escrow for the benefit of the shareholders of the first acquired and exchanged in connection with the second reorganization. When the stock is placed in escrow, the shareholders of the first acquired would have to have full ownership rights in such stock including the right to dividends and to vote such stock. Under such conditions, the stock in escrow can be exchanged pursuant to the second reorganization and there will be no taxable event. Of course, the disadvantage to the acquiring corporation in the first reorganization is that the contingent stock will have to be issued earlier than it otherwise would be. However, without such protection, the shareholders of an acquired corporation where there is a contingent pay-out involved can suffer serious

 tax disadvantages in the event of a later reorganization involving the acquisition of the acquiring corporation in the first reorganization.

Voting Stock in Corporate Reorganizations

Where there are differences of opinion between the purchaser and the seller as to the value of a corporation being acquired in a nontaxable reorganization, the use of "contingent" shares has proved to be a satisfactory solution to both parties. Under such an arrangement, a tentative value might be placed on the business and if the profitability of the acquired corporation exceeds a certain specified amount, an additional number of shares of the acquiring corporation would be transferred to the sellers in accordance with some predetermined formula. Thus the total number of shares actually to be issued in connection with any particular acquisition might not be ultimately determined for some time following the reorganization.

For the purpose of issuing an advance ruling, the IRS has set forth certain guidelines in Rev. Proc. 67-13, 1967-1 CB 590, where all the shares to be issued in connection with the reorganization are not issued at the time of the initial transfer. Among the conditions required for a favorable determination are: (1) the maximum number of shares which may be issued in the reorganization must be stated in the plan of reorganization; (2) all the stock will be issued within five years of the date of the reorganization; and (3) at least 50% of the maximum number of each class of shares which may be issued must be issued in the initial distribution.

It is sometimes suggested that the voting stock received by an acquired corporation or its shareholders be placed in a voting trust, perhaps along with some of the shares of the acquiring corporation owned by its former shareholders. Carrying the voting trust idea too far will jeopardize the status of the reorganization if the effect of the voting trust is to deprive the recipients of stock in the reorganization of their vote, and would cause the stock to be regarded as other than "voting stock."

As long as the trustee or trustees of the voting trust are independent of the parties involved in the reorganization, especially the acquiring corporation or its shareholders, possibly there would be no problem, but the Reorganization Branch will not rule on that point with regard to a reorganization question. Simi-

larly, it would appear that no problem should exist where the trustees of the voting trust are representatives of the acquired corporation. On the other hand, if the trustees of the voting trust represent both the acquired and acquiring corporations or represent solely the acquiring corporation or its former shareholders, it will be held that the acquired corporation or its shareholders did not receive "voting stock."

Merger, Partial Liquidation and Buy-Out All in One

Two closely held corporations, *A* and *B*, had been engaged for many years in owning and operating numerous real properties for income-producing purposes. Both corporations were owned in the same proportion by different members of a family. Corporation *B* also had preferred stock outstanding which was held by other members of the family. Some of the common stockholders wanted to get out of the real estate business while others desired to continue.

In order to accomplish the divergent goals of the stockholders, the following plan was adopted:

1. Merge Corporation *A* into Corporation *B*.
2. Adopt a plan of partial liquidation of Corporation *B* to the end that some of the properties would be disposed of and the proceeds used to redeem the preferred stock.
3. The ultimate goal would be to sell additional real estate and redeem the common stock interest (more than 50% of the outstanding stock) of those common stockholders who desired to get out of the real estate business. The end result would be that the real estate business would be continued on a reduced basis by Corporation *B* with the corporation being owned by one or more of the present common stockholders.

In seeking a ruling covering the tax-free status of the merger, the question arose as to whether there would be sufficient continuity of interest to meet the 50% requirement of Rev. Proc. 66-34, 1966-2 CB 1232. In order to satisfy the IRS that there would be the requisite continuity of interest, the common stockholders agreed that there was no present intention to sell, redeem or otherwise dispose of more than 50% of the common stock of the surviving corporation within two years from the merger date.

Subject to that two-year continuity of interest condition, the IRS ruled favorably on the tax-free consequences of the merger

Sec. 368 and ruled that the redemption of the preferred stock would result in capital gain or loss as a partial liquidation under Sec. 346(a), provided the redemption occurred before the end of the succeeding taxable year and was accomplished from the proceeds of the sale of real properties.

IRS Is Ruling on Sec. 368(a)(2)(D) Mergers Involving "Boot"

Effective October 22, 1968 the Code was amended by the addition of Sec. 368(a)(2)(D), which permits a statutory merger to qualify under Sec. 368(a)(1)(A) where "substantially all" the properties of the merged corporation are acquired for stock of the corporation in control of the acquiring corporation.

In view of the "substantially all" requirement, the fate of transactions involving the use of cash or other property in addition to stock of the controlling parent has been uncertain. While it has been assumed by many practitioners that the use of "boot" in such a transaction would not disqualify it as long as the continuity of interest requirement is met, no regulations have yet been issued and, in their absence, the IRS has until recently appeared reluctant to issue rulings on such mergers.

However, it is now understood that the IRS will rule favorably even in situations where as much as 30% to 35% of the consideration in such a merger consists of cash.

Uses of Stock Rather Than Cash In Making Tender Offers

Three take-over bids have employed the technique of making tender offers using only stock, with the prospect of the entire transaction qualifying as a tax-free reorganization.

Under take-over conditions, it is difficult to expect that a tender offer will result in securing the 80% needed to qualify for a tax-free exchange of stock. A take-over bid using the form of a statutory merger is only partially tax free; i.e., the acquisition of sufficient stock (less than 50%) to force a merger usually necessitates the use of cash and is taxable. The subsequent merger for the balance of the stock is the only part of the exchange which may qualify as tax free if all the merger rules are met.

In the three take-over bids mentioned above, the Revenue Service has been requested to rule that the transactions will be tax free under the following circumstances.

1. If 80% of the stock cannot be acquired by tender, and
2. If sufficient stock is received to "force" a merger, then
3. The tender step will be considered as part of an overall plan of merger, qualifying all exchanges as parts of a tax-free reorganization.

The companies are trying to use the Service's step-transaction approach to their advantage—i.e., by stating that in substance it is their intent to make the acquisition, whether by merger or otherwise, thus suggesting that all their maneuvering actions are a part of one plan of reorganization.

It is believed that tender followed by a merger approach can be argued to be part of one plan of reorganization, but it is not known whether the Service will rule favorably.

Contingent Stock in Acquisition of Two or More Corporations—IRS Limits Rulings

It is understood that the Reorganization Branch of the IRS will not issue an advance ruling in a case involving the acquisition of two or more corporations in which contingent shares are to be given on the basis of the consolidated earnings of all the to-be-acquired corporations, unless they are owned by the same persons in substantially the same proportions.

As part of one plan, the assets of three related corporations (*A*, *B* and *C*) were to be acquired by corporation *D* in exchange for its voting stock. Some of the shareholders in *A*, *B* and *C* owned stock in all three corporations, but their proportionate interests were not the same; other shareholders owned stock in one or two but not all three corporations. Under the proposed transaction, a specified number of shares of *D* voting stock would be issued at closing and allocated among *A*, *B* and *C* in proportion to the relative values of their net assets transferred. Within five years thereafter additional voting shares of *D* would be issued based on the combined earnings for such period of the acquired businesses which were to be operated as a single division of *D*. The contingent shares would be issued to the three corporations in the same proportions as the shares were issued at the closing.

The Reorganization Branch took the position that it would be

Sec. 368 possible for the contingent shares to be attributable to the earnings of only the *A* business (with the *B* and *C* businesses reflecting losses in the five-year period) and thus, under the plan, the *D* shares that should go to the *A* shareholders would be issued to shareholders of *B* and *C*. In any event, it would be pure chance if the contingent shares were distributed among the three corporations in the same proportions as the earnings derived from the three businesses during the five-year period. Because of the likelihood that some shares would go to persons other than those beneficially entitled to receive them, the Reorganization Branch declined to issue an advance ruling as to the tax effect of the proposed transaction.

On the other hand, it is understood that the Reorganization Branch stated that it would grant a favorable ruling if the stock of *A*, *B* and *C* was held by the same persons in substantially the same proportion. In that case, none of the contingent shares could end up going to persons not beneficially entitled to them.

Employment Contracts and Reorganizations

In "B" and "C" reorganizations, accompanied by employment contracts, the IRS takes a close look at the reasonableness of the compensation under the employment contract, just in case the compensation is pegged so high as to violate the solely-for-voting-stock rule. Where the salaries are set at levels in excess of what the stockholder-employee used to receive prior to the reorganization, such increase should be explained satisfactorily.

Where rulings are requested, failure to furnish such explanation may delay the ruling materially or cause an unfavorable ruling to be issued.

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Don't Lose a Subsidiary's Operating Loss Carryover

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

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

For example, assume the following taxable income or losses for *B* Company, a subsidiary of *A* Company, since its organization on July 1, 1962:

Fiscal year ended June 30	*Income (Loss)*
1963	($100,000)
1964	10,000
1965	5,000
1966	(5,000)

Assume further that it was near the end of the company's 1967 fiscal year and management knew that the result of operations for 1967 would be a loss. The company was not expected to do much better in the 1968 fiscal year.

It was quite evident, then, that a large portion of *B* Company's 1963 loss would never be used to offset taxable income since it could not be carried beyond 1968, and *B* would not have sufficient earnings to utilize it by that time. In this situation, the parent, *A* Company, should consider liquidating or merging the subsidiary (tax free) in order to utilize the subsidiary's loss.

The latest date on which the transaction could have been consummated without losing any portion of *B*'s 1963 loss was June 30, 1967. Consummated on that date, *B*'s unabsorbed 1963 loss could be utilized (to the extent of *A*'s taxable income) for *A*'s fiscal year ended June 30, 1968.

Note, however, that if the liquidation occurred on June 29, 1967 (or any other date in the year ended June 30, 1967, other than June 30) the period from the liquidation to the end of *A*'s current taxable year (June 30, 1967) would be counted as a full year for loss carryover purposes and *B*'s losses could be utilized only to the extent of *A*'s income for such period.

Designation of Surviving Corporation

In planning for the preservation of net losses in corporate acquisitions under Sec. 381(a), the general rule is that it is immaterial which of the corporations is the surviving entity;

 however, there are at least three situations affecting reorganizations of the types described in Sec. 368(a)(1)(A) and (C) in which the designation of the surviving corporation can make a real difference.

1. As the taxable year of the transferor corporation ends on the day of the transfer, a foreshortening of the five-year carryover period will result unless that date coincides with the close of the taxable year of both the transferor and the acquiring corporation. This follows because a part-taxable year is the same as a full year in checking out the five years over which the carryover may be spread. For example, a calendar year transferor's loss in 1962 may be spread over only four years if it is merged into a calendar year acquiring corporation on any day in 1963 other than December 31. The span would be two part-taxable years in 1963 and full years in 1964, 1965, and 1966. The best approach is to merge on December 31, 1963, but if that cannot be managed, consideration should be given to designation of the profitable corporation as the transferor and having the loss corporation as the surviving corporate entity, since only the transferor's year ends on the date of the transfer.

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

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

Date of Distribution for Carryovers Under Sec. 381

Under Sec. 381, the time when carryover items are first taken into account by a successor corporation is referred to as the "date of distribution or transfer." Sec. 381(b)(2) provides an

option as to the date of distribution or transfer when all the property in a transaction subject to the carryover provision is not transferred on one day. Normally, this date is the date on which distribution or transfer is completed. However, under regulations, the date when substantially all the property has been distributed or transferred may be used if the distributor ceases all operations, other than liquidating activities, after that date.

This option may present an opportunity for constructive tax planning. For example, assume a distribution to a calendar year corporation which is substantially complete in October 1967 but which will not be fully completed until February 1968. If the option is exercised and the earlier date is deemed to be the date of distribution or transfer, any available net operating loss carryovers from the distributor might be usable by the distributee in 1967, instead of 1968.

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

Non-Sec. 381 Carryovers in Statutory Mergers

A close examination of Rev. Ruls. 59-395, 1959-2 CB 475 and 68-350, 1968-2 CB 159, gives rise to a conclusion that there are carryovers available in a statutory merger or consolidation in addition to the specific items enumerated in Sec. 381(c). Moreover, there may be carrybacks and claims for refund.

Rev. Rul. 68-350 deals with the question of whether an unused foreign tax credit which arose in a pre-merger taxable year of an absorbed constituent corporation could be used by the acquiring corporation after the merger. The ruling holds that since (1) a foreign tax credit carryover is not one of the items enumerated in Sec. 381(c), (2) Regs. Sec. 1.381(a)-1(b)(3) provides that no inference is to be drawn about whether any item or tax attribute which does not fall under Sec. 381 shall be taken into account by a successor corporation, and (3) Rev. Rul. 59-395 permits certain carryovers in a statutory merger or consolidation in a pre-Sec. 381 transaction, the foreign tax credit carryover may be used to the extent that the post-acquisition foreign taxable income resulting from the pre-fusion business of the absorbed constituent corporation will permit its use. The ruling

Sec. 381 points out that the burden of identifying the foreign taxable income attributable to the absorbed corporation is on the taxpayer.

Although Rev. Rul. 68-350 does not deal with the point, its reasoning and citation of precedents would seem to indicate that a carryback of an excess foreign tax credit of a resultant corporation attributable to assets acquired from an absorbed constituent should be carried back to the absorbed constituent. It is to be noted that Sec. 381(b) prohibits the carryback to a transferor corporation of only a net operating loss. Indeed, the rationale of *Libson Shops, Inc.* v. *Koehler*, 353 U.S. 382 (1957), the decision which placed in motion the rulings being discussed here, also confirms the logical conclusion that such an excess foreign tax credit should *not* be carried back to the pre-merger years of the continuing corporation. To do otherwise would result in an ability to carry back the foreign tax credit to *two* taxpayers!

The above principles may have application in matters other than carryovers and carrybacks. For example, assume that on June 15, 1969, Corporation *A* purchases for cash all the stock of Corporation *X*, that Corporation *A* is merged into Corporation *B* on September 15, 1969, and that Corporation *X* is liquidated into Corporation *B* on May 15, 1970. Does Corporation *B* acquire the *X* stock by "purchase" (Corporation *A* so acquired it), so that Sec. 334(b)(2) will apply to the liquidation of Corporation *X* into Corporation *B*? Rev. Ruls. 59-395 and 68-350 are support for an affirmative answer.

It is safe to say that the significance of a statutory merger or consolidation will not be fully developed for many years. In the meantime, there may be real advantage in using an "*A*" reorganization in preference to a "*C*" reorganization.

Investment Credit Carryover

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

Inequity in Rules Governing Loss Carryovers in Mergers

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

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

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

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

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

Capital Loss May Be Better for a Corporation Than Ordinary Loss

The tax adviser generally finds himself in the position of wanting to treat losses from speculative ventures of corporations as ordinary losses rather than capital losses. However, in the following circumstances, capital loss treatment may be more advantageous.

Take, as an example, a corporation that has had poor luck in real estate speculation and has accumulated substantial losses. Assume that for various business reasons the corporation is going to merge with another corporation which has substantial unrealized appreciation in real estate held for investment and that the shareholders of the loss corporation will receive stock having a market value of only 5% of the market value of the acquiring corporation after the reorganization. If the carryovers are net operating loss carryovers, Sec. 382(b) operates to reduce the available loss carryovers by 75%. However, if the loss carryovers are capital loss carryovers, there does not seem to be a comparable provision for reduction of the loss carryovers. Therefore, the surviving corporation may have a better chance of utilizing the loss carryovers if the losses are capital losses rather than ordinary losses.

Minimizing the Impact of Sec. 382(b)

Sec. 382(b) can cause a reduction in net operating loss carryovers (which otherwise would be available) of either acquiring or transferor corporations which participate in those types of reorganizations specified in Sec. 381(a)(2). Generally, if the stockholders of a corporation with carryovers wind up owning less than 20% of the stock of the acquiring corporation, the acquiring corporation will be able to use only that portion of the loss which is represented by the ratio of such ownership to 20.

For example, assume that Corporation *P*, a publicly held corporation, acquires in a "C" reorganization all the assets of Cor-

poration *X*, which has loss carryovers. These assets are retained by *P* and operated as a division of *P*. Assume further that the former *X* stockholders, as a result of owning *X* stock, own 5% of the stock of *P* after the transaction. In this case only 5/20, or 25%, of *X*'s carryovers may be taken into account by *P* after the reorganization, assuming that the carryovers are otherwise available, and not disallowed by, for example, Sec. 269.

The stock ownership test is made with respect to the acquiring corporation, which need not be *P*, even though *P* directly acquires the assets of *X*. Regs. Sec. 1.381(a)-1(b)(2)(i) defines the acquiring corporation generally as "that corporation which, pursuant to the plan of reorganization, *ultimately* acquires, directly or indirectly, *all* of the assets transferred by the transferor corporation." If, in the previous example, the plan of reorganization provided for the immediate transfer by *P* of *all* the former *X* assets to *P*'s wholly owned subsidiary *S*, *S* would be the acquiring corporation (see Example (2) of Regs. Sec. 1.381(a)-1(b)(2)(ii)). Such a transfer does not destroy an otherwise valid "C" reorganization because it is expressly permitted by Sec. 368(a)(2)(C).

Although Sec. 368(a)(2)(C) permits the transfer of either "part" or "all" of the former *X* assets to *S*, it is necessary for all assets to be transferred to *S* if *S* is to be the acquiring corporation. If less than all the former *X* assets were transferred to *S*, *P* would be the acquiring corporation (see Examples (3) and (4) of Regs. Sec. 1.381(a)-1(b)(2)(ii)).

Having thus established that *S* is the acquiring corporation, attention is now turned toward Sec. 382(b)(6), as amplified by Regs. Sec. 1.382(b)-1(g)(1), which deals with this specific situation. The former stockholders of *X* are treated as owning, after the reorganization, stock of *S* equal in value to the fair market value of the stock which they hold in *P*. If *S* was newly created for the sole purpose of participating in the above transaction, the former *X* stockholders will be deemed to own 100% of the stock of *S*. The reason for this result is that the *S* stock has a value equal to the pre-organization value of *X*, as *S* has the identical assets. Since this value was represented by the fair market value of the *P* stock just given to the former *X* stockholders in an arm's-length exchange, the resulting ownership of *S* by the former *X* stockholders is 100% for the purpose of Sec. 382(b)(6).

If before the transfer *S* had been an existing subsidiary of *P* with a value equal to three times that of *X*, the former *X* stock-

Sec. 382 holders would be deemed to own 25% of the outstanding stock of S, the acquiring corporation. Either 100% or 25% is above 20% and in either case there would be no reduction in the net operating loss carryovers of *X*. Of course, the carryovers of *X* may be used only against income of *S* and not of *P*, but this could have much more potential than using only 25% of *X*'s carryovers against the income of *P*.

Regs. Sec. 1.382(b)-1(g)(2) makes clear that the use of S should not be a mere transitory step. If S were liquidated into *P* before the *X* carryovers were used, the test of ownership would be made by reference to *P* and not by reference to S.

The above example has been stated in terms of a "C" reorganization with an immediate transfer of the assets to a subsidiary. The same economic results could be achieved by other reorganization techniques, including:

1. An "A" reorganization with *P*, with transfer of all assets to S.
2. An "A" reorganization directly with S, with the former *X* stockholders receiving *P* stock, as now permitted by Sec. 368(a)(2)(D).
3. A "C" reorganization directly with S, but using *P* stock as the consideration given by S.

Redemption May Affect Net Operating Loss Carryovers

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

Appreciation in Value of Assets of Profit-Sharing Trusts

Sec. 401

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

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

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

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

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

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

Effect on Capital Gain Treatment. Sec. 402(a)(2) provides for capital gain treatment of distributions, except for the amount thereof representing contributions for plan years beginning after 1969, where the total amount payable with respect to any employee is paid within one taxable year of the distributee on account of the employee's death or other separation from service, or on account of the employee's death after his separation from service. How will a second payment affect the capital gain treatment of the first payment which was thought at the time to be the total amount payable, and what treatment will be accorded to the second payment?

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

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

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

In this connection the revenue ruling implies, without stating in so many words, that where an after-developed type of adjustment is made and the payment is received in the same taxable year of the beneficiary as the original total lump-sum payment, the second payment also would qualify for capital gain treat-

ment. This result seems contrary to the logic used in giving capital gain treatment to the first two payments which are made in different taxable years, but it is not likely that any taxpayer will be found who will complain of this treatment.

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

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

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

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

If the employer's stock is included in the investment portfolio, the disclosure requirements of Regs. Sec. 1.401(b)(5)(ii) must be complied with.

Sec. 401

Profit-Sharing Plan Amendment Under Unusual Circumstances

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

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

1. The premature termination problem was probably avoided.
2. Any possible controversy as to whether distributions to the other participants withdrawing from the plan were caused by their separation rather than termination of the plan was avoided.
3. All the tax advantages of a profit-sharing plan continued for the two remaining stockholder participants. The original group had over 50 participants.

Capital Gain in Qualified Plans

The obvious superiority of long-term capital gain as compared with ordinary income has become so idealized that few stop to think that the capital gain opportunity (except for distributions of amounts representing employer contributions for plan years beginning after 1969) involved in an election for the newly retired to take a lump-sum distribution rarely results in a net tax advantage. Upon a little reflection, the thought comes through that, subject to but a few exceptions, as a matter of tax economics only those who will receive substantial annual income after retirement will benefit from the capital gain rate. One exception relates to distributions in kind of employer's securities purchased with the employer's contributions which have appreciated in value. Another would be a large unused capital loss carryover. As a rule the leveling-out advantages of annual distributions will provide a more beneficial result considering that there will be: (a) lower annual income after retirement; (b) extra personal exemptions for husband and wife, if over age 65; and (c) a nontax reason (in cases where the former employee benefits from improved investment performance)—avoidance of the problem of investing the lump-sum distribution on as sound a basis as the professionals acting for the qualified plan.

Retired Employees and Consulting Contracts

The Pension Trust Branch of the IRS has issued a number of advance rulings on whether employees who retire and immediately enter into consulting contracts with their employers will be considered to have separated from service for purposes of the capital gain treatment on lump-sum distributions under Sec. 402(a)(2). Before ruling, the Pension Trust Branch requires the employee to submit a copy of the consulting contract and a detailed statement of the duties and circumstances of the individual's employment so that a comparison can be made between the employee's relationship with his employer both before and after his retirement. In ruling on this question the Pension Trust Branch follows the rulings issued by the Employment Tax Branch on the employer-employee relationship. Rulings on the employer-employee relationship have been published including Rev. Ruls. 69-647, IRB 1969-52, 12; 56-528, 1956-2 CB 689; 55-695, 1955-2 CB 410; 55-466, 1955-2 CB 397; and 54-586, 1954-2 CB 345. The capital gain treatment apparently depends upon whether the subsequent services are rendered as an independent contractor.

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

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

Benefit Plans in a Reorganization

In spite of the changes made by the 1969 Tax Reform Act, capital gain treatment of all or part of distributions from a pension or profit-sharing plan because of separation from service may still be achieved. If the payment is not on account of

separation from service, the distribution is taxed as ordinary income. The Internal Revenue Service has issued many rulings involving what constitutes a separation from service in a reorganization.

Recently, however, the IRS has litigated the question of separation from service in a reorganization. Furthermore, it has been successful in convincing courts that in fact there is no such thing as a separation from service in a reorganization where the employee one day is working for Company A and the next day, due to the reorganization, is still carrying out his same function at his same desk but is now working for Company B. In *Gittens* v. *Comm'r,* 49 TC 419 (1968), the IRS persuaded the Tax Court to rule that there was no separation from service despite the fact that in Rev. Rul. 65-147, 1965-1 CB 180, the IRS itself had ruled, on very similar facts, that there was a separation from service (see also *U.S.* v. *Haggart,* 410 F2d 449 (CA-8, 1969).

Rev. Rul. 69-157, 1969-1 CB 115, may provide a solution. Here the IRS ruled that an employee trust retains tax-exempt status even though contributions under the plan have been discontinued and the trust is retained solely to make distributions in accordance with the term of the plan. Thus, in the reorganization it may be possible to keep the trust alive as a tax-exempt organization until all employees are separated from service of the new employer. Upon separation each employee would receive a lump-sum distribution, all or most of which should be capital gain. When all distributions are made, the trust would then terminate. Of course, it would be important that appropriate language in the trust instrument be included to cover the reorganization situation.

"Separation From Service" for Capital Gain on Lump Sum Distribution From Employees' Trust

It frequently happens that a former employee's services after his retirement age may be actively sought by his former employer. Continued employment as an employee, even on a part-time basis, will defeat the separation from service requirement for the partial or total capital gain treatment of a lump sum distribution from a qualified employees' trust.

In such circumstances, it may be possible for the former employee to continue rendering services *as an independent con-*

tractor and still be regarded as having been separated from the service of the employer. *Sec. 402*

The dividing line between continued services performed as an employee and continued services performed as an independent contractor is a fuzzy one. See Rev. Rul. 69-647 (IRB 1969-52). While, in general, the status of a particular person rendering services depends upon the specific relationship surrounding his employment, the IRS has developed certain guidelines, for internal use only, which are followed in considering specific ruling requests concerning the employee-independent contractor question. In order for the IRS to rule in advance that an independent contractor relationship exists, and accordingly a former employee may be regarded as separated from service, the following conditions must be met:

- The consulting fee to be paid the individual under the consulting agreement must be 30% or less of the compensation paid the individual when he was an employee of the corporation.
- The services rendered by the individual under the consulting agreement must not be identical to the services rendered by such individual when he was an employee.
- The time devoted by the individual in rendering the services to the corporation under the agreement must be 30% or less of his available time.

Even if these guidelines are met, the question of whether an employee or an independent contractor relationship exists will still be referred by IRS to the Employment Tax Branch for its determination based on all the facts and circumstances.

Tax-free Exchange of Sec. 403(b) Plan Annuity Contracts

Sec. 403

A Sec. 501(c)(3) organization established an employee-annuity arrangement whereby its employees agreed to a reduction in current compensation if the employer purchased individual retirement annuity policies issued by an insurance company. After several years, the employer proposed to exchange the existing individual retirement annuities for a group annuity contract to be underwritten by another insurance company. As a condition precedent to continuation in the employee-annuity purchase program, each employee was required to agree to surrender his individual annuity contract and transfer any funds

Sec. 403 "received" therefrom to the new group plan. Any employee who did not enter into such a binding agreement was not permitted to continue participating in the employer's annuity purchase arrangement.

In a private ruling, the IRS concluded that the cash value of the individual retirement annuity contracts would not be considered as "received" for purposes of Secs. 403(b) and 451 if such funds were, under a legally binding agreement, transferred to the new group-annuity purchase program. Therefore, the deferment of taxation to participating employees would continue until distributions are actually or constructively received by the participants. In so ruling, the IRS expressly referred to Rev. Ruls. 55-368 (1955-1 CB 40) and 55-315 (1955-1 CB 258), stating that even though they related to qualified plans, the same principles apply to Sec. 403(b) annuity arrangements. (With regard to plans including owner-employees: see Rev. Rul. 68-160, 1968-1 CB 167; compare Rev. Rul. 69-254, 1969-1 CB 129.)

Sec. 404 Paying Pension Trust With Note

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

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

Capitalization of Pension Costs

A revenue agent questioned the deductibility of pension plan contributions which were capitalized on the books. He referred the question to the National Office for technical advice.

A favorable response was issued to the taxpayer in which the Service has reaffirmed its long-standing position (see I.T. 3408, 1940-2 CB 178) that pension costs incurred in connection with

self-constructed property are currently deductible. Although the favorable letter states that the National Office will continue to study the general issue, any change in position would be prospective only.

Sec. 404

Qualified Plan Contributions by Accrual Employers

Some of our readers may not have appreciated the significance of the ruling announced by the IRS regarding the timing of contributions to qualified pension and profit-sharing plans. In Rev. Rul. 66-144 (1966-1 CB 91) it is held that if an accrual-basis taxpayer has an extension for filing its income tax return, a payment made within the extended period for filing will be deemed to be timely regardless of when the return is actually filed. This interpretation by the IRS may seem quite liberal to many practitioners who have always operated on the premise that payment of the contribution had to precede the actual filing of the return.

Deferred Vacation Pay

Under Sec. 404(a)(5) and Regs. Sec. 1.404(a)(12) nonforfeitable contributions under a plan of deferred compensation not qualifying under Sec. 401(a) are deductible in the year paid. A recent private ruling held that this rule applies to deferred vacation pay.

The taxpayer formerly had a plan under which vacation pay accrued and was paid in the same calendar year. A new labor contract was negotiated under which vacation rights would vest on December 31 of each year and would normally be exercised in the following year. However, by making arrangements with the company by December 31, employees could defer their vacation for one year. Thus, an employee with vested vacation rights at December 31, 1967, which normally would be exercised in the calendar year 1968, could defer the exercise of the rights until calendar year 1969.

The ruling held that vacation pay was currently accruable where the rights would be exercised in the year immediately following, but was deductible only when paid where the employee elected to defer his vacation for a year.

Sec.404 Determination of Profit-Sharing Contribution Simplified

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

Sec. 421 "Disqualifying Dispositions" of Restricted or Qualified Stock Option Stock

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

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

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

the corporation is entitled to a deduction merely because the disqualifying disposition has been made.

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

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

Qualified Stock Options—Closely Held Companies

In devising a qualified stock option plan for officers and employees of closely held corporations, the practitioner is faced with several practical problems not normally encountered in planning for publicly held corporations. Aside from the initial question of fair market value at the date the option is granted, these problems include: (1) How does the employee or his heirs dispose of the stock acquired? and (2) How can the corporation or its shareholders avoid the creation of minority interests held by persons unfamiliar with the business (e.g., executors or heirs of the deceased employee)?

One solution might be to give the corporation the right to repurchase the stock. Rev. Rul. 54-467, 1954-2 CB 207, and Rev. Rul. 64-312, 1964-2 CB 117, indicate that an obligation to resell the stock to the employer corporation for its then fair market value in the event of termination of employment will not postpone the date on which the fair market value of the stock and the option price must be compared for qualification purposes. In other words, the selling price is not restricted; the

Sec. 421 only restriction concerns the identity of the purchaser.

As a practical matter, closely held corporations need to be able to use an objective standard in their repurchase contract to avoid the possibility of disputes and litigation concerning the repurchase price. (The fair market value of closely held stock is hard to come by.) Whether tying the repurchase agreement to a formula in order to determine a fair market value—such as book value per share, a price-earnings multiple, or a combination of these—will satisfy the IRS is not entirely clear. Book value per share does not seem to be viewed by the IRS as necessarily a reliable formula; Regs. Sec. 1.421-6(d)(2)(ii), Example 4, indicates that book value is considered to be different from fair market value. Nevertheless, it would seem that book value can be indicative of fair market value, particularly if used in a more sophisticated formula, such as the use of a weighted average of book value and a multiple of average earnings per share, as has been done in many estate tax cases. An additional improvement would be involved if such a formula were coupled with contractual provisions which would:

1. Permit the employee or his heirs to require the corporation to repurchase at the formula price for a period of time, say, six months following temination of employment.

2. Give the corporation or its shareholders a call on the stock at the formula price at the end of the same period, provided that the corporation or its shareholders meet the terms of any bona fide higher outside offer received by the employee or his successors during such six-month period.

Sec. 424 Effect of Spin-off on Employee Stock Option Plan

After receiving a favorable ruling permitting the spin-off under Sec. 355 of the Code of an 80% owned subsidiary, the parent company, whose stock was listed on the New York Stock Exchange, requested a ruling as to the effect of the spin-off on the price called for pursuant to its restricted stock option plan. The Service authorized a reduction of the option price equal to the decrease in the fair market value of the parent company's stock immediately after the spin-off, as a result of its selling the distribution, provided that the decrease did not exceed the difference between the fair market value of the parent company's stock immediately before the spin-off and the original option price.

ACCOUNTING PERIODS AND METHODS OF ACCOUNTING

Adoption of Fiscal Year by Affirmative Acts

Sec. 441

Rev. Rul. 68-125, 1968-1 CB 189, has clarified the situation with respect to a new taxpayer (usually a corporation) which wishes to adopt a fiscal year. There had been concern on the part of practitioners that Regs. Sec. 1.441-1(b)(3) required a timely filing of a return on or before the due date (not including extensions) appropriate for the particular year-end. Rev. Rul. 57-589, 1957-2 CB 298, did nothing to dispel this concern, although it did make clear that the timely filing of a Form 7004 (the automatic extension of time for a corporation) was sufficient to establish an accounting period. Prior to Rev. Rul. 57-589, new corporations bent every effort to file a complete initial return on time, without extension.

Rev. Rul. 68-125 states that an accounting period has been established if, prior to the due date (not including extensions) of the return for the desired initial taxable year the taxpayer has caused his books and records to reflect the adoption of the desired year-end. Late filing of a return for the initial period will not by itself preclude the adoption of the desired fiscal year.

Achieving Equity Among Partners On a Change of Year Adjustment

Sec. 442

When a partnership obtains IRS permission to change its annual tax accounting period, conditions usually attached by the IRS can disturb the equity of existing profit-sharing arrangements, and adjustments may be required among the partners to offset this.

Under the terms of a typical letter granting permission to change, the partnership, as a condition for obtaining permission, is required to include as an item of income in its return for the short period a transitional "adjustment" equal to the taxable income for the months after the short period which were "cut off" its former year. The income for these months is also included in the first return covering the full new year.

To compensate for this double inclusion of income, one-tenth

of the amount of the "adjustment" may be deducted from partnership income for each of the ten taxable years beginning with the first year under the new period or until the partnership terminates, if earlier, at which time the unrecovered balance is deductible.

Although the effects of the change at the partnership level may be clearcut, the allocation of the transitional adjustments among the individual partners must be carefully considered in any case in which there may be changes in profit-sharing percentages, admissions of new partners, or withdrawals of partners during the ten-year period. This is because each partner who is a member of the firm when it changes fiscal years in reality pays tax twice on some of his share of partnership taxable income. He should eventually recoup this double tax through his share of the special 10% deductions. If he ceases to be a partner or reduces his participation before the ten-year period has expired, however, he will not have fully recouped the doubling up of taxable income and will have suffered a permanent tax detriment, unless the partnership takes steps to provide for an equitable apportionment of the 10% special deduction among the partners in future years. A similar result would obtain if newly admitted partners were permitted to share in the special 10% deductions.

One way to reach what would appear to be an equitable result would be to treat the partnership's taxable income for the "double-up" period as a "special" income item for the partnership's short taxable year, and the resulting ten-year deduction as a "special" deduction item for future taxable years. This approach appears permissible under Sec. 704 of the Code.

Under this arrangement the "special" annual deduction would be apportioned to a partner on the basis of his percentage interest in the "special" income. Thus, a partner who included 5% of the "special" income in his individual income tax return would be allotted 5% of the "special" annual deductions. This method of apportionment would continue irrespective of changes in general profit-sharing percentages, whether such changes are due to new profit-sharing arrangements among existing partners or the admission of new partners.

Upon a partner's withdrawal from the partnership, prior to the expiration of the ten-year amortization period (including a withdrawal due to death or retirement), the unrecovered share of the "special" deduction could be allocated to him or his estate in the year of withdrawal. Under this arrangement,

the remaining active partners participating in the "special" deduction could receive a reduced deduction for the year in which the withdrawal occurs. However, their remaining shares of the "special" deduction would be recovered in future years.

Other equitable arrangements for allocating the "special" deduction, such as amortization of a partner's share on the basis of his estimated years of active participation, should also be acceptable since they should result in reasonable economic consequences (Regs. Sec. 1.704-1(b)(2)).

Net Losses and Automatic Change of Accounting Year

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

The position of the Service on this question, as stated in Rev. Rul. 65-163, 1965-1 CB 205, holds that the taxable income for the short period and for the taxable year preceding such period means taxable income as defined in Sec. 63, exclusive of any net operating loss deduction.

Automatic Change of Taxable Year After Short Period

A frequent question arises concerning whether or not a corporation can change its annual accounting period under Regs. Sec. 1.442-1(c) without prior approval of the Commissioner if the corporation has been in existence for only a short time.

There is no requirement that the corporation need to have been on its former accounting period for any specific length of time. All that is required is that the corporation not have changed its annual accounting period within the ten calendar years preceding the short period. As long as this and the other conditions are met, the corporation may take advantage of the automatic change provision.

One special set of circumstances may apply, however, where

Sec. 442 the corporation has been in existence for only a very short time. The IRS takes the view that if the "immediately preceding" taxable year is a period of less than 12 months, the 80% test regarding the current annualized short-period taxable income may still be met, and, accordingly, the conditions for automatic change may be fulfilled. This special circumstance would arise, for example, in the first year following the first year of a corporation's existence. It might also arise in the first year following the emergence of a corporation from an affiliated group filing a consolidated federal income tax return.

Since this is not a published position of the IRS, it may be advisable to file a protective Form 1128 in such situations.

Permanent Deferral of Tax

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

Permission to Change Taxable Year; Watch Short-Period Loss

In connection with an application for permission to change a taxable year, Form 1128 requires that estimated income or loss for the short period be indicated. In the event that operations for the short period are expected to result in a loss, disclosure of the amount which would be available for carryback to prior years is also required. The purpose for such information is to permit the IRS to determine that the change in accounting period would not result in a substantial acceleration of the utilization of a net operating loss. Accordingly, the permission letter which the Service issues in connection with the change

of an accounting period generally recites as a condition that any loss for the short period will not exceed the dollar amount thereof estimated in the application.

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If the actual loss for the short period turns out to be greater than the amount estimated in the application for change, the approval of any change would be voided for failure to satisfy all the conditions of the change unless the Service amended the permission letter to include the amount of the actual loss. Of course, there is no assurance that the Service would approve any such amended request, although approval should be granted if the net operating loss for the former taxable year (covering 12 months and determined by a special cutoff) equals or exceeds the loss for the short period required by the change. Where the loss for the short period is larger than the loss for the full former taxable year, the Service will generally require that the benefits of the short-period loss be spread over a ten-year period to avoid a "substantial distortion of income." Such action is generally in accord with the guidelines for changes of accounting period outlined by Rev. Proc. 66-6, 1966-1 CB 615, except that the amount of the net operating loss for the short period permitted under the "de minimis" rule is specifically defined.

Changes in Accounting Practice Under Rev. Proc. 64-16

Sec. 446

Under the provisions of Rev. Proc. 64-16, 1964-1 CB 677, a taxpayer will usually be permitted to change his accounting, for federal tax purposes, to any treatment acceptable and consistent under the income tax regulations. One prerequisite is that the taxpayer agree to take the adjustment between the two methods of accounting into effect over a ten-year period. The ten-year period for allocating the resulting adjustment is to begin with the "year of transition." Usually the year of transition is the taxpayer's first taxable year for which a return has not been filed at the time the request is made.

Since there is no deadline for the filing of a request under Rev. Proc. 64-16, it frequently occurs that a request will be filed and, before the ruling is issued by the Service, the period of extensions for filing the tax return for the year of transition will expire. In two recent situations where the period for filing the return had been extended for the maximum six months and

 no further extensions could be obtained, the taxpayers filed returns and took into effect the contemplated accounting practice as well as the one-tenth adjustment, treating the year for which the return was filed as the year of transition.

In both of these situations, the Commissioner was notified when the return was filed that such filing had taken place and that the revised accounting practice had been reflected in the return, including the one-tenth adjustment. As an added precaution, one of the taxpayers filed a statement with the return in which it announced its intention to either file a copy of the subsequent approval of its application for the change or to file an amended return in the event approval to make the change was denied. In both instances the Service, subsequent to the filing of the tax return for the year of transition, issued a favorable ruling designating the year for which the return had been filed as the year of transition. In light of the above, it is suggested that there should be no hesitancy in requesting a change in accounting practice under Rev. Proc. 64-16 to be applicable to any transition year for which a return has not been filed even though it may be necessary to file such return shortly thereafter and before the ruling request can be acted upon. If the taxpayer assumes favorable action and files the return as if such favorable action had already transpired, the Service will issue its ruling despite the prior filing of the return.

Change in Billing Practice Not a Change in Method of Accounting

In *Decision, Inc.*, 47 TC 58, a calendar year taxpayer, on the accrual basis, was a publisher of business directories. Although the directories were not issued until February, advertisements had to be in the publisher's hands by the preceding November. Advertisers were billed soon after receipt of the copy. Thus, for tax purposes, the advertising revenue accrued in the year prior to publication of the directories. The income was held to be taxable in the year it was billed.

In 1963 the company changed its billing practice. The effect was to delay the billing date from November to January of the year of publication. The tax result of this change was to create a substantial net operating loss in 1963.

The IRS claimed this was a change of accounting method which could not be accomplished without prior consent under

Sec. 446(e). The Tax Court disagreed. It ruled that it was a business policy decision which was within the province of management. The Court said: "To sustain this argument of [IRS] would have the effect of denying a business the right to determine the terms of sale of its product without clearing the matter with the [IRS], clearly an odious propagation of the tentacles of the government anemone."

Select Year of Accounting Change With Care

Rev. Proc. 64-16, dealing with changes in accounting practice, provides that the procedure is generally applicable to the first taxable year for which a return has not been filed at the time the request is submitted. This presents an excellent "timing" opportunity.

For example, consider a request under the Rev. Proc. involving the inclusion of burden in inventory, under the following circumstances:

Date	*Omitted Burden*
December 31, 1965	$2,000,000
December 31, 1966	2,500,000
December 31, 1967	1,500,000

If the year ended December 31, 1966, is selected as the transition year, the annual adjustment for the next ten years will be $200,000 and taxable income for 1966 will also be increased $500,000. On the other hand, if 1967 is selected as the transition year, the annual adjustment will be $250,000 but taxable income for 1967 will be reduced by $1 million.

IRS Reverses Position on Treatment of "120-Month" Spread of Change-in-Accounting-Practice Adjustments

Until recently, the National Office of the IRS interpreted the phrase "ten-year period" to mean a period of 120 months, rather than ten taxable years, in connection with the terms and conditions for approved changes in accounting practice under Rev. Proc. 64-16 (1964-1, Part 1, CB 677). The phrase "ten-year period" is now interpreted to mean ten "taxable years" as de-

Sec. 446 fined in Sec. 441(b). In a recent private ruling, one-tenth of a positive adjustment had to be reflected in each of three successive short taxable years, which fell within an 18-month period because of the acquisition of the taxpayer's stock and the filing of a consolidated return.

The new position is consistent with that taken in Rev. Rul. 70-180 (IRB 1970-16, 8). There, it was held that a full 10% of the deficiency in the bad debt reserve of a commercial bank, determined under Rev. Rul. 65-92 (1965-1 CB 112), could be deducted in each of two short taxable periods that fell within one calendar year. This occurred because the stock of the calendar year bank had been acquired during the year, and its new parent corporation filed a consolidated return (Regs. Sec. 1.1502-76(b), (d)).

It has been indicated that the new position will be applied whether the adjustment is positive or negative. Therefore, it would be appropriate to file a claim for refund for a taxpayer which had, in accordance with the prior IRS position, deducted a *negative* adjustment based on the number of months in a short taxable year rather than the full 10%.

Treatment of Ten-Year Spread When Operations Cease

The usual rule under Rev. Proc. 64-16, 1964-1 CB 677, regarding the ten-year spread of the adjustment which is generally incorporated in the written collateral agreement between the taxpayer and the IRS, is that if the taxpayer who has changed his accounting practice and agreed to take into income the resulting adjustment over a ten-year period (starting with the "year of transition") ceases to engage in a trade or business before expiration of the ten-year allocation period, the entire remaining balance of the adjustment must be reflected in the final tax return.

However, it should be noted that Rev. Rul. 68-527, 1968-2 CB 162, takes the position that in a transaction to which Sec. 381(a) is applicable (i.e., unless treated as a purchase of assets, the complete liquidation of a subsidiary; transfers of property in reorganizations falling within Sec. 368(a)(1)(A),(C) or (F) and, in some instances, (D)) the remaining balance of the adjustment arising from an accounting method and/or practice change allocable over a ten-year period carries over to the acquiring corporation. Rev. Rul. 68-527 applies not only to

adjustments arising through Rev. Proc. 64-16, but also to transitional adjustments referred to in Rev. Proc. 67-10, 1967-1 CB 585, and Rev. Proc. 64-51, 1964-2 CB 1003. Tax planning possibilities are clearly now available for items a taxpayer wishes to change but may not have changed because future transactions were contemplated that would have triggered the reporting of the balance of the ten-year adjustment in the taxpayer's final return.

Spreading Foreign Taxes Under Rev. Proc. 64-16

An interesting twist arose recently where a taxpayer requested and received permission to change its practice of reporting royalty income from foreign licenses from the cash basis to the accrual basis. In this case there was a "positive" transitional adjustment reflecting the royalties accrued as of the beginning of the transitional year which had not yet been reported on the cash basis. This transitional adjustment was to be taken into account over ten years beginning with the transitional year.

In the normal course the accrued royalties at the beginning of the transitional year would be collected shortly thereafter, and foreign withholding taxes would be extracted. The question arose as to the treatment of these foreign taxes for foreign tax credit purposes.

If the foreign taxes withheld were to be taken into account in the year actually withheld, a distortion would be introduced between the foreign source royalties reported as income and the foreign taxes paid.

In order to eliminate this distortion, the taxpayer requested and received permission to take the foreign taxes applicable to the transitional adjustment into account as a credit or deduction over the same ten-year period during which the transitional royalty income adjustment would be reported.

Rev. Proc. 64-16

The National Office of the IRS will not consider applications for changes in accounting practices under Rev. Proc. 64-16 once a case gets to the Appellate Division. Practitioners should, therefore, bear this in mind, and, if there is a possibility that a ten-year spread-forward under Rev. Proc. 64-16, 1964-1 CB 677, may be desirable in ultimately settling a controversy with the

Sec. 446 IRS, they should consider requesting a District conference rather than an Appellate conference to preserve their rights under Rev. Proc. 64-16.

IRS Clarifies Position on Changes in Accounting Methods

Three rulings by the IRS have helped clarify the Service position on two questions relating to changes in book accounting methods. These rulings considerably reduce the danger of adverse tax effects in such situations.

The questions arise in relation to two provisions of the Code. Under the general rule, a taxpayer must file his tax returns under the method of accounting used in keeping his books. At the same time, the Code requires that permission be obtained before making a change in accounting method for tax purposes. There has been concern that, despite this latter requirement, the fact of a change's being made for book purposes could give the Service the right to require the new method to be followed for tax purposes. The basis for this might be that making the change for book purposes is in effect an informal request for a change for tax purposes.

One of the rulings (Rev. Rul. 68-83, 1968-1 CB 190) dealt with a national bank that, in order to comply with banking regulations, had changed its bookkeeping from the cash receipts and disbursements method to the accrual method. It did not request permission to change its method for tax purposes and, in fact, proposed to continue the cash method. The Service held that the taxpayer should continue to file its income tax returns on the cash method but that its permanent books and records must clearly reflect a proper reconciliation between the two methods.

A second ruling (Rev. Rul. 68-98, 1968-1 CB 191) related to a taxpayer that had valued its inventories for both book and tax purposes by using a consistent nominal cost for a "normal" quantity of goods in stock. This is a method that is not recognized as acceptable in accounting for either tax or financial statement purposes, and the taxpayer was required by a federal regulatory agency to change to valuing all goods at lower of cost or market. However, the taxpayer did not make the change for federal income tax purposes. On examination, an adjustment was made by the Service to value inventories at lower of cost or market, an adjustment that probably could have been made regardless of the

book change. This adjustment was held to be a change of accounting method but one that was "not initiated" by the taxpayer. This means that, to the extent the taxpayer had a corresponding understatement of inventory amounts at the beginning of its first year under the Code of 1954, the adjustment will be on a "tax-free" basis.

Both these rulings relate to book changes required by federal regulatory authorities and, therefore, should not be regarded as giving complete protection to any taxpayer that changes its book method of accounting. However, they do represent a clarification of Service position on a question about which there has been a great deal of uncertainty, particularly when considered in the light of Rev. Rul. 68-35, 1968-1 CB 190. This ruling deals with the situation of a taxpayer that has consistently maintained its books on the cash receipts and disbursements method of accounting. In a subsequent year the taxpayer kept its books for quarterly statement purposes only, on the accrual method of accounting. This was done for management purposes. At the end of the taxable year, the taxpayer made accounting adjustments to convert its permanent books and records to the cash method of accounting. The ruling holds that the taxpayer may continue to use the cash method of accounting for federal income tax purposes, provided the adjustments required to convert from the accrual to the cash method of accounting may be readily verified from the taxpayer's permanent books and records.

Taxpayers in similar situations who have been reluctant to make changes for book purposes only may wish to consider obtaining a ruling permitting such changes.

Method of Accounting for Long-Term Contracts Can Be Changed

Under Rev. Proc. 64-16, 1964-1 CB 677, permission to change from the percentage-of-completion to the completed-contract method of accounting for income from long-term contracts may be obtained from the IRS.

Recently, the Service granted permission to make such a change. The adjustment required to be made over the ten-year period to reflect the change in accounting is to be determined under a transitional formula. This formula requires that stated percentages of the income from all partially completed long-term contracts at the end of each taxable year during the ten-

year period are to be reported under the percentage-of-completion method. The remainder of the income from these contracts is to be reported under the completed-contract method; i.e., deferred until the taxable year in which such contracts are completed. The stated percentages during the ten-year period are 90% in the year of change, 80% in the second year, etc., until 0% in the tenth year.

This transitional formula appears to have been designed to prevent an immediate deferral of a substantial amount of the income of a taxpayer, where the deferral is a result of a change in accounting.

It differs from the usual determination of the adjustment required to be made under Rev. Proc. 64-16. Normally, the amount of the adjustment would be the amount of income already reported under the percentage-of-completion method as of the beginning of the year of the change in accounting.

Exception to Ten-Year Spread of Change in Accounting Practice

Under Rev. Proc. 64-16, 1964-1 CB 677, a change in "accounting practice" requires that a resulting adjustment be spread ratably over a ten-year period. What if the facts during the ten years depart from the situation which was contemplated?

For example, an accrual-method taxpayer, currently not reporting rents which have accrued but remain uncollected, might agree to report the uncollected rents when accrued. If there were a resulting adjustment of, for example, $30,000, an amount of $3,000 would be taken into income during the year of transition and in each of the succeeding nine years. If in the second year the taxpayer charges off as a bad debt $25,000 of the total $30,000 not previously included in income, may he still defer the reporting of the income over the next nine years or must he include in income the portion attributable to the bad debt written off?

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

Caution Advisable to Change From Cash to Accrual Method

Under Rev. Proc. 67-10 (1967-1 CB 585) which calls for filing Form 3115 with the District Director, a taxpayer using the cash receipts and disbursements method of tax accounting is permitted to make an automatic change to the accrual method provided there is compliance with all the conditions prescribed in the procedure. However, it is questionable whether the procedure may be used if the taxpayer is not using a strictly cash method. Conceivably the IRS could take a position that a taxpayer who uses Rev. Proc. 67-10 to make a change from an accounting method that is hybrid in any way has not complied with all the conditions of the procedure.

To avoid any problem with Rev. Proc. 67-10, a taxpayer who is not using a strict cash method might be better advised to apply for the change under Rev. Proc. 64-16 (1964-1 CB 667). A change from cash to accrual method may not be made under Rev. Proc. 64-16 but this procedure may be used in changing certain items under a hybrid method to the accrual method.

The advantage in this is that a taxpayer can get a positive response to his request for a method change and will not have to wait until the return for the year of change is examined. Also, where its application is appropriate, Rev. Proc. 64-16 will usually allow the change to be made for an earlier taxable year.

Permission to Change Accounting Method Not Binding

Often a taxpayer will request and receive permission to change an accounting method or practice, as under Rev. Proc. 64-16 (1964-1 CB 677), and then later in the year will find the change to be unexpectedly detrimental. This raises the question whether the taxpayer is "locked in" to the requested change once permission has been granted.

In these cases the taxpayer has a flexibility of choice until the tax return for the year of change is filed. If the taxpayer chooses not to give effect to the change because of developments later in the year, he may do so without question. The IRS has indicated that this rule applies with equal force to applications filed on Form 3115 as well as those submitted under Rev. Proc. 64-16.

Sec. 453

A Pledge Need Not Be a Disposition

The IRS has been taking the position that any pledge of installment receivables is a disposition causing acceleration of income under Sec. 453(d). This position has been indicated even where the receivables are retained by the seller and the pledge is on a non-notification basis. This is a considerable extension beyond Rev. Rul. 65-185 (1965-2 CB 153) in which the receivables were assigned as security and the customer advised to make payments to the pledgee.

The IRS position has not been accepted by the Tax Court; see *Town and Country Food Co., Inc.* (51 TC 1049). Where financial considerations indicate a pledge of receivables is in order, tax advantages of installment reporting should continue to be available. Some care in the arrangements for the loan is desirable to prevent the loan-pledge transaction from being considered a sale. To the extent practical, the following precautions should be taken:

- Loan payments and interest should not be related to collections of receivables.
- The borrower should retain receivables and make collections itself.
- In the event of default by a customer, the borrower should have the right to substitute collateral rather than be charged for the amount in default.
- It probably is preferable to avoid having the loan proceeds approximate the amount which would be received in the case of a sale.
- In the event of default, any excess upon sale should be returned to the borrower.

Adoption of Installment Method and Its Effect on Bad Debt Reserve

It has become an established practice for taxpayers to arrange a sale of their installment accounts receivable as of the end of the year preceding the adoption of the installment method of reporting income. If a bona fide sale of receivables is effected, the taxpayer is not required to report the amount realized on the sold obligations a second time under Sec. 453(c) when the obligations are subsequently collected. These sales are generally arranged through a bank, without recourse, although the bank may retain a hold-back as security for the re-

payment of the obligation. The taxpayer (seller) generally acts as collection agent for these receivables for the bank.

The IRS has contended, sometimes successfully, that reserves for bad debts be restored to income in a variety of situations, e.g., the sale of all assets pursuant to a liquidation under Sec. 337. In a private ruling on a sale of receivables prior to the adoption of the installment method of reporting income, involving a factual situation similar to that described above, the IRS required, as a condition to recognizing the transfer of receivables as a bona fide sale, that the entire balance in the reserve for bad debts allocable to the sold customer obligations be restored to the taxpayer's income for the year of sale. The ruling specifically expressed no opinion concerning the establishment of any new reserve under Sec. 166(g) relating to the accounts sold.

Whether or not the restoration of the reserve for bad debts is proper in these circumstances, its effect should be considered in connection with any sale of receivables prior to adopting the installment method of reporting income.

Indeterminable Selling Price— Protect Your Capital Gain

Where a business is sold for cash under a contract providing for an open-end or contingent sales price, the seller faces several tax problems which may better be explained by use of an example.

Jones, the sole shareholder of XYZ, sold all his stock to *P*. The sales contract provides for a minimum price of $300,000 plus a percentage of the next three years' capitalized earnings. An initial payment of $50,000 is to be made on closing with the balance payable in five annual installments commencing one year from closing. The XYZ stock is a capital asset in the hands of Jones.

The IRS has issued a Technical Advice Memorandum stating that a sale involving an indeterminate price does not qualify as an installment sale under Sec. 453. Although this position may be controversial, it appears that the safety of an installment sale election is not available to avoid taxation of the entire gain in the year of sale.

On the other hand, no tax consequences result from a sale or exchange until the transaction is considered "closed" for tax purposes. If it can be established that contractual rights to

Sec. 453 future payments have no ascertainable fair market value, only the cash received will be taxable at the time of sale. The transaction will remain "open" and all future payments will be treated as capital gains. The leading authority on this point is *Burnet* v. *Logan* (283 U.S. 404, 1930) as interpreted in *Carter* (CA-2, 170 F2d 911, 1948). Whether a transaction is deemed to remain "open" is essentially a question of fact.

It is important to note that the Treasury position is that only in "rare and extraordinary" cases will property be considered to have no fair market value. This position is stated in Regs. Sec. 1.1001-1(a) and in Rev. Rul. 58-402, 1958-2 CB 15. However, Rev. Rul. 58-402 focuses primarily on the opportunity to convert ordinary income to capital gains. Where this feature is not present, it appears unduly harsh to require the immediate valuation of the right to future payments. The result will be that such value (plus any cash received) will be taxable as a capital gain at the time of sale to the extent adjusted basis is exceeded, thus burdening the seller with the obligation to pay tax although he may have received very little of the sale price in cash. Moreover, since the transaction is closed at the time of sale, any subsequent payments in excess of the value assigned to the contract rights will constitute ordinary income.

It is obvious, then, that the seller is in a much better position if the transaction remains "open," since the tax will be deferred until the receipt of the cash and there will be no risk of ordinary income through undervaluation. If the taxpayer does determine that the contract has no ascertainable fair market value, the method of presentation on the tax return in the year of sale should be consistent with this position.

Installment Reporting on Sale of Corporation

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

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

This procedure allows the sellers to use installment reporting on the sale of their stock and ultimately to receive a mortgage on the real estate or other assets to secure the purchaser's installment obligation. Rev. Rul. 55-5 (1955-1 CB 291) appears to be authority for the proposition that the replacement of the mortgage for the stock as security does not accelerate the profit of the sellers. On the other hand, the purchaser must be alert for any potential income under Sec. 1245 or 1250 (depreciation recapture) or tax increase under Sec. 47 (early disposition of investment credit property) which might result from liquidating the corporation after he purchased the stock.

Installment Sales by Estates and Trusts

Where the property held by an estate or trust has increased in value and it is proposed that a sale be made on the installment basis, attention should be focused on the matter of acceleration of reporting the profit which results where the installment obligation is distributed, such as on the termination of the estate or trust. For example, if the proceeds of the installment sale are to be reported over a ten-year period and administration of the estate terminates one year after the sale, the profit which otherwise would be reportable over the remaining nine years becomes taxable to the estate in the year of termination. Obviously, the consummation of the sale should be deferred until after the asset has been distributed. Transfer of the installment receivable asset from the estate to a testamentary trust also would accelerate taxation of the installment profit, as would distribution of the installment obligation upon termination of the trust. By reason of Sec.

 453(d)(3), no acceleration results from transmission of installment obligations at death of the owner. In that event, the income element becomes an item of income in respect of a decedent and is taxable under Sec. 691.

Disposition of Installment Obligations

Sec. 453 permits a taxpayer to report gain from sales of property on the installment basis, provided certain conditions are met. Should the obligations received under installment sales be transmitted, distributed, sold or otherwise disposed of, recognized gain or loss results in the year of disposition. In dealing with transfers of installment obligations between related taxpayers, Sec. 453 and regulations issued thereunder have provided several exceptions to this general rule.

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

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

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

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

Where a corporation adopts a plan of liquidation under Sec. 337 and sells its assets, under an installment sale, within one year after adopting the plan, there is no gain to the corporation upon distribution of its installment obligations to the stockholders. This is so, provided the installment obligations were received from sales qualifying for nonrecognition under Sec. 337. The

Sec. 453

transferee stockholders, however, must take into consideration the fair market value of the installment obligations in computing the total received on liquidation. Gain or loss on liquidation of the corporation is then measured by the total value of assets received less the basis of the stock of the liquidated corporation.

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

Manufacturers May Use Installment Reporting

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

The IRS has issued a favorable ruling in this matter. As a result of the change, a substantial amount of federal income tax will be deferred.

Tax Savings by Accruing Savings Bond Interest

Sec. 454

Rev. Rul. 64-104, 1964-1 CB 223, dealing with the status of unreported increment in value reflected in the redemption price of Series E United States Savings Bonds as income in respect of a decedent under Sec. 691(a), serves as a reminder of the possibility of utilizing the election contained in Sec. 454 to minimize taxes. Under Sec. 454, a cash basis taxpayer (which includes most individuals) can elect to treat the annual incre-

Sec. 454 ment in Series E Bonds as income in the year it accrues. If the election is made, it applies to the entire amount of increment existing as of the beginning of the election year in addition to the amount accruing within such year.

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

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

Series E Bonds

Ownership of Series E United States Savings Bonds may be transferred, under Treasury Department regulations, to a person who holds one of certain specified close family relationships to the original holder.

Rev. Rul. 55-278, 1955-1 CB 471, makes clear that, in such a circumstance, the accrued interest (the increment in value, as represented by the excess of redemption value over original subscription price) is taxable to the donor *in the year of the gift* to the extent, of course, that the accrued interest had not been previously reported under the accrual method or under the optional method extended to cash basis taxpayers under Sec. 454(a).

Year-End Interest Accrual by Banks

Banks filing federal income tax returns on the accrual basis may not always be allowed a deduction for accrued interest on savings deposits. Where interest is computed only on deposits which are not withdrawn prior to the interest payment date and that payment date does not coincide with the bank's taxable year-end, the Commissioner has stated that a deduction for accrued interest is not allowable (Rev. Rul. 67-352, 1967-2 CB 176). Therefore, a calendar-year bank that credits interest to its accounts on November 1 may find that the accrual of two months' interest to December 31 could be subject to disallowance. The Commissioner argues that, since interest is not paid on funds withdrawn, the bank only has a contingent liability for the two months' interest. This position has been upheld by the Tax Court in *Peoples Bank and Trust Co.,* 50 TC 750 (1968).

A bank finding itself faced with this situation may avoid the problem by changing the interest payment date to coincide with its taxable year-end and thereby eliminate the need for an interest accrual. Another method would be to compute and allow interest on a monthly basis thereby creating a definite liability at year-end.

The above alternatives bring up a subsidiary question. Would such a change in the method of paying interest be a change in accounting method requiring the Commissioner's consent?

The Commissioner stated in his ruling that if a change is necessary to create a proper accrual it will be a change of accounting method requiring the Commissioner's consent. The decision in *Peoples Bank and Trust Co.* apparently supports this position. However, a change in interest payment practices was not before the Court. In another case not involving a bank where a change in billing dates was before the court, it was held that this was a change in business policy and not a change of accounting method requiring the Commissioner's consent (*Decision, Inc.* 47 TC 58 (1966)).

Reserve for Returns and Allowances

Generally speaking, reserves for estimated future expenses or losses are not deductible. Accordingly, taxpayers are ordinarily not entitled to current deductions for anticipated future cash discounts, warranty expenses, repairs and other similar items.

Sec. 461 There is a tendency to place an accounting reserve for returns and allowances automatically in the category of reserves for estimated future expenses. To the extent that such a reserve is designated to cover future returns or allowance claims which have not yet been asserted, this treatment is correct.

However, experience indicates that often a significant portion of a reserve for returns and allowances is designed to cover both returns which had been made before the end of the year, but not yet processed for credit, and allowance claims which had been asserted by the customer before the end of the year. Frequently the customers have sent to the seller a "debit memo" or some other chargeback advice.

A reserve, or portion of a reserve, to cover these latter items does not fall within the category of reserves for estimated future expenses. These items are already in dispute by the end of the taxable year. Ordinarily, a dispute precludes the accrual of income just as it precludes the accrual of a deduction. For example, Rev. Rul. 60-237, 1960-2 CB 164 states:

"Where the item (of income or deduction) depends upon a contingency or future events, it is not accruable until the contingency or events have occurred. Where the liability is substantially in controversy, *accrual of income or deductions must await* the resolution of the controversy." (Emphasis supplied.)

It seems that when a customer who has been billed asserts a charge against the seller, the customer is controverting the seller's claim, and the item is in dispute. In *Pennsylvania Match Co.* 4 BTA 944 (1926), it was held that a seller's income was properly reduced in the taxable year in which allegedly defective goods were returned and not in the subsequent year when the seller examined them and concurred that the goods were defective.

Sec. 471

Ruling Barring Inventorying of Real Estate Questioned

Is the inventory method of accounting available to members of the real estate industry? The IRS says "no" in Rev. Rul. 69-536 (IRB 1969-43). In *Atlantic Coast Realty Co.* (11 BTA 416 (1928)), which is cited in the ruling, the Board of Tax Appeals concluded that an earlier ruling to the same effect was reasonable. The Board noted that inventories were required where needed to reflect income clearly and upon such basis as "con-

forming as nearly as may be to the best accounting practice in the trade or business. . . ." quoting from an earlier version of the inventory provisions of the Code. The Board found that there was no evidence showing that inventories were practical in the real estate business.

Today, the inventory method of accounting is generally accepted for the real estate industry though it may not have been in 1928 when *Atlantic Realty* was decided. Therefore, it is submitted, *Atlantic Realty* does not support the ruling and the denial of the use of inventories to the real estate industry may be unlawful discrimination.

Lifo and Bargain Purchases

Sec. 472

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

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

As inventory is zero at the beginning of the year, the year-end inventory consists of new items entering a pool for the first time, and the base-year unit cost of each entering item is the current-year cost of that item, unless the taxpayer is able to reconstruct or otherwise establish a different cost (Regs. Sec. 1.472-8(e)(2)(iii)). Therefore, base cost and current cost can be treated as

Sec. 472 the same under Regs. Sec. 1.472-8(e)(2)(iv), and the resulting ratio for the first taxable year is 100%. In the second taxable year the comparison of base-year cost and current cost will result in a high ratio, which should hold the Lifo inventory down to the bargain-price level and prevent any large realization of gross profit. The Lifo election in such case should be made for the year in which the inventory is purchased.

Election of Lifo After Financial Statements Issued on Different Basis

Often the decision to adopt Lifo for federal income tax purposes for a taxable year may not be made until shortly before the due date of the return for the year of adoption. In many cases the decision on adopting Lifo for tax purposes will not have been reached at the time financial statements for the year may have been issued. Under these circumstances, may Lifo nevertheless be elected in spite of the requirement for reflecting Lifo in the financial statements contained in Sec. 472(c)?

The informal IRS view is that the issuance of financial statements before the filing of the taxpayer's return for the year of election would not invalidate the Lifo election as long as the taxpayer properly reflects the use of Lifo in subsequent financial statements.

Sec. 481

Change in Accounting Method: Spreading Positive Adjustment

Taxpayers requesting a change in accounting method on Form 3115 will be required to take a positive adjustment into income in the year of change, subject to the provisions of Sec. 481, unless a ten-year spread is specifically requested. Formerly, a ten-year spreadforward of the pre-1954 Code portion of the adjustment was specifically authorized by Sec. 481(b). However, this provision expired so that changes made for years beginning after December 31, 1963, must follow the general rule which provides at best for a spreadback to the two immediately preceding years.

A ten-year spreadforward is automatic under Rev. Proc. 64-16,

1964-1 CB 677, for both positive and negative adjustments. In addition, for method changes requested on Form 3115, it is understood that the National Office imposes a ten-year spread of negative adjustments as a condition of granting the requested change. This is not true where method changes involving positive adjustments are involved so that taxpayers must specifically request the ten-year spread of these adjustments.

This procedural difference is significant in cases where the taxpayer can request a change under either the revenue procedure or on Form 3115.

Sec. 482 Applicable Among Foreign Affiliates

Most U. S. companies with foreign affiliates have been principally concerned with the application of Sec. 482 to intercompany dealings between the U. S. parent and its foreign subsidiaries. However, the wording of Sec. 482 may be sufficiently broad to reach transactions between foreign affiliates if the resulting adjustments would affect the U. S. tax liability of the domestic parent.

An interesting example of the possible application of this type of adjustment is the creation by inter-affiliate allocations of subpart F income which is then taxed to the U. S. parent.

To illustrate the above, let us assume that Corporation *X*, a United States corporation, owns Corporation *Y*, a British corporation and Corporation *Z*, a Swiss holding corporation. Let us further assume that *Z* has made an interest-free loan to *Y*. Under Regs. Sec. 1.482-2 the Service may attempt to allocate to *Z* interest income which is derived from an appropriate arm's-length interest rate charged to *Y* for use of the loan.

The interest earned by *Z* would constitute foreign base company income and, since *Z* is a Swiss corporation subject to relatively low tax rates, *X* will recognize this income for United States tax purposes under Sec. 951.

Thus, if a base company located in a low tax country loans interest-free money to another foreign affiliate, there is a definite possibility that the Service will impute interest to the base company and subject the United States corporation to tax on this income under subpart F. It is not difficult to visualize similar results in other situations.

Sec. 482

Rev. Proc. 65-17 as a Protective Measure in Brother-Sister Corporation Situations

It may be advisable to invoke Rev. Proc. 65-17, 1965-1 CB 833, as a protective measure in a brother-sister corporation situation where Sec. 482 allocations are made. Assume the following facts: Individual A owns 100 per cent of the stock of corporations X and Y. A revenue agent proposes to adjust the pricing of intercompany sales from X to Y under Sec. 482 to meet an arm's-length standard. The effect is to increase the taxable income of X and decrease the taxable income of Y. In addition, the revenue agent proposes to treat the amount of adjustment as a dividend to individual A from corporation X and a capital contribution from A to Y.

Individual A can probably be protected from dividend consequences if corporations X and Y are granted permission under Rev. Proc. 65-17 to establish an account receivable due X from Y. Of course, the account must be satisfied in accordance with the terms of the agreement. Even if the revenue agent does not propose a dividend against the shareholder of the brother-sister corporations, it may still be advisable to make timely application under the procedure to forestall the finding of a dividend at a later date when the return of the shareholder is examined. But note that Rev. Proc. 65-17 may not be invoked for years beginning after 1964 if it is determined that the pricing arrangement was designed to avoid federal income taxes. See Rev. Rul. 69-630, (IRB 1969-51).

Relief From Sec. 482 Reallocations

Under Sec. 482, reallocation of income from a foreign affiliate to a controlling United States company often results in an increase in U. S. income taxes to be paid by the U. S. company. At the same time, the foreign income tax liability of the foreign affiliate generally will have been determined on the basis of the original treatment of the transactions giving rise to the 482 adjustment. The net effect is that the total of U. S. and foreign income taxes paid by the two companies could exceed what would have been paid if the transaction between the two companies had been consummated on a basis consistent with the 482 adjustment.

For years beginning prior to January 1, 1965, Rev. Proc. 64-54, 1964-2 CB 1008, provides relief where a Sec. 482 adjustment resulted in the economic double taxation just described. The relief granted was to allow the U. S. company to credit the foreign tax on the allocated income against the increase in U. S. taxes resulting from the allocation. For years beginning after December 31, 1964, relief under Rev. Proc. 64-54 is not available. There are, however, some avenues that might be utilized in reducing the effect of a Sec. 482 adjustment.

Regs. Sec. 1.482-(1)(d)(3) would allow a U. S. company to "set off" an adjustment proposed by the IRS. For example, if the U. S. company were selling apples at less than list price to a foreign affiliate and were also selling oranges to the same company at a price in excess of the list price, then the U. S. company could offset the excess price charged for the one commodity against the lesser price charged for the other commodities.

Although this setoff provision is new to the regulations under Sec. 482, in practice it has been generally accepted by the Service in the same circumstances.

Another remedy might be available where the tax treaty between the U. S. and the country of the foreign affiliate provides for relief from double taxation.

Under such treaty provisions, the U. S. company or the foreign affiliate may request that a correlative adjustment be made to the income of the affiliate. Although the provisions for relief from double taxation have been in effect in tax treaties for many years, the IRS only recently issued a Revenue Procedure implementing these provisions (Rev. Proc. 70-18, 1970-29 IRB, effective June 26, 1970).

Another avenue open to the U. S. taxpayer may be the utilization of the procedures of Rev. Proc. 65-17, 1965-1 CB 833, as amended, which continues to be available to taxpayers. Rev. Proc. 65-17, as applied to years beginning after December 31, 1964, provides that if the transaction giving rise to the 482 adjustments did not have as one of their principal purposes the avoidance of federal income taxes, then the U. S. company might repatriate from the foreign company the amount allocated under Sec. 482 without incurring any U.S. income tax. The Rev. Proc. also provides that if dividends have been received from the foreign corporation, such dividends may be received free of U. S. tax.

Factors that will be considered in determining whether or

 not the transactions resulting in the 482 adjustment had as a principal purpose the avoidance of federal income tax are listed in the Rev. Proc. Among these factors are dividends received from the foreign corporation, income tax (including foreign taxes) resulting from the transactions, and the extent to which the U. S. company attempted to comply with the 482 regulations in existence at the time of the transaction.

Where the U. S. company qualifies under Rev. Proc. 65-17 and elects to repatriate the Sec. 482 allocation, it will be required to include in taxable income interest at an annual rate of 5% on the amount of the adjustment. The interest is to be included in taxable income for each intervening year from the year for which the 482 adjustment had been made until the date of the repatriation.

Setoff Under Sec. 482 Regulations

Ordinarily, Sec. 482 which permits allocation of income and deductions among controlled taxpayers is available only to the Commissioner. However, when the Commissioner proposes Sec. 482 adjustments, Regs. Sec. 1.482-1(d)(3) provides the taxpayer an opportunity to raise other adjustments which will offset the proposed allocation.

Example: *X* Corporation sells its product to controlled Corporation *Y* for resale at 60% of the selling price charged third parties in arm's-length sales. Total sales to *Y* for the taxable year would have been $100,000 higher if the arm's-length price had been charged and the Commissioner proposes to increase *X*'s income by this amount with a correlative adjustment to the cost of sales of *Y*. However, *X* occupies part of a building owned by *Y* for which no rental is charged and for which a $50,000 rental value can be established. In this case, the value of the rental benefit received by *X* will be set off against the sales allocation. The setoff will be made in such a way as not to change the characterization of income or deductions.

An important point to remember is that the taxpayer must notify the District Director of the basis of any claimed setoff within 30 days after the date of the letter transmitting the revenue agent's report. A thorough review of operations for possible setoffs should be made immediately upon receipt of a report proposing Sec. 482 adjustments. Attempts to establish a setoff at conferences will probably be to no avail.

Contingent Stock, Escrowed Stock: Imputed Interest

In general, Sec. 483 provides that where property is sold for deferred payments and either no or an unusually low rate of interest is stated, an imputed interest factor is to be used. The section is applicable where the effective interest rate, if any, is less than 4% per annum simple interest and, in the event the 4% test is not met, the effective rate of interest to be used in imputing interest is 5% per annum compounded semiannually.

Regs. Sec. 1.483-2(a)(2) makes it clear that the concept of imputed interest applies to the transfer of contingent stock in connection with corporate reorganizations. Such contingent stock is stock which may be issued in the future in connection with a corporate reorganization under Sec. 368(a)(1). The Service has ruled that the use of contingent stock will not disqualify a reorganization so long as the six conditions set out in Rev. Proc. 67-13, 1967-1 CB 590, are met. Thus, subsequent delivery of contingent stock will represent, in part, interest expense to the acquiring corporation and interest income to the recipient.

A distinction must be drawn between reorganizations involving contingent stock and those involving escrowed stock. Under a contingent stock arrangement, only a portion of the stock consideration of the acquiring corporation is issued currently. Under the escrowed stock arrangement, all the stock consideration is actually issued and a portion of it is placed in escrow. The escrowed stock may have the right to vote currently and, in addition, may be canceled upon the happening of a subsequent event, such as a determination of undisclosed liabilities of the transferor. As illustrated in Examples (7) and (8) of Regs. Sec. 1.483-1(b)(6), the IRS adopts the position that the contingent stock arrangement does not represent a closed transaction for tax purposes while the escrowed stock arrangement is a closed transaction. Thus, the imputed interest theory is not applicable to escrowed stock.

Imputed Interest

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

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

Sec. 483

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

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

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

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

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

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

8. In computing income under Sec. 1372(e)(5) in determining the status of a subchapter S corporation. The effect of imputed interest could be particularly harsh for companies wishing to avoid an involuntary termination of subchapter S status.

9. In applying the rules under Secs. 861 and 862 relating to income from sources within and without the United States.

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

Accrual Basis Seller May Delay Reporting Interest Income by Using Sec. 483

Sec. 483 imputes an interest element when property is sold under certain circumstances for deferred payments when the terms of sale do not provide for an adequate rate of interest on the deferred payments. Failure to provide adequate interest results in the imputation of interest, presently at the annual rate of 5% compounded semiannually.

A significant aspect arises from the fact that, if the imputed interest rules apply, Regs. Sec. 1.483-2(a)(1)(ii) makes clear that in the case of an accrual method seller, the imputed interest applicable to any payment is taxable as income in the year in which the payment is due. This rule affords the accrual method seller the opportunity of delaying the reporting of interest.

Example. A capital asset was sold for a single payment of $100,000, payable on the tenth anniversary of the sale. Nothing was stated as to interest. Table I, Column (b), of Regs. Sec. 1.483-1(g)(2) indicates that on the due date of the payment the seller is entitled to receive proceeds from the sale of $61,027 and interest of $38,973 ($100,000 less $61,027). The $38,973 is taxable on that date (assuming no default in excess of 90 days). No interest was reportable at any earlier time. This deferral is indeed an oddity, especially when viewed in the light of such developments as the recent addition to the Code of Sec. 1232(a)(3), which requires immediate ratable reporting of unrealized original issue discount, even by cash basis taxpayers. (Incidentally, gain or loss on the transaction would be computed with reference to a sale price of $61,027.)

Sec. 483

Suppose, alternatively, that the contract of sale had called for a price of $61,027, payable on the tenth anniversary of the sale together with all accumulated interest at the rate of 5%, compounded semiannually. This would result in a single payment of $100,000 on the tenth anniversary. However, in this circumstance, adequate interest was stated, and Sec. 483 does not apply. The interest of $38,973 accrues over the ten-year life of the obligation, and interest would be reportable by the accrual basis seller in amounts increasing from $3,089 in the first year of the obligation to $4,819 in the obligation's tenth year. Accordingly, a substantial tax deferral may be effected by the accrual basis seller by structuring a deferred payment transaction to fall under Sec. 483.

The use or the avoidance of Sec. 483 should be carefully considered in a deferred payment sale to which the section is potentially applicable.

EXEMPT ORGANIZATIONS

Social Clubs and the Problem of Bona Fide Guests

Sec. 501

In recent years, the IRS has addressed itself to the extent to which clubs exempt from federal income tax under Sec. 501(c)(7) may make their facilities available to the general public.

 It is understood that this resulted from considerable pressure on the IRS from taxpaying restaurants and clubs.

As a result, the IRS issued Rev. Proc. 64-36, 1964-2 CB 962. In general, the procedure confines its blessings to annual gross receipts of the club from the general public of either (1) $2,500 or less, or (2) 5% or less of total gross receipts (as defined in the procedure).

The procedure defines "general public" as persons other than members of the club or their bona fide guests.

Who are bona fide guests? Certain employees of the IRS take the position that receipts from guests who pay their own expenses under a guest card are receipts from the "general public." Under their position, the term "bona fide guest" includes only guests whose expenses are borne and paid by a member. It does not exempt receipts from holders of a bona fide guest card.

This interpretation of "bona fide guest" does not seem valid. Rev. Proc. 64-36 specifically excludes club members *and* their bona fide guests from the "general public" category.

Furthermore, in *Coeur d'Alene Country Club* v. *Viley*, 64 F Supp. 540 (1946), a country club was held to be exempt even though 26% of its gross income was from greens fees paid by nonmember guests. The Court clearly indicated that it did not consider receipts from guests as receipts from the general public and, in fact, treated receipts from the general public as a separate category. Likewise, in *Aviation Country Club, Inc.*, 21 TC 807 (acq. 1954-2 CB 3), guest patronage payments were from 20 to 25% of the club's total receipts. The Tax Court did not see fit to hold that such receipts were from the general public.

It would appear, therefore, regardless of who pays their bills, members' guests are not the "general public." Nevertheless, clubs should be on notice that the IRS, in applying Rev. Proc. 64-36, may be applying a "who pays the bill" test. Clubs should also bear in mind the warning in the procedure of danger if the club, regardless of the gross receipts test, advertises or otherwise solicits outside business.

It should be kept in mind that the Tax Reform Act of 1969 extends the unrelated business income tax to Sec. 501(c)(7) organizations. Thus, for taxable years beginning after 1969, receipts by a club from the general public will be taxed notwithstanding the fact that such receipts are not substantial enough to cause the club to lose its tax-exempt status.

Exemption Rulings Are Sometimes Misleading

The private charitable foundation (organized either as a nonprofit corporation or as a trust) offers a particular advantage in that contributions can be made through a foundation, to individuals and unorganized groups which, if made directly, would be clearly nondeductible.

To avoid arguments with revenue agents about the deductibility of contributions to foundations, donors find it desirable to have a favorable Treasury ruling in advance. Until late in 1963, the Treasury required a foundation to operate at least one full year, and submit a list of all income and disbursements during that year, before it would consider issuing a ruling. Although the IRS no longer requires this waiting period as a matter of course (Rev. Proc. 69-3, 1969-1 CB 16), it has retained an option to do so. If a ruling follows the waiting period, the last paragraph regularly contains a statement to this effect: "This exemption may be jeopardized by distribution of your funds to . . . ." There follow the names of all who have received the foundation's funds who are not listed in the Treasury's latest "Cumulative List of Organizations Described in Section 170(c)." Such a warning naturally disturbs a client. Very logically he asks, "Does this mean my foundation cannot make any more contributions to the donees named? The "warning" does not mean this at all!

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

Sec. 642(c) allows a trust an unlimited deduction (as compared to the percentage limitations for individuals) for amounts devoted to charitable, etc., purposes. Again there is no requirement that contributions go only to organized and qualified donees.

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

Sec. 501 impairing its tax-exempt status if such contribution is within the scope of its permissible activities.

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

When the Treasury says a private foundation's status may be "jeopardized" by giving money outside the approved "Cumulative List," this means only that the Treasury will not guarantee *in advance* that grants to a given unlisted recipient fall within the foundation's charitable purposes. But foundations always have the right to show that, in fact, a particular grant was made with a charitable or educational motive, and that such distribution was therefore entirely proper.

Sec. 512 Aggregating Income and Expense of Unrelated Trade or Business

The exploitation of exempt functions is dealt with at some length by the regulations pertaining to unrelated trade or business income. The question arose recently whether an exempt organization with two unrelated business activities (two publications) could aggregate the income and expenses of the two businesses since one was very profitable while the other was only marginal.

The problem centered in an apparent conflict between Regs. Sec. 1.512(a)-(1)(a) and Regs. Sec. 1.512(a)-1(d). Regs. Sec. 1.512(a)-1(a), a definition section, is written in the plural, providing that two or more unrelated business activities may be aggregated. Regs. Sec. 1.512(a)-1(d), on the other hand, which deals with authorized deductions, is written in the singular, referring to one trade or business. Thus, it is not clear when referring to subsection (d) if the limitation in that subsection is to be applied on a single periodical basis or on the aggregate basis as suggested in subsection (a).

This question was discussed informally with IRS officials

at the National Office who confirmed that the two businesses could be combined. One of the conferees mentioned that the *Federal Register* requires regulations to be written in the singular whenever possible, and for this reason, subsection (d) was written as such. It was not written with the intention of limiting or denying the aggregating of unrelated business activities.

Sec. 512

CORPORATIONS USED TO AVOID INCOME TAX ON SHAREHOLDERS

One Distribution Does the Work of Two

Sec. 531

There is an opportunity to solve an accumulated earnings (Sec. 531) problem when a corporation has made a decision to elect subchapter S for a forthcoming year.

A dividend paid within 75 days of the end of the year will be considered as a distribution of the previous year's earnings and profits (Sec. 563(a)). This same dividend will be considered to be a distribution of the current year's subchapter S undistributed taxable income. It is possible, therefore, to solve two problems with one dividend distribution.

Tax-Free Exchanges of Personal Holding Company Assets

Sec. 541

Many personal holding companies are in the position of owning assets which have substantially appreciated in value. Some owners of these companies would like to liquidate them, but find for one reason or another that it is not practicable to do so under Sec. 333, and hesitate to liquidate because of large inherent capital gain tax which would naturally result in shrinkage of principal. Some open-end investment companies are offering to acquire for their own stock either the stock or assets of personal holding companies resulting in tax-free exchanges qualifying under provisions of Sec. 368(a)(1)(B) or (C). Of course, the "continuity of business enterprise" requirement of Regs.

Sec. 541

Sec. 1.368-1(b) must be satisfied for the transaction to qualify as a reorganization. But see the liberalized treatment of this requirement in Rev. Rul. 63-29, 1963-1 CB 77.

Generally, there is no "loading" charge made by the investment company on its shares so issued. However, if there is a substantial difference between the unrealized appreciation of the personal holding company assets and the investment company assets, some adjustment in the number of investment company shares to be issued will be necessary. Any such adjustment normally will be less than the tax liability which would result from the sale of the assets.

Under appropriate circumstances an exchange of this type should be quite attractive to the personal holding company shareholders. There is no diminution of capital invested by reason of capital gain tax paid, shares of an investment company whose earnings and dividends receive favorable tax treatment are received and, of course, the shares are readily marketable.

Thoughts on the Sale of a Business

The following comments relate to certain aspects of a change in ownership of a business from the viewpoint of the seller.

If the business assets are to be sold at amounts not greatly in excess of book values, the advantages of retaining the selling corporation as a personal holding company should be considered. This would be most appealing if the shareholder's cost basis of the corporate stock were quite low. If the cash realized from the sale were invested in stock of domestic corporations, only 15% of the dividend income would be subject to corporate income taxes, and in many situations this could go on for a long time and the resulting corporate taxes would be relatively small in relation to capital gains taxes that would have resulted from prompt liquidation. The corporation could be continued until the death of the principal shareholders, when the corporation might be liquidated or the decedent's stock retired or, if possible, partially redeemed under Sec. 303.

In situations in which the corporation sells its business assets and continues in existence, and if there is substantial income in the year of the transaction, the question of applicability of the Sec. 531 tax on accumulated earnings might be raised. Business needs would hardly be a factor if the assets at year-end consisted of cash or investments. Careful timing of dividend

Sec. 541

payments may offer some relief. In the year of the transaction it is unlikely that the corporation would be a personal holding company, but it no doubt would be in the following year. Sec. 563(a) provides that for purposes of the Sec. 531 tax a dividend paid within two and one-half months after the close of the year shall be considered as paid during the prior year. In computing undistributed personal holding company income under Sec. 545(a) and 561, credit is given for dividends paid during the year. Thus a dividend paid in the first two and one-half months of the year following the sale of the business assets does double duty.

Consider a case where the corporation continues in existence, but the assets are sold at an amount that results in a loss in the year of the transaction. This loss may, of course, be carried back against prior years' income and thus there is an advantage in "cleaning up" pending matters so that any resulting cost or expense may be reflected in the carryback loss. It is assumed that the corporation will become a personal holding company and this same operating loss that has already been carried back against prior years' income may, under Sec. 545(b)(4), be deducted in arriving at undistributed personal holding company income in the following year. In this circumstance, the operating loss also does double duty.

Personal Holding Company and A Consolidated Return

Sec. 542

Frequently a taxpayer discovers that a member of an affiliated group, standing alone, is a personal holding company (PHC). Following this discovery, he may conclude that the problem may be avoided by filing a consolidated tax return and making the PHC test on a consolidated basis.

However, the provisions of Sec. 542(b)(2) should not be overlooked. Sec. 542(b)(2) provides that an affiliated group is ineligible for the consolidated PHC computation if (1) any member of the affiliated group derives 10% or more of its adjusted ordinary gross income from outside the group, and (2) 80% or more of that outside income is PHC income as defined in Sec. 543. Note that it takes only one member of the group to make the entire group ineligible.

Moreover, if any member of the affiliated group is excluded by Sec. 542(c) from PHC status (banks, insurance companies,

Sec. 542 etc.), the PHC test cannot be determined on a consolidated basis even though all other requirements are satisfied.

If there is any doubt, it may be advisable to have a subsidiary which is or may be a PHC distribute its income. By such a dividend, the paying company can avoid the PHC tax if it is later determined that the affiliated group was ineligible for a consolidated determination of PHC liability. The dividends paid would be tax free within the consolidated group. Of course, care must be taken to ensure that the distribution of the dividend will not result in the payee being classified as a PHC.

Sec. 543-45 Short-Term Capital Gains and Personal Holding Companies

In determining personal holding company status we find that adjusted ordinary gross income (Sec. 543(b)) excludes all gains from the sale or other disposition of capital assets. That is to say that capital gains are eliminated from both the numerator and the denominator of our fraction that measures the critical 60%.

For example, a corporation has $1 of dividends on securities and $10,000 short-term capital gain. The personal holding company income is, therefore, $1, and the adjusted ordinary gross income is also $1. This corporation is a personal holding company because at least 60% of its adjusted ordinary gross income is personal holding company income.

We are now confronted with the computation of undistributed personal holding company income. That starts not with personal holding company income but with taxable income. One of the deductions allowed in computing undistributed personal holding company income is the excess of net long-term capital gain over net short-term capital loss for the taxable year. Since the capital gains in our example are short-term capital gains, we cannot use such gains as a deduction in computing undistributed personal holding company income. We therefore find ourselves in the peculiar position of having to pay a 70% personal holding company tax on the short-term capital gain, even though such gain was excluded from the definition of personal holding company income and also excluded from the definition of adjusted ordinary gross income.

Looking once again at our example, we would have $10,001 of undistributed personal holding company income which would be

taxed at 70%. If the securities could have been held until the gain became long-term capital gain, we would then have an undistributed personal holding company income of $1 ($10,001 of income, less $10,000 of net long-term capital gain, as allowed by Sec. 545(b)(5)).

What to do? The answer, obviously, is to hold these securities for more than six months. This can save $7,000 of personal holding company tax. Otherwise a dividend of $10,000 must be paid to accomplish the same result.

Capital Loss Carrybacks and Personal Holding Companies

Sec. 1212(a)(1)(A), as amended by the Tax Reform Act of 1969, now generally allows corporations to carry back for three years a net capital loss incurred in a year beginning after 1969. This carryback is subject to certain special rules, none of which though relate to personal holding companies.

Accordingly, it appears that the effect of capital loss carrybacks on personal holding companies—specifically, on undistributed personal holding company income—must, at least at this time, be determined on the basis of existing precedents.

Three portions of Sec. 545 immediately suggest themselves for consideration:

Sec. 545(a), which states that the "starting point" for computing "undistributed personal holding company income" is the taxable income of the year;

Sec. 545(b)(1), which allows a deduction for federal income taxes; and

Sec. 545(b)(5), which allows a deduction for the excess of the net long-term capital gain for the taxable year over the short-term capital loss for such year, reduced by federal income taxes applicable to such excess.

Although the point is arguable, it appears that the undistributed personal holding company income of a taxable year is retroactively reduced by the carryback of a net capital loss from a subsequent taxable year. In support of this conclusion, Sec. 1212(a)(1) treats the carryback as a short-term capital loss in the year to which it is carried back; it therefore is taken into account as a reduction of the taxable income "starting point," assuming that there was a net capital gain (either short-term, or long-term, or both). There seems to be no question that a

 capital loss carryover, to the extent used to offset capital gains of the year to which carried, reduces the taxable income "starting point." Finally, if the rule were otherwise, the amount of the carryback effectively used as an income tax deduction would never be deductible in computing undistributed personal holding company income because the amount thus used would never enter into the computation of the taxable income "starting point" of any other taxable year.

The effect of the carryback upon the deduction for federal income taxes under Sec. 545(b)(1) is even more arguable. In general, a deduction is allowed for income taxes *accrued*, even though the corporation reports on the cash method. Rev. Rul. 6 (1953-1 CB 120) holds that a reduction in federal taxes by reason of a net operating loss carryback from a subsequent year does not accrue until the close of the loss year. Concededly, this ruling dealt with the predecessor of Sec. 535(b)(1), relating to the determination of the accumulated earnings tax. However, the present Sec. 535(b)(1) is identical with the first sentence of Sec. 545(b)(1). Such precedents as Rev. Rul. 173 (1953-2 CB 227), which holds that the amount of federal income taxes used as the base for the computation of an ad valorem penalty (negligence, delinquency, or fraud) is not reduced even though the taxes are in fact reduced by the carryback of a subsequently incurred net operating loss, may seem even further afield; but at least they do not point to a different conclusion. On the other hand, Rev. Rul. 6 does lead to an inequitable result: If a personal holding company had only short-term gains (which were eliminated or reduced by a carryback), it does not seem fair to reduce taxable income for the capital loss carryback, while continuing to deduct the original, unreduced, amount of federal income tax.

The third consideration, Sec. 545(b)(5), seems to present the least problems. An excess of net long-term capital gain over net short-term capital loss may, of course, be reduced by a capital loss carryback. However, this excess (before the carryback) was eliminated from undistributed personal holding company income. A reduction by the carryback would thus have no effect. While the excess is reduced by federal income taxes attributable thereto, there seems to be no major difficulty in making a commensurate reduction in the attributable federal income taxes.

The significant point is that a capital loss carryback (to the extent applied against a net short-term capital gain) represents a potential benefit to personal holding companies and their stockholders. If, before the carryback, there was undistributed

personal holding company taxable income subject to a 70% tax rate, the amount of the tax would be reduced. Even if no tax was paid because of a sufficient deduction under Sec. 561 by reason of dividends paid during the taxable year, it appears that the capital loss carryback would create a dividend carryover under Sec. 564. This carryover could reduce dividend requirements for the two years following the year in which the carryback was applied. However, if the carryback was applied in the third taxable year preceding the year of the net capital loss, the news of the capital loss would probably arrive too late to be of any benefit, since the dividend carryover period is only two years. (There might be some relief if the company had used the Sec. 563(b)(2) deduction (formerly 10%, now 20%) for dividends paid after the close of the taxable year.)

Sec. 545

The above complexities may explain why the Tax Reform Act of 1969 did not deal with the impact of capital loss carrybacks on personal holding companies. It is, however, quite clear that legislation should now be addressed to the uncertainties which have been created.

Distribution of Appreciated Securities as a Dividend

Sec. 561

Where a corporation owns appreciated securities which are readily marketable, it often is desirable to pay out a portion thereof as a dividend in kind. The corporation does not have to pay the capital gain tax on the appreciation although the dividend to individual shareholders is taxed on the basis of the market value of the shares so distributed. However, this practice may have limited value for personal holding companies and corporations vulnerable to the penalty tax on unreasonable earnings under Sec. 531. These two penalty taxes are mutually exclusive and cannot be applied to the same corporation in a taxable period. Regs. Sec. 1.562-1 states in part that the amount of the dividends-paid deduction with respect to a distribution in property shall be the adjusted basis of the property in the hands of the distributing corporation.

Take the case of a personal holding company or a business-type corporation which has a net income after tax of $25,000 and distributes 1,000 shares of stock of a listed company having a market value of $25 a share but a cost basis of $5 a share. The company has paid out only $5,000 in dividends for the year in terms of the dividends-paid deduction and $20,000 of

Sec. 561 undistributed earnings remain under either Sec. 541 or 531. The personal holding company provisions would apply automatically, but the tax on unreasonable accumulations does not operate on mechanical principles.

In the assumed situation, since the stockholders have reported total dividend income equal to the net income of the corporation after tax for the year, it is unlikely that the IRS could urge successfully under Sec. 531 that there has existed in the corporation a purpose of avoiding the income tax with respect to its shareholders. However, if the total of the value of the distributions to stockholders in kind and cash during the year was less than the net income after taxes, Sec. 531 might apply. Accordingly, in this type of situation, as well as in a personal holding company, it is not advisable to distribute low-cost, high-market-value assets as a dividend. However, see the following item for an example of distribution of high-basis-low-value assets.

Sec. 562 Property Dividends by Personal Holding Company

P Company, a personal holding company, frequently realizes capital losses from the sale of securities. Instead of selling securities which have declined in value, a tax advantage can be obtained by distributing them as a property dividend. The result is that the corporation receives a dividends-paid deduction equal to the basis of the securities so distributed, while the stockholders include only the value thereof in taxable income. Dividend income of the shareholder is thus reduced in the amount of the loss not taken by the corporation. Since the stockholders are in high tax brackets, overall tax saving is sizable.

The advantage of this technique as compared to selling the stock at a loss and then distributing the proceeds is that the capital loss on a sale is not deductible in determining undistributed personal holding company income while the distribution in kind, in effect, secures the deduction of the loss and enables the corporation to retain earnings at a tax cost not to exceed 25%.

Sec. 563 Reorganizations—Dividends Paid After Close of Year

Companies which would otherwise be subject to the accumulated earnings tax imposed by Sec. 531 (because adjusted taxable income exceeds the sum of dividends actually paid during

the part of the year subsequent to the first two and one-half months plus whatever accumulated earnings credit might be available) may pay dividends on or before the 15th day of the third month following the close of the year. In accordance with Sec. 563(a) and (c), these dividends are deemed to have been paid during, and on the last day of, the preceding year and thus will eliminate, or at least reduce, the tax otherwise imposed under Sec. 531.

In effect, corporations which would otherwise be liable for payment of tax under Sec. 531 may defer the dividend impact on its shareholders. In a situation where all taxpayers use the calendar year, a tax deferral of one year is possible.

A corporation which is thus retaining current earnings in excess of the reasonable needs of its business may become a transferor corporation in a reorganization. For example, it may be the absorbed corporation in a statutory merger or it may transfer substantially all its assets to another corporation in a "C" reorganization. In either of these cases the corporation's taxable year will close by reason of Sec. 381(b).

With respect to the accumulated earnings tax, it would seem that the ability to create a dividends-paid deduction by payment after the close of the year has been cut off. The acquiring corporation is a different corporation, and no authority seems to permit the association of a dividend paid by one corporation with the undistributed taxable income of a different corporation.

Note that the above problem does not arise in a "B" reorganization, in which the acquired corporation remains in existence. The reorganization does not end the fiscal year of the acquired corporation (unless the acquired corporation joins a new affiliated group which files a consolidated federal income tax return). In any event, a timely dividend to the new parent will qualify for the dividends-paid deduction (Rev. Rul. 68-409, 1968-2 CB 252).

A parallel problem is present with respect to dividends by a personal holding company, which ordinarily may also be paid on or before the 15th day of the third month following the close of a taxable year, but only to a maximum extent of 20% of the dividends paid during the year. Fortunately, a personal holding company does have the benefit of Sec. 381(c)(17), under which the acquiring corporation in a reorganization may pay a deficiency dividend with respect to an acquired corporation.

Of course, if the corporation subject to a tax liability under

Sec. 563 either Sec. 531 or 541 is the surviving, or transferee corporation in a reorganization, the above problem does not exist. In any event, special attention should be given to all Sec. 531 and 541 problems in considering reorganizations.

Post-Year Dividends May Not Be PHC Escape Hatch

Dividends paid within two and one-half months after the close of a taxable year are not a reliable method of averting personal holding company tax. Consider the following example:

XYZ CORPORATION
Year Ended 12/31/69

Gross rental income	$100,000
Dividends and interest	15,000
Ordinary gross income	$115,000
Depreciation, interest expense, property taxes	35,000
Adjusted ordinary gross income	$ 80,000

Since the $65,000 adjusted rental income ($100,000–$35,000) exceeds 50% of the $80,000 adjusted ordinary gross income, the first half of the test to avoid personal holding company (PHC) classification is met. The second test requires that other PHC income be less than 10% of ordinary gross income. If more than 10%, the excess must be distributed as a dividend or the corporation will be a personal holding company (Sec. 543(a)(2)(B)). In this example, other PHC income of $15,000 exceeds 10% of ordinary gross income (10% × $115,000 = $11,500) by $3,500. Dividends of at least $3,500 must be paid to avoid PHC status.

Dividends may be paid during the year but many companies do not know the extent of their personal holding company problem until after year-end. Dividends paid within two and one-half months after the close of the taxable year may be considered as paid during the taxable year (Sec. 563(c)). But Sec. 563(b)(2) limits these post-year dividends to 10% of the dividends paid during the taxable year in computing the dividends paid deduction. (The 1969 Tax Reform Act amended Sec. 563(b) to provide for a 20% maximum limitation, rather than 10%, for taxable years beginning after December 31, 1969.) Approximately 91% of the $3,500 in required dividends, or $3,200, must be paid within the taxable year. Only 10% of the total dividends,

or $320, may be paid within the two and one-half months after the close of the year. *Sec. 563*

If dividends during the taxable year were insufficient to distribute the excess personal holding company income, the corporation still has one last resort—consent dividends (Sec. 565).

The stockholders may elect to include the $3,500 as a dividend constructively distributed on the last day of the corporation's taxable year. But the $3,500 is treated as a simultaneous contribution to paid-in capital and cannot be distributed tax free to the stockholders. This is the big deterrent to consent dividends. Another drawback is the requirement that consents must be filed not later than the due date for the corporation's returns.

A corporation may inadvertently become a personal holding company if it erroneously relies on dividends paid within the two and one-half month period to escape such classification. Assume that no dividends were paid during the taxable year and the corporation distributed $3,500 during the two and one-half month period in the mistaken belief that PHC status would be avoided. Consent dividends would not be available after the due date of the return and the corporation may be faced with a prohibitive PHC tax upon IRS examination. The only recourse would then be a deficiency dividend of the *entire* undistributed personal holding company income, not merely $3,500.

BANKING INSTITUTIONS

A Novel Solution to a Sec. 593(f) Problem

Sec. 593

Sec. 593(f) provides, in the case of a savings and loan association, that any dividend distribution in excess of earnings and profits accumulated since 1951 or any distribution in redemption of stock will be deemed to be a distribution out of the tax bad debt reserve. As provided in Sec. 593 (f)(2), the amount charged against the bad debt reserve, and required to be included in income, is a grossed-up amount. The grossed-up

Sec. 593 amount included in income is apparently not part of the income meeting the requirements of the 85% gross income test for a savings and loan association and is also not specifically excluded in computing the 85% gross income test. See Regs. Sec. 301.7701-13(c)(3)(ii).

It therefore appears that such created income is part of the ineligible 15% income. Thus if other ineligible income plus the created income exceeds 15%, the gross income test is not met. Consequently, the association would not be an association for tax purposes, and the provisions of Sec. 593 are then not applicable.

The moral appears to be that if a dividend must be paid or stock redeemed, the amount involved should perhaps be large enough so that the gross income test is not met, thus avoiding the application of Sec. 593 for the year. Of course, the association loses a bad debt deduction, but there are some situations where this may be of no importance, such as where the reserve limitations may be already exceeded.

It should be noted that the gross income test was evolved by the Treasury in an effort to apply the statutory requirement that substantially all the business of a savings and loan association shall consist of investing in real property loans. Accordingly, the regulations provide that even if an association does not meet the gross income test it will nevertheless meet the statutory requirement if it can demonstrate that substantially all its business consists of investing in the prescribed loans; also that transactions which are necessitated by exceptional circumstances will not be considered a substantial part of the association's business. The IRS might therefore contend that the association is subject to Sec. 593(f) treatment under the foregoing facts.

NATURAL RESOURCES

Sec. 612 Bonus Depletion Restoration

If a lease expires without production, Regs. Sec. 1.612-3(a)(2) requires that the prior depletion deduction taken by the lessor

with respect to the bonus received must be restored to income. For many years it has been accepted practice that such restoration is not required where the lessor has received even nominal amounts from the sale of minerals extracted. Primary authority for this tax treatment has been the *Dolores Crabb* decision, 41 BTA 686.

In the *Crabb* case the Court held that the depletion taken ($4,125) on a bonus payment ($15,000) should not be restored to income because there had been actual production from the lease, even though small in amount (lessors' portion–$36.98).

In *Seth Campbell,* 41 TC 91, the lessors had received a lease bonus of approximately $70,000 in January 1959. The lessee drilled a well shortly thereafter and in the process of attempting to complete the well, recovered approximately 15 barrels of new oil along with 270 barrels of load oil. The lessee failed in its efforts to make a producer and abandoned the lease in May 1959. Subsequently, the lessors were successful in collecting a royalty of $1.84 with respect to the 15 barrels of new oil recovered from the well. Under these facts, the Tax Court held that the lessors were not entitled to percentage depletion with respect to the bonuses received. The Court distinguished *Crabb* since in that case, except for unsuccessful methods employed, a commercial well might have resulted and, furthermore, the bonus had been received in a year prior to the year in which the lease expired. (The well had actually been abandoned in the year the lease bonus was received.) In the concurring opinion in the *Campbell* case, several judges expressed the belief that the *Crabb* case should no longer be followed.

In 1968 the IRS withdrew its acquiescence in the *Crabb* case and substituted its nonacquiescence therefor. The test currently being applied by some field personnel of the IRS requires restoration of bonus depletion unless the lessee obtains a commercial well. They are interpreting "commercial" to mean that the well produces income in excess of currently incurred out-of-pocket operating costs. There is no clarification yet whether such production must occur for any specific length of time.

Although the revocation of the prior acquiescence in *Crabb* did not officially transpire until early 1968, some IRS personnel are proceeding under the assumption that the revocation is applicable to all non-statute-barred years.

ESTATES, TRUSTS, BENEFICIARIES AND DECEDENTS

Sec. 642 Estate Loss Available to Beneficiary Prior to Termination

As a general rule, beneficiaries of an estate or trust are denied the benefit of any excess estate or trust deductions except in the year of termination of the estate or trust. In that year, beneficiaries may deduct net operating loss carryovers, capital loss carryovers and an excess of deductions on termination (Sec. 642(h)).

Sometimes, in a year prior to the year of termination, an estate will have accounting income, but from a taxable income standpoint will have a loss. If the net loss is partially attributable to depreciation, and if all or a portion of the accounting income for the year has been distributed to a beneficiary, the question then arises as to whether the beneficiary may utilize all or a portion of the net loss attributable to depreciation.

Sec. 642(e) provides that depreciation is deductible by an estate or trust only to the extent it is not allowable to the beneficiaries under Sec. 167(h). In the case of an estate, Sec. 167(h) requires that the depreciation deduction be apportioned between the estate and the heirs, legatees and devisees on the basis of the income of the estate allocable to each. Regs. Sec. 1.167(h)-1(c) does not amplify the language of the Code.

The term "income" as used in these provisions apparently has reference to trust and estate-accounting income. These terms are used in most of the tax service instruction booklets for preparation of a Form 1041.

An allocation according to income appears to be mandatory. This conclusion was reached in *Estate of Ida Wray Nissen,* 41 TC 522, reversed by the Fourth Circuit Court of Appeals but on other grounds. The Fourth Circuit recognized that the provisions concerning depreciation for estates differ from those concerning trusts in that they do not provide for apportioning the allowable depreciation deduction in accordance with the terms of the governing instrument.

According to the Fourth Circuit in the *Nissen* case, there is one limitation on the allocation, however. The terms "heirs, legatees, and devisees" do not include all persons who might possibly

derive some pecuniary benefit from an estate. Thus depreciation could not be allocated to discretionary income distributees who received distributions of income from the estate, because they did not have any right to the corpus and were not heirs, legatees or devisees under the applicable local law.

There is very little authority interpreting Sec. 167(h) with respect to estates. The legislative history is conflicting. (See S. Rep. No. 1622, 83rd Cong., 2d Sess., with respect to Sec. 167(h)—which was then 167(g), Sec. 611(b)(4) concerning depletion, and Sec. 642(e).)

Consider the following example. In a year prior to the year of termination, both accounting and taxable income of an estate, exclusive of depreciation, is $10,000, all of which is distributed to the sole beneficiary of the estate. If for income tax purposes depreciation is $15,000, said deduction of $15,000 should be available to the beneficiary so that he will have a net deduction of $5,000 to offset other income on his individual income tax return.

In situations where the depreciation deduction will exceed the estate accounting income, the fiduciary has some tax planning flexibility. The distribution of the accounting income should pass down a depreciation deduction to the beneficiaries, or, if distribution is not made, the nature of the depreciation deduction is such that in many cases it will probably be a part of a net operating loss carryback or carryover. The ability to "distribute" a depreciation loss from an estate to a beneficiary presents a tax planning opportunity which may sometimes be overlooked. If corpus disbursements are deducted for income tax purposes, then the advantage to the beneficiary may be even more significant.

This comment respecting depreciation is generally applicable to depletion also.

Capital Gain Deduction in Year of Termination

It is often the case that an estate or a trust has sizable capital gains and comparable deductions in its final year. In such an instance, the distribution deductions would reduce the fiduciary's taxable income to zero. On the surface it would appear, therefore, that the fiduciary would not be allowed a capital gain deduction. This appearance is fallacious, however, since the fiduciary would, in fact, be allowed a capital gain

Sec. 642 deduction on any capital gains not distributed to the beneficiaries (Sec. 1202).

For example, assume an estate has only an $80,000 long-term capital gain and a $30,000 interest expense deduction in its year of termination. The estate's return should show:

Long-term capital gain		$ 80,000
Interest expense		(30,000)
		50,000
Distribution deduction	$50,000	
Capital gain deduction	15,000	
Exemption	600	(65,000)
Taxable income		$(15,600)

The capital gain deduction is allowed since the estate distributed only $50,000 of its $80,000 capital gain. The deduction available is 50% of the remaining $30,000 not distributed. Sec. 642(h)(2) provides, in part, that if upon termination an estate has for its last taxable year deductions—other than its personal exemption and charitable contributions—in excess of gross income for such year, the excess is to be allowed as a deduction to the beneficiaries succeeding to the property of the trust. The $15,000 capital gain deduction of the estate that is in excess of its gross income, therefore, is not lost. Instead each beneficiary is entitled to his proportionate share of the estate's excess capital gain deduction. This amount is to be used by the beneficiaries only as a deduction *from* adjusted gross income and there are no carryover attributes available for the deduction (i.e., any unused portion of the deduction is lost).

Effect on Beneficiaries of a Trust's Loss Carryback

Some time ago there were filed refund claims for beneficiaries of a trust on the basis that distributions by the trust were nontaxable because a net operating loss carryback from a later year was sufficient to eliminate the distributable net income of the trust for the year of the distribution. The revenue agent who examined the claims took the position that the net operating loss carryback did not change the taxability of the original distributions.

In answer to a request for technical advice, the National Office

overruled the agent and allowed the refund. It stated that Sec. 642(d) allows an estate or trust the benefit of a net operating loss deduction. In addition, it stated that Sec. 643, which defines distributable net income, does not require taxable income to be modified by the elimination of a net operating loss deduction. Therefore, distributable net income is determined by taking into account a net operating loss deduction, even though the loss arose in a year following the year of the distribution. *Sec. 642*

See also Rev. Rul. 61-20, 1961-1 CB 248, relating to estates, which is to the same effect.

Distributable Capital Gain of Estate

Sec. 643

Suppose investment real estate is sold by an estate at a gain, and it constitutes the only taxable income of the estate. Suppose further the proceeds are distributed to one of several residual beneficiaries, in full settlement of his interest in the estate. Is the capital gain part of the distributable net income under Sec. 643 of the Code? While capital gains are ordinarily excluded from distributable net income, it seems apparent that in this situation the capital gain has actually been distributed to a beneficiary and that, accordingly, it is deductible by the estate and taxable to the beneficiary to whom it is distributed. (See Regs. Sec. 1.643(a)-3(a)(2).)

Where this type of situation arises the incidence of the capital gains tax should be covered in the agreement between the estate and the beneficiaries in advance of the sale of the property.

Pour-Over Trusts and Income Taxes

Sec. 651-63

Sometimes a testator sets up a trust during his lifetime, and in his will he provides for additions to the trust. This has an income tax disadvantage. The setting up of a separate trust in the will would create a new taxpayer and a new climb up the rate brackets. An addition to the originally created trust adds more income in the upper brackets to that trust. The practical and administrative advantage of one trust can be accomplished by providing in the will that both trusts can be administered as one for convenience, but that they are each to be separate entities. This accomplishes both simplicity and tax economy.

Sec. 651-63

Foreign Trusts Still Present Tax Savings Possibilities

Creation of foreign trusts under certain circumstances still appears to present tax savings possibilities despite the tightening of the rules with respect to distributions of accumulated income and capital gains. For example, assume cash is transferred by a U.S. citizen to a foreign trust created by him. The trust provides for distribution of current income, accumulation of capital gains, and termination of the trust ten years and one day after the cash is transferred. The income beneficiaries are nonresident aliens, relatives of the creator, and the creator's wife is the remainderman. The income derived by the foreign trust, including capital gains, will be from sources outside the United States. The trust will be managed by a foreign trustee not related to the grantor. No powers are reserved by the grantor which would treat him as the owner of any part of the trust under the grantor-trust rules of Secs. 671-677.

Since the trust is a simple trust and the grantor is not considered as the owner of any part of the trust, the capital gains accumulated by the trust will not be subject to U.S. income taxes. Nor will the capital gains be taxable to the U.S. remainderman under the throw-back rules when distributed on termination of the trust, since the trust is required to distribute ordinary income currently. The income will not be subject to U.S. tax since it will be derived from sources outside the U.S. and distributed to nonresident aliens.

In addition, there may be interest equalization tax savings. Cash transfers to the trust are presumed to be for the purpose of acquiring foreign securities and subsequent investments by the trust will therefore be subject to the tax. However, later reinvestments should not be taxable. Only acquisitions of foreign securities by U.S. persons, including domestic trusts, are subject to the tax. Since the foreign trust is a not a U.S. person, and no part of the trust is treated as owned by a U.S. person under the grantor-trust rules, the turnovers in foreign securities will not be taxable.

Possible Inequitable Effect of Corpus Distribution From Estate

An important tax effect apparently results from a distribution of corpus to one residuary beneficiary if there is an inadequate,

or no, distribution to other residuary beneficiaries in the same taxable year of the estate. Under Sec. 661(a), provision is made for the deduction of "other amounts" properly paid or credited by an estate or trust. Correspondingly, Sec. 662(a)(2) provides that any such distribution is includable in the taxable income of the beneficiary with certain exceptions as provided by Sec 663.

In the case of a trust, a distribution to a beneficiary without corresponding distributions to other beneficiaries may constitute taxable income to the distributee only to the extent of his proportionate share of the distributable net income of the trust, if the accounting requirements of Sec. 663(c), and Regs. Sec. 1.663(c)-1 with respect to separate shares being treated as separate trusts are satisfactorily met. This procedure for limiting taxability to a beneficiary where other beneficiaries do not receive distributions is applicable only to trusts.

There is no corresponding specific limitation in the case of a distribution from an estate. Thus, assuming that a corpus distribution to a residuary beneficiary exceeds the amount of the distributable net income, with no distribution to other residuary beneficiaries during the same taxable year of the estate, the distributee will be taxable on the estate's entire distributable net income for such year. Where such effect would be undesirable, there should be sufficient distributions to the other beneficiaries within the taxable year to result in equitable tax consequences.

Income Tax Planning for Estates and Trusts

The decedent's estate passes under his will partially to Trust A (a marital deduction trust) and partially to Trust B, the surviving wife being the income beneficiary of each trust. Two plans for tax saving or deferment have been proposed. The beneficiary uses the calendar year. The estate will adopt a fiscal year ending February 28, and the two trusts will adopt a fiscal year ending January 31. The result of this plan will be that the income of the estate for Year 1 (if distributed) will fall into the trusts' returns for Year 2 and from there (if distributable) into the beneficiary's return in Year 3. Thus, a dollar of income derived by the estate for the year ended February 28, 1966, will be includable (if distributed) in the returns of the trusts for the year ending January 31, 1967, and (if distributable) in the beneficiary's return for the year ending December 31, 1967.

Distributions of income of the trusts to the beneficiary are

mandatory. On the surface this seems to eliminate the trusts as taxable entities so far as dividing the income in such a manner that it would be isolated in the hands of the trusts and taxed at lower rates. A plan has been evolved, however, whereby distributions of corporate stock owned by the decedent will be made from the estate to the two trusts. The view is that this will constitute a distribution of income to these trusts for federal income tax purposes but that for trust accounting purposes under state law, such distribution will be considered a distribution of corpus and, therefore, the trustee will not be required to make distributions to the beneficiary. The amount distributed to the trusts will therefore be taxable to them. Cash distributions will be made directly to the widow by the estate pursuant to a paragraph of the will which authorizes such distributions. The overall result will be the division of the income received by the estate into four approximately equal amounts taxable to the estate, each of the two trusts, and to the widow with the resulting minimization of federal income tax liability. The success of this plan will depend upon local law, although in most states the rules applicable to these exact facts are probably as outlined above.

Example: The estate of O has a corpus of $200,000, and distributable net income for the year ended February 28, 1966, of $20,000. It distributes corporate stock worth $5,000 to each of Trusts A and B, and distributes $5,000 cash to the widow. The four entities will be taxable on the $20,000 of income as illustrated in the following table.

Estate of O	– year to 2-28-1966	$5,000
Trust A	– year to 1-31-1967	$5,000
Trust B	– year to 1-31-1967	$5,000
The widow	– year to 12-31-1966	$5,000

Distribution of Appreciated Property by Estates and Trusts

In Rev. Rul. 67-74, 1967-1 CB 194, the IRS has made public its position regarding recognition of gain resulting from distribution of appreciated property by simple trusts. The ruling holds that a distribution of appreciated property in lieu of cash by a trust required to distribute all income currently will be treated as if the trust had distributed the cash and the beneficiary had

Sec. 651-63

then purchased the property from the trust with the cash received. Assuming all the income of the trust is taxable income, the trust is taxable on the gain represented by the difference between its basis for the property and the amount of the distribution obligation satisfied by its transfer.

This ruling officially confirms the Commissioner's position that such distributions by simple trusts do not qualify under the nonrecognition rule of Regs. Sec. 1.661-(a)(2)(f) and therefore do not carry the possible tax advantage attaching to certain property distributions by complex trusts and estates to which that rule applies.

The cited regulation states that gain or loss is not realized by an estate or trust (or the other beneficiaries) because of a property distribution, as long as the distribution is not in satisfaction of a specific amount of money or the right to receive other specific property.

The regulations under Sec. 661 further provide that the fair market value of the property at the time of distribution is deductible by the trust or estate to the extent of distributable net income. The beneficiary's basis for the property will be its fair market value when distributed, to the extent that value is included in his gross income.

Distributions of appreciated property by fiduciaries who have discretionary power with respect to income or corpus distributions will frequently qualify under these rules, although it is advisable for the fiduciary to specify that such a discretionary distribution is of a certain property rather than a dollar amount payable in certain property. Accordingly, an estate or complex trust which holds appreciated property frequently may be able to distribute such property without paying income tax on the difference between its basis and the fair market value at the time of distribution. The beneficiary at the same time acquires a stepped-up basis for the property without paying any more tax than would have been paid had cash rather than property been distributed.

Capital Gains of Short-Term Trusts Should Not Be Overlooked

Sec. 673

Much has been written about the advantages of the ten-year reversionary trust. Such a trust is a very effective means of transferring income from a high-bracket taxpayer to one paying lower

Sec. 673 taxes, while allowing the grantor to regain his principal at the end of the trust term.

In recommending such a trust, the problem of capital gains should not be overlooked. Ordinarily, capital gains are added to the corpus of the trust. If this is done, the gains are taxable to the grantor in the year in which they occur, because they are considered as income being held for future distribution to him. It should also be remembered, incidentally, that capital losses chargeable to principal of such a trust are currently deductible by the grantor as if they were realized by him directly (Regs. Sec. 1.677(a)-1(f) and (g), example (2)).

The taxation of such gains to the grantor may be avoided by providing in the trust instrument that they are to be included in the income going to the income beneficiary. If the income is currently distributable, the capital gains will be taxed to the beneficiary. If the trust income is to be accumulated for later distribution to the beneficiary, all the income including the capital gains will be taxed to the trust.

Sec. 677 Minors—Trust or Custodianship?

To the extent that income of a trust is used to discharge or satisfy the obligation of the grantor to support or maintain the beneficiary, it is includable in the taxable income of the grantor, and is subject to the throwback rules. To avoid this, the income should be used only for those items which are clearly beyond the support obligation.

Whether the cost of providing a child with a college education, for example, comes within the definition of legal support would depend on state law. Considering the manner and direction in which our social and economic environment is progressing, it is conceivable that state courts will hold a college education a necessity.

A custodial arrangement is not considered to constitute a trust and therefore is not taxed as a separate entity (Rev. Rul. 56-484, 1956-2 CB 23). It follows, therefore, that the throwback rules are not applicable even though the IRS has held that the *current* custodianship income applied for support is taxable to the parent (Rev. Rul. 59-357, 1959-2 CB 212). Accordingly, a parent should not be taxed on income accumulated in prior years which is expended for support of a minor in a subsequent year.

Intermittent accumulation and expenditures of income in a

custodial arrangement, therefore, help to avoid the inclusion of income in a parent's return. In many cases the income from gifts made in custodial form will be applied in the future to defray the cost of higher education so that income accumulated over many years will be dispersed over a comparatively short period of time, with minimal, if any, adverse tax effects to the parents.

Benefit From Gifts Subject to Payment of Gift Tax Liabilities

A device sometimes used by taxpayers when making gifts of stock is to make the gift on the condition that the donee pay the gift tax arising from the gift.

An interesting aspect arises when the net gift is to a trust. Under Sec. 677(a), if income of a trust is used to satisfy a legal obligation of the grantor of the trust, such income is taxable to the grantor. The application of this section has been upheld where a gift of stock has been made to an irrevocable trust with the condition that the trust pay the gift tax resulting from the transfer to the trust (*Craig R. Sheaffer*, 37 TC 99 (1961); see also Rev. Rul. 57-564, 1957-2 CB 328).

The distinction between a payment constituting the discharge of a liability of the donee and one constituting the liability of the donor apparently was not recognized by the Tax Court in the *Sheaffer* decision. However, one method by which the effect of Sec. 677(a) may be ameliorated is suggested by the *Estate of Annette S. Morgan*, 37 TC 981. In *Morgan*, an individual established irrevocable trusts for the benefit of her issue. Stock was transferred to the trusts on the condition that the trustees pay the gift tax incurred in establishing the trusts. At the date the gift tax was due to be paid, the trustee borrowed the exact amount of the gift tax payment from a bank, pledging the stock held by the trusts as security. The trustees then paid the gift tax with the proceeds of the loan. In subsequent years the loan was repaid from the dividend income of the trusts.

The question before the Court was whether the repayments of the loan constituted payments for the benefit of the grantor of the trusts, taxable to the grantor under Sec. 677. The Court addressed itself to the problem of whether the grantor received any monetary benefit from the method by which the trustees chose to meet their obligations to pay the gift tax. The Court

Sec. 677 said no, reasoning that the only benefit to be received by the grantor was to be the payment of her gift tax obligation. This benefit had been received when the trustees paid the gift tax after choosing to borrow the necessary money. The grantor received no benefits at a later date when the trustees repaid the loan with income of the trust.

If the *Morgan* decision is followed, donors may be able to avoid the often substantial income tax cost of selling assets in order to pay gift tax.

Sec. 691 Computing the Sec. 691 (c) Deduction

Difficulties in computing a Sec. 691(c) deduction arise where there is a marital deduction involved in the estate tax return. See Example (2) of Reg. Sec. 1.691(d)-1(e) and Rev. Rul. 67-242, 1967-2 CB 227. There is one case, *Estate of Thomas Desmond,* 13 TCM 889, wherein the Court would appear to have agreed with the Commissioner that the inclusion of the full income rights in the marital deduction could be tantamount to cancelling out the inclusion of the income rights in the gross estate. Under these circumstances, no estate tax may be attributed to the income rights. For this reason, carefully drawn wills often seek to exclude Sec. 691(a) items from the amounts passing to the surviving spouse which qualify for the marital deduction. On the other hand, once the amount of the 691(c) deduction is computed, each person who includes a 691(a) item in income (including the surviving spouse) is entitled to a pro rata portion of such deduction (*Helen Rich Findlay,* 39 TC 580, aff'd. 332 F2d 620 (CA-2, 1964)).

PARTNERS AND PARTNERSHIPS

Sec. 704 Limitation on Partner's Share of a Partnership Loss

Sec. 704(d) of the 1954 Code provides that "a partner's distributive share of a partnership loss shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership. . . ."

Sec. 704

At first blush, one would consider the basis of a partner's interest in a partnership as the balance of his capital account (subject to some possible adjustments not reflected on the books). From this it follows that if a partner's share of the partnership loss exceeds his capital account, then, to the extent of such excess, the loss is not deductible until the capital is restored.

The shortsightedness of this treatment is in assuming that the tax basis of a partner's interest consists solely of his capital account. Sec. 752 provides that an increase in the basis of a partner's interest in a partnership results from an increase in a partner's share of the liabilities of a partnership, even if the partnership is on a cash basis (Rev. Rul. 60-345, 1960-2 CB 211).

Therefore, if a partnership increases its liabilities (as well it might do when a loss is sustained) and this results in an increase in the individual partner's share of these liabilities (as it usually does), the partner's basis of his partnership interest has increased. Therefore, a greater portion (if not all) of the loss would be deductible.

Income in Respect of a Deceased Partner

Sec. 706

Sec. 706(c), providing that a deceased partner's share of current partnership income is includable in the return of his estate, was intended to prevent the pyramiding of partnership income for two taxable periods in the deceased's last return.

As with many remedial provisions in the Code, this one can be detrimental in some circumstances. Where the death of a partner occurs late in his taxable year and he is survived by his wife, the joint return for the year of death would include no income from the partnership and perhaps no net income from other sources, while the return for the estate would include the distributive share of partnership income for the entire year. The estate's income tax might then be higher than would result for the individuals if the partnership income were fully includable in the joint return of the decedent and his surviving spouse. Also, there is then no accrued income tax liability on the income from the partnership allowable as a deduction in computing the taxable estate of the decedent, even though nearly all of the income was earned during the decedent's lifetime. The estate would, however, be able to treat the partnership income attributable to the predeath period as "income in respect of a decedent"

 and claim a deduction for the estate tax paid with respect to such income (Regs. Sec. 1.753-1(b)).

When time permits, the income tax problem may be resolved by means of a distribution from the estate to the wife prior to the close of her taxable year. Another corrective can come from selection of the best fiscal year for the estate in coordination with the years and income of the beneficiaries. It is also possible, in the partner's will, to name the widow as successor in interest to the partner with respect to the income of the partnership year in which he dies, in which case such income will be taxed to the widow (Regs. Sec. 1.706-1(c)(3)(iii)).

Closing the Partnership Taxable Year With Respect to a Corporate Partner

Corporations which are members of partnerships (or of other unincorporated ventures which for federal income tax purposes are treated as partnerships) appear to be increasing in number. Consequently, tax advisers to corporations will become more concerned with Sec. 706, which deals with the question of when a partnership's taxable year closes with respect to a particular partner.

Unfortunately, Sec. 706 and the regulations thereunder are oriented to individuals. Special problems of a corporate partner do not receive consideration, and must be analyzed and resolved without the light of specific regulations. The following reflects conclusions under variants of a given basic fact pattern:

- A corporation has owned a partnership interest of less than 50%.
- At no relevant time does any circumstance or combination of circumstances result in a termination of the partnership under Sec. 708(b).
- The critical event discussed occurs on June 30, 1970.
- The corporation employs a September 30 fiscal year.
- The partnership reports on a calendar year.

Nonliquidating distribution (dividend) paid by transfer of partnership interest. This appears to be most analagous to a gift of a partnership interest by an individual. The first sentence of Regs. Sec. 1.706-1(c)(5) indicates that the distribution does not end the partnership's taxable year with respect to the corporate partner making the distribution, whether all or a part

of its interest was distributed. The last sentence of this section indicates that income applicable to the distributed partnership interest from January 1, 1970 to June 30, 1970 will be included in the corporation's fiscal year ended September 30, 1971 (the year in which falls December 31, 1970, the regular close of the partnership's year).

Distribution of all assets (including entire partnership interest) in complete liquidation. This transaction, both technically and equitably, seems to demand a different result from the nonliquidating distribution (dividend). Under Sec. 331(a)(1), amounts distributed in complete liquidation (including the partnership interest) are treated as a payment in *exchange* for the corporation's stock. (Secs. 332 and 333 do not depart from this concept.) Since the completely liquidated corporation has apparently "exchanged" its entire partnership interest, partnership income for the six months ended June 30, 1970 will (by reason of Sec. 706(c)(2)(A)) be included in the corporation's return for its last taxable period of nine months ending on that date. This conclusion is reinforced by equitable considerations—there would be no corporation in existence for any taxable year including the partnership's year-end of December 31, 1970, and delayed taxation of the income would encounter practical difficulties.

Contribution of partnership interest to another corporation in a nontaxable Sec. 351 transaction. This also appears to be an exchange. Note that the "sale or exchange" of a partnership interest does not have to be a *taxable* sale or exchange. For example, if an individual exchanges his entire interest in one partnership for an interest in another in a like-kind exchange under Sec. 1031(a), it appears that the year of the former partnership would close as to the individual. A Sec. 351 transaction is also an exchange (even though nontaxable), and the transfer of the entire partnership interest seems to close the partnership year with respect to the corporate transferor, again under Sec. 706(c)(2)(A). Accordingly, income from January 1, 1970 to June 30, 1970 would be taxed in the corporation's year ending on September 30, 1970.

However, if less than the entire partnership interest is transferred, Sec. 706(c)(2)(B) would apply, and the partnership year would not close with respect to the transferor corporation. Consequently, income attributable to the retained interest for the entire year ended December 31, 1970, plus income attributable to the transferred interest for the six months ended June

 30, 1970, would be reported by the corporation in its fiscal year ending September 30, 1971.

"B" reorganization. Since the corporate partner is not directly affected by a "B" reorganization under Sec. 368(a)(1), it appears that (in the absence of a consolidated return, which is discussed below) there is no effect on the corporate partner. Accordingly, there would be no change in the reporting on the basis of the nine-month lag which exists for any September 30 fiscal year taxpayer which is a member of a calendar year partnership.

"C" reorganization. In a "C" reorganization under Sec. 368(a)(1), the corporate partner exchanges substantially all its assets (including its entire partnership interest) solely for voting stock of the acquiring corporation; thus, there again appears to be an exchange of the partnership interest. The result and reasoning would be similar to that described under complete liquidation.

"A" reorganization. If the corporate partner is not the surviving corporation in a merger ("A" reorganization under Sec. 368(a)(1)), one possible solution is that the conclusion reached with respect to a "C" reorganization also applies to the "A" reorganization. However, there has developed a body of law which is based upon the concept that in a statutory merger or consolidation each constituent, absorbed, or merged corporation is in effect completely embodied in the resulting or surviving corporation. See, for example, Rev. Ruls. 59-395 (1959-2 CB 475) and 68-350 (1968-2 CB 159). This concept suggests the conclusion that no sale or exchange within the meaning of Sec. 706(c)(2) occurs upon a merger and that, except for a possible change in fiscal year, the old corporate partner simply continues, embodied in the surviving corporation.

Consolidated return with new affiliated group. Suppose a corporate partner becomes a member of a previously unrelated affiliated group which files a consolidated tax return on the basis of a calendar year. This could result from either a nontaxable acquisition of its stock (e.g., a "B" reorganization) or a taxable acquisition of its stock (e.g., a cash purchase) by a member of the group. In either case (assuming there was no "reverse acquisition"), the corporate partner would file a return for the period from October 1, 1969 to June 30, 1970, in accordance with Regs. Sec. 1.1502-76(b)(2). This early closing of the fiscal year, however, had no other effect on the corporate partner which would terminate the partnership's year as to it. Accordingly, partnership income for the entire period from January

Sec. 706

1, 1970 to December 31, 1970 would be included in the consolidated return of the affiliated group for the year 1970—even though the partner was a member of the group only from July 1, 1970 and even though a disproportionately large part of the 1970 partnership income may have been earned before July 1. If a large loss was incurred before July 1, Regs. Sec. 1.1502-15 (relating to "built-in deductions") would operate, in effect, to limit the pre-July 1 portion of the partnership loss to the taxable income of the corporate partner earned after June 30. There is, however, no limitation on items of "built-in income," although in an extreme case the IRS might apply Sec. 269 to eliminate any benefit which might result from reporting all the corporate partner's 1970 partnership income in the consolidated return.

Problems Involved When a Partner Acquires Partnership Property

Sec. 707

The tax problems of a partnership are some of the most difficult in the field of the income tax law. They may come sharply into focus when a partner desires to acquire personally a property that constitutes part of the partnership's assets. To effect this acquisition, two methods may occur to him. The first is the simple purchase from the partnership. If the cash for this purpose is not available, the partner may purchase the asset by giving his obligation for the price. If this method is not satisfactory, he may simply withdraw the property from the partnership, reflecting it by a charge against his capital account. His choice of method may have a marked effect on immediate tax results as well as future tax considerations.

Sec. 707 makes it possible for a partnership to sell to a partner as though he were an unrelated person, with two exceptions: (1) a loss on such a sale is disallowed if the partner owns directly or indirectly an interest of more than 50% in the partnership; (2) a gain is taxed as ordinary income if realized on the sale of property (whether or not depreciable) which is not a capital asset in the hands of the transferee, if the partner has more than 80% interest in the capital or profits. It is interesting to contrast this ordinary income provision with Sec. 1239. That section calls for ordinary income treatment on sales between spouses and between more than 80% stockholders and their corporations, limited to property which, in the hands of the transferee, is subject to an allowance for depreciation.

Sec. 707 Suppose, however, that the partner does not wish to obligate himself for the purchase price of the asset, but that with consent of the other partners, he withdraws the equipment in question as a distribution of part of his share of the partnership. The basis of the asset in his hands is then determined by following the rules set forth in Sec. 732(a). Note, however, that this section does not apply to the extent that a distribution is treated as a sale or exchange of property under Sec. 751(b) (relating to unrealized receivables and inventory items). Sec. 732(a) provides that the basis of the property distributed in this fashion shall be its adjusted basis in the partnership's hands, but no more than the adjusted basis of the partner's interest in the partnership before distribution. Sec. 733 provides that the partner's basis for his partnership interest is reduced (but not below zero) by the adjusted basis to him (determined under Sec. 732) of the asset received. This can result in the reduction of the withdrawing partner's capital account to a very substantial degree, while a bona fide purchase, which would result in the substitution of a receivable for the asset, would leave the capital account intact. If the partnership should sustain an operating loss in the year in which this distribution of property occurs, it is possible that a portion thereof might not be allowable to this particular partner because of this reduction in his capital account. Sec. 704(d) disallows such a loss to the extent that it exceeds the basis of the partner's interest in the partnership at the end of the loss year, and it may not be deducted until the basis is restored by payments into the partnership, subsequent partnership earnings, or an increase in liabilities. This reduction of the capital account, and therefore of the allowable operating loss, might have been avoided by the purchase of the asset instead of its withdrawal.

Let us assume that the asset is purchased by the partner and the receivable representing his purchase obligation is greater than his capital account. If this obligation should be cancelled by the partnership at a later date, it would doubtless be considered to represent the receipt of cash by the partner. There, under Sec. 731, he might be subject to capital gain tax on the difference between the amount of the obligation thus cancelled and the basis of his partnership interest. Needless to say, a careful examination of possible tax consequences should be made in this situation before any steps are taken to accomplish the partner's purpose. It may prevent later frustration and disillusionment when the tax returns of the parties are prepared.

Avoiding the Taxation of More Than a Year's Income *Sec. 708*

The taxation of substantially more than a year's income in one year can be quite expensive taxwise and is certainly a state of affairs to be avoided if at all practicable. Unless caution is exercised, this may occur under some circumstances in the case of partners in a partnership having a fiscal year ending within the calendar year of the partners.

A potentially dangerous situation can arise when with respect to a fiscal year partnership there is a sale or exchange of 50% or more of the total interest in partnership capital and profits. Sec. 708(b) of the 1954 Code provides that a partnership shall be considered to be terminated for income tax purposes if this occurs. This would mean that the partnership year would end at that time, resulting in the taxation of the income of the entire fiscal year to that date in the returns of the partners for the calendar year in which the termination takes place. After the sale of the interest, the partnership as it is newly constituted would necessarily have an accounting period ending December 31 unless permission could be obtained from the IRS to adopt a fiscal year. This could result in the taxation of substantially more than a year's income in this one calendar year.

Sec. 1.708-1 of the regulations provides that a liquidation of a partnership interest is not a sale or exchange for purposes of Sec. 708. Therefore, if the partnership interest of the retiring partner is being acquired by the other partners, the practical solution to this poblem might be the liquidation of the retiring partner's interest by the partnership itself rather than its purchase by the remaining partners. Such a liquidation could, however, be disadvantageous to the retiring partner. Because of the operation of Sec. 736, a portion of the cash which would have been treated as capital gain on a sale might be considered as ordinary income on a liquidation. For example, a liquidating payment for goodwill will be treated as ordinary income unless the partnership agreement specifically requires a payment for such goodwill (*V. Zay Smith,* 313 F2d 16 (CA-10, 1962), *Jackson Investment Co.,* 41 TC 675, nonacq.). This phase of the problem must be analyzed before the liquidation route is selected.

Gain or Loss on Partnership Interest *Sec. 731*

If a partner withdraws from a partnership and receives only cash in liquidation of his interest in partnership property (no

Sec. 731 portion of which is deemed to be either a distributive share of partnership income or a guaranteed payment), Sec. 731 makes clear that the difference between such money and the basis of the partnership interest to the withdrawing partner is a recognized gain or loss.

Less clear is the taxable year in which such loss or gain is reportable by a partner who employs the cash method of accounting. If the withdrawal of the partner was arranged before the end of the year, either by notice or other special contractual provision, it appears that the rules governing sales of securities in December where delivery is made in January may have application. This results in a recognition of the loss in the year of withdrawal, but a gain will not be taxed until the proceeds are determined and paid over in the subsequent year.

This solution is also the practical one, since the loss will be claimed in the earlier year, whereas the gain will not be reported until the later year. Reporting the loss in the earlier year would ordinarily be advantageous, especially since unused capital losses of noncorporate taxpayers may be carried forward indefinitely.

Sec.741

Basis of Partnership Interest Acquired at Different Dates

Can a partnership interest purchased and sold for the same price produce gain or loss? Consider a partnership in which *A*, *B*, and *C* are equal partners. *A*'s basis in his partnership interest is $1,000. If *A* purchases *C*'s interest for $5,000 and subsequently sells it to *D* for $5,000, what is the tax basis of the interest sold? Rev. Rul. 59-109 (1959-1 CB 168) states that a fraction of a partnership interest is a capital asset, but does not indicate how its basis should be determined. Neither does the Code or regulations. Is the basis an average or pro rata share of the total cost, or should a specific identification or Fifo method be used?

If a person is capable of owning only one partnership interest in a given partnership, the basis of the partial interest may have to be determined by a pro rata allocation of the total cost. If so, in the above example, a pro rata allocation would produce a gain of $2,000: $5,000 – 50% of 1,000 + 5,000). The specific identification method could produce either a gain of $4,000 ($5,000 – 1,000 = $4,000) or no gain or loss ($5,000 – 5,000 =

$0). The Fifo method would produce a gain of $4,000 ($5,000 − 1,000 = $4,000). Of course, whether any gain or loss realized on the sale should be treated as long-term or short-term capital gain may also depend on the method used to ascertain the basis of the fractional interest. *Sec. 741*

All partial sales of a partnership interest should be scrutinized to evaluate the possible tax implications.

Capitalizing on Interest Prepaid by Partnerships

Sec. 754

A sale of a partnership interest generally will be capital gain to the seller under Sec. 741. If the partnership had taken deductions for prepaid interest, the seller will find that he may have converted an ordinary deduction into capital gain. Prepaid interest does not seem to be a Sec. 751 asset (unrealized receivable or substantially appreciated inventory) whose disposition results in ordinary income.

On the other side of the transaction, the purchaser of the partnership interest may be paying a substantial amount of prepaid interest which cannot be deducted by the partnership. Under these circumstances, the seller may have to make an appropriate adjustment in the selling price. However, if the partnership elects to have special basis adjustments under Sec. 754, prepaid interest would be an asset to which such an adjustment would apply. Therefore, an ordinary deduction should be passed through to the buyer each year for up to 12 months' amortization of the prepaid interest per year (as well as his share of the partnership's other items of income or deductions).

REGULATED INVESTMENT COMPANIES AND REAL ESTATE INVESTMENT TRUSTS

Capital Loss Carryovers Modify Conduit Approach For Regulated Investment Companies

Sec. 852

Regulated investment companies (as defined in Sec. 851) and their shareholders are subject to federal income taxes in the

Sec. 852 manner set forth in Sec. 852. Subject to significant exceptions, regulated investment companies are treated as mere conduits for dividends (which qualify for the $100 exclusion or the corporate dividends received deduction), for other ordinary income, and for long-term capital gains.

As a result of the stock market decline, many regulated investment companies sustained net capital losses. These losses were not deductible since a regulated investment company's deduction for capital losses is limited to the amount of its capital gains. (Note that the new capital loss carryback for corporations, effective first for a net capital loss sustained in a taxable year beginning after December 31, 1969, is not applicable to regulated investment companies by reason of Sec. 1212(a)(4)(B).)

Net capital losses of a regulated investment company may be carried forward for five years, in accordance with Sec. 1212(a)(1)(B), and will be treated as short-term capital losses in any year to which carried.

Example 1. In 1969 a regulated investment company sustained a net capital loss of $1,000,000. Assume during 1970 the following items of income will be realized:

Ordinary income, net of deductions	$200,000
Net long-term capital gain	500,000
Net short-term capital gain or loss	None

If dividends of $200,000 are paid out during 1970 (after giving effect to Sec. 855, relating to dividends paid by a regulated investment company after the close of its taxable year), the shareholders will report $200,000 of ordinary income but there will be no further taxable income for either the company or its shareholders. "Investment company taxable income," as defined in Sec. 852(b)(2), will be zero. Nor will there be any amount of excess of net long-term capital gain over net short-term capital loss, which would be subject to the corporate long-term capital gains tax rate, since the capital loss carryover of $1,000,000 will offset the long-term capital gains actually realized during 1970.

Example 2. Assume the payment of dividends of more than $200,000—$600,000 for example—in 1970. What effect would this have upon the company and its shareholders? First, the additional $400,000 amount may not qualify as a "capital gain dividend" under Sec. 852(b)(3), because capital gain dividends are limited in amount to the excess of the company's net long-term capital gain over its net short-term capital loss. As ex-

plained in the previous example, the capital loss carryover from 1969 has reduced the $500,000 excess realized in 1970 to zero.

However, the entire amount of $600,000 appears to be taxable as ordinary dividend income to the shareholders because it was paid out of current earnings and profits for 1970. The 1969 capital loss was a charge to earnings and profits in 1969 (IT 3253, 1939-1 CB 178). Although the 1969 loss had an effect on *accumulated* earnings and profits as of January 1, 1970, there would be no effect on *current* earnings and profits for 1970 since it is inferable from IT 3253 (as well as from general principles) that realized capital gains are an addition to earnings and profits—even though for income tax purposes they are offset by a capital loss carryover. Sec. 852(c), which sets forth a special rule for determining earnings and profits of regulated investment companies, does not apply to this situation.

Observe, in summary, the anomaly: the large capital loss carryover causes the additional distributions in 1970 to be taxed as ordinary dividend income because they are paid out of the current earnings and profits generated by the 1970 long-term capital gains; whereas, if there had been no capital loss carryover, the $400,000 additional amount could have (and should have) been designated as capital gain dividends, which are taxed to the shareholders as long-term capital gain. Moreover, if there were no carryover, the remaining $100,000 could either be paid out as a capital gain dividend after the close of 1970 under Sec. 855 or designated as undistributed capital gains under Sec. 852(b)(3)(D). The latter provides, in effect, for a constructive capital gain dividend accompanied by a constructive contribution to capital and appropriate adjustment of basis on the part of the shareholders.

Note that a company which has elected regulated investment company status for federal income tax purposes from its inception usually does not have any significant amount of accumulated earnings and profits. In any event, the results described above are not dependent on the existence of accumulated earnings and profits.

TAX BASED ON INCOME FROM SOURCES WITHIN OR WITHOUT THE UNITED STATES

Sec. 871 Aliens May Indulge in Clean-up Sales Before Becoming Residents

With many foreign professional and business personnel emigrating to the United States, the question often arises as to the U.S. tax consequences to resident aliens who dispose of their personal residences abroad at a gain. The same question should arise regarding all other assets.

An alien reporting income on the cash receipts and disbursements method who sells his foreign residence after acquiring the status of resident alien for U.S. tax purposes is subject to U.S. tax on the entire amount of gain even though such gain accrued when the resident alien was not subject to U.S. tax. In Rev. Rul. 55-62, 1955-1 CB 212, the Internal Revenue Service held that fair market value on the date the alien became a resident of the United States is not the basis to be used for computing gain; the entire gain, measured by the normal rules relating to basis, is includable in the gross income of the resident alien.

Careful tax planning in this connection would lead the alien to dispose of his personal residence before acquiring resident alien status in the U.S. Failing this, the resident alien would have to fall back on Sec. 1034 which permits gain on sale of a residence to escape tax, provided a replacement residence is acquired within prescribed periods. However, Sec. 1034 treatment results in a mere postponement of the recognition of the gain; eventually it may be taxed.

While Sec. 1034 provides a limited safety valve in the case of residences, gains which may be realized on other types of property may not have a tax shelter available. It behooves an alien to take inventory of all his assets, including securities, prior to moving to the U.S. and to seek advice with respect to taxes which may be levied on gains by both his homeland and the U.S. A careful scheduling of realizations of gains and losses will minimize all foreign and U.S. taxes.

U.S. Capital Gain Tax Offset by Foreign Tax Credit

Sec. 901

The foreign tax credit computation under Sec. 904 can produce some interesting results.

Assume that a United States citizen is a permanent resident of Canada. He receives substantial salaries which qualify as "earned income" as defined by Sec. 911(b). These salaries are taxable in Canada, but are exempt from United States tax under Sec. 911(a)(1), subject to the limitations on amounts imposed by Sec. 911(c)(1). Assume he sells in Canada securities which he owns at a substantial capital gain. Under present Canadian law he will incur no tax on the gain.

If the Canadian tax on his salaries during the year of sale exceeds the United States capital gain tax on the sale no United States tax will be payable, even though the capital gains will, of course, be includable in his United States return. Canadian taxes of other years not used as foreign tax credits may also be used as credits against the capital gains tax within the limits of Sec. 904(d).

Such gains are considered to be income derived from Canada even though they are not subject to Canadian tax (G.C.M. 22556, 1941-1 CB 310). Rev. Rul. 54-15, 1954-1 CB 129 concedes that the Canadian taxes paid on the salaries may be used as a basis for credit against United States tax even though incurred on Canadian income exempt from taxation in this country. (See also *James H. Brace,* 11 TCM 906 (1952) and *Associated Tel. and Tel. Co.,* 306 F2d 824 (CA-2, 1962).)

Unused Foreign Tax Credits of U.S. Citizens Who Work Overseas

Sec. 904

On return to the United States from overseas employment many citizens find that they have available unused foreign tax credits because of their Sec. 911 exemption for income earned abroad. Naturally, the unused foreign tax credit may be available for use through the carryback or carryforward procedures. However, they may only be so utilized if the citizen has foreign source income (Sec. 904(d)). Since all too often the returning citizen has no apparent source of foreign income, the excess foreign tax credits will be lost.

One way of generating foreign source income is through the sale of tangible personal property in a foreign country. Gains

Sec. 904 realized on listed securities of any U.S. corporation sold in a foreign country where title passes abroad will satisfy the tax requirements relating to foreign source income (Regs. Sec. 862-1 (a)(6)). Note that it is well settled that for this purpose securities meet the definition of personal property. In certain countries, as for example Canada and Australia, gains on sales of securities are not presently subject to foreign taxation. The net result to the citizen is that his excess foreign tax credit is used to offset the U.S. tax on capital gains he realizes in this manner.

Another potential source of foreign income may be in the citizen's foreign personal residence. Realization of gain from the sale of real property located without the United States constitutes foreign source income (Sec. 862(a)(5)). A substantial gain may be built into the foreign residence if its basis has been reduced by Sec. 1034 gain realized on the sale of the citizen's U.S. residence at the time he was transferred abroad. Since the nonrecognition of gain provisions of Sec. 1034 are mandatory, the citizen should not acquire a U.S. replacement residence within the prescribed periods. The U.S. tax on the gain on the sale of the foreign residence will be offset with unused foreign tax credits and the citizen will obtain a stepped-up basis for his new residence in the United States.

A third source of foreign income is compensation paid to the citizen by his employer for foreign business trips. Many companies, in order to maximize foreign tax credits which otherwise would go unused, have the employee generate foreign source income by making foreign business trips both before and after his stay abroad. For example, Executive A is returned to the U.S. office of his employer on January 1, 1969, after having worked four years in Germany. In training his replacement, he makes several trips to Germany subsequent to his transfer back to the U.S. Salary earned during these trips constitutes foreign source income and would provide a base for the use of foreign credit carryovers (Regs. Sec. 1.862-1(a)(3); see also Rev. Rul. 69-238, 1969-1 CB 195).

Sec. 911 Advantage of 510-Day Rule Over Foreign Residence Rule

Whereas, prior to 1963, it was generally advantageous for a U.S. employee transferred to an overseas location to claim exemption from U.S. taxation under the bona fide foreign residence

rule rather than under the physical presence (510-day) rule, the reverse may now be true in certain circumstances. *Sec. 911*

Citizens being sent abroad for the first time, or after a lapse in a previous foreign residence, are initially subject to the maximum exclusion of $20,000 per full year, or $54.79½ a day for each day of bona fide foreign residence if less than a full year. Thus, if an employee is sent abroad and establishes a foreign residence on September 1, 1966 and remains abroad indefinitely, his maximum exclusion for 1966, computed under the bona fide foreign residence rule, would equal $6,685 (122 × $54.79½). However, if he elected to compute his maximum exclusion for 1966 under the physical presence rule (i.e., $54.79½ per day for each day in a qualifying 18-month period), the period does not have to start with September 1, 1966. It can start earlier. He can get the maximum exclusion by figuring the 18-month period to start July 24, 1966 and end January 23, 1968. He would be abroad 510 days in this period. Accordingly, the exclusion computed in this manner would equal $8,822 (161 × $54.79½), significantly greater than the maximum as computed under the bona fide residence rule. Likewise, in the year of departure, the physical presence limitation computation may be more beneficial than the bona fide residence limitation computation. In either case, the allowable maximum exclusion should be worked out under both methods to see which yields the more beneficial result.

Of course the higher maximum would be beneficial only if the employee actually earned enough from foreign sources to utilize the maximum exclusion.

Deficits May Insulate Subpart F Income From U.S. Tax

Sec. 952

Ordinarily, undistributed "subpart F income" (certain "passive" and "tax haven" income) of second-tier (or more remote) foreign subsidiaries is taxed directly to a U.S. parent corporation as though it had been earned by a first-tier foreign subsidiary.

However, if an intervening foreign corporation (or other foreign corporations in the particular chain of foreign corporations) has a deficit for the taxable year, the deficit may be applied to reduce the amount of subchapter F income taxable to a parent. Thus, for example, profits of a controlled corporation in the Bahama Islands deriving its income from interest, dividends and foreign-based company sales income may be offset

Sec. 952 by an intervening controlled Canadian corporation's losses.

Consideration might be given to this feature in structuring the chain of ownership of foreign subsidiaries of U.S. parent corporations.

GAIN OR LOSS ON DISPOSITION OF PROPERTY

Sec. 1001

Payment of Debt With Property May Create Taxable Income

The general rule is that payment of a debt by transferring property to the creditor is a sale or exchange of the property. The situation is the same as if the property had been sold for cash and the cash used to pay the debt.

A statutory exception to the rule is made with respect to indebtedness of a subsidiary to its parent. If the subsidiary is completely liquidated in a transaction in which no gain or loss is recognized to the parent, then no gain or loss is recognized to the subsidiary upon the transfer of properties in satisfaction of its indebtedness to its parent.

Another exception to the rule relates to charitable contributions. The satisfaction of a pledge to a charitable organization by means of a donation of property does not give rise to a taxable gain or deductible loss whether or not the property has appreciated or depreciated in value (Rev. Rul. 55-410, 1955-1 CB 297). A contribution is deductible only to the extent that it is actually paid regardless of when pledged and regardless of the method of accounting employed by the taxpayer. Since the pledge itself is not deductible, it would be inconsistent to treat the payment of the pledge as a deductible contribution and, at the same time, the satisfaction of a debt. Accordingly, the transaction is not viewed as the payment of an indebtedness with the tax consequences which would ordinarily follow from the use of appreciated or depreciated property to pay the debt.

In *General Shoe Corporation* (282 F2d 9 (CA-6, 1960)) the court ruled that a contribution of appreciated realty to a tax-exempt employees' pension trust resulted in a capital gain to

the employer to the extent the market value exceeded the basis of the property. This was so even though the employer had no legal obligation to make the contribution. The Supreme Court in *Thomas Crawley Davis* (370 U.S. 65, 1962) extended this principle of capital gain realization to appreciated property transferred from a husband to his wife in a divorce settlement. The value of the consideration passing to the husband could not be measured directly, so it was assumed that such consideration was equal in value to the value of the property transferred by the husband.

Sec. 1001

Watch Identification of Securities Delivered

Sec. 1012

Regs. Sec. 1.1012-1(c) states a "first-in, first-out" rule with respect to the basis of securities sold when the taxpayer had acquired lots of stock on different dates or at different prices. If the lot from which the stock was sold cannot be adequately identified, the stock sold or transferred shall be deemed to come from the earliest of such lots, purchased or acquired. If, however, the lot from which the stock is sold can be adequately identified, the rule stated in the preceding sentence is not applicable.

The interesting thing about this rule is that it is not optional with the taxpayer. Assume that a taxpayer had acquired three lots of 100 shares each of a certain stock at the following prices:

Order of Purchase	*Cost*
1	$5,000
2	3,000
3	4,000

For the sake of simplicity, we shall assume that there have been no reorganizations, stock dividends or other capital adjustments during the period of the taxpayer's holding.

If the taxpayer sold 100 shares of the stock and simply selected at random any of the three certificates for delivery, he cannot rely on the application of the first-in, first-out rule and use a cost of $5,000. If upon examination the revenue agent is able to establish that he in fact used the certificate which cost $4,000, that will be the lot which was deemed sold.

Instances have been reported in which the examining agent has contacted the issuer in order to establish the correct basis of securities sold (usually to the detriment of the taxpayer). It

Sec. 1012 follows that taxpayers should not act in a casual manner with respect to the identification of securities sold. Complete familiarity with Regs. Sec. 1.102-1(c) is a "must."

Sec. 1015

Gift of Appreciated or Depreciated Assets

All other things being equal, a gift of appreciated assets is better than a gift of the same values in cash. The reason is that with the appreciated assets, part of the gift tax is salvaged through the addition of that tax to the basis of the assets, which means that there will ultimately be less profit on the sale of those assets and hence less income tax.

In the case of depreciated assets, the pendulum can swing in favor of the cash. The depreciated assets in the hands of the donor retain their original cost bases, making available the full loss, when realized. However, in the hands of the recipient no loss can be taken unless it represents further depreciation in values after the gift.

Sec. 1017

Deferring Tax on Repurchase of Own Bonds

It seems possible to defer the tax resulting from the purchase of bonds at a discount by having an affiliated company, rather than the issuing company, purchase the bonds with its own funds. Since the bonds will still be outstanding, no tax should be due until maturity.

In *Peter Pan Seafoods, Inc.* (CA-9, 417 F2d 670), a subsidiary was organized, apparently for the purpose of purchasing the parent's outstanding mortgage notes. The court found that the new corporation (organized by 85% of the stockholders) had raised funds from the parent's stockholders, individuals and a bank—economically significant activities of its own. The court, reversing the lower court, held no gain was recognizable to the parent-issuer of the notes.

Redemption of Outstanding Debt

A depressed corporate bond market may provide an opportunity for corporations with surplus working capital to repurchase outstanding debt at a price less than face value. This can

Sec. 1017

be accomplished without the recognition of current taxable income provided the taxpayer files a consent to the reduction of bases of certain assets as of the beginning of the taxable year in which the retirement of indebtedness occurs. These assets, as specified in Regs. Sec. 1.1017-1(a), and the order in which the reduction is to be made are as follows:

1. Assets purchased from proceeds of the indebtedness.
2. Assets secured by a lien relating to the indebtedness.
3. Assets (including depreciable and depletable property) other than accounts and notes receivable and inventory.
4. Accounts and notes receivable and inventory.

The basis reduction for the last two categories is to be applied ratably over all assets within the group where the total amount of the reduction applicable to the group is less than the aggregate bases of the assets within the group.

The effect of filing the consent will generally be the postponement of current taxable income at the expense of future tax depreciation and depletion deductions, and possibly the realization of greater gain on disposition of the property. In addition to the interest factor involved in the tax postponement, there is the added possible advantage that the gain on the disposition may constitute capital gain to the extent that the depreciation recapture rules are not applicable or nondepreciable property such as land is involved. On the other hand, if the reduction of basis involves Sec. 38 property, there will be recapture of the investment credit. Regs. Sec. 1.47-2(c) dealing with recapture of the credit provides that the property, to the extent of the basis reduction, will be treated as ceasing to be Sec. 38 property with resulting recapture. The cessation is considered to occur within four years of the date the property was placed in service regardless of the actual period which may have expired.

Involuntary Conversions— Use and Occupancy Insurance

Sec. 1033

The *M* Company has a use and occupancy insurance policy which provides for a flat per diem allowance for the loss of the use and occupancy of its property destroyed in whole or in part by fire or other specified casualties. This policy does not provide for the reimbursement of any profits that would otherwise be earned during the period of business interruption. The company

Sec. 1033

has a building with a tax basis of $500,000; it is covered by a fire insurance policy in a maximum amount of $1 million replacement cost, and by the U&O policy in the maximum amount of $800,000. The building was totally destroyed by fire, and the company recovered $1,800,000 under the two policies.

Query: How should the $800,000 which was received under the U&O policy be treated for tax purposes?

An official of the IRS in Washington advises that the proceeds of the U&O policy would be considered as proceeds of an involuntary conversion only if the insurance contract were completely silent as to reimbursement for loss of profit. Therefore, the tax treatment is entirely contingent upon the wording of the policy. If, in arriving at the per diem amount, the computation relates in any way to the estimated profits during the period of interruption, the entire proceeds are includable in gross income pursuant to Regs. Sec. 1.1033(a)-2(c)(8).

Assuming, however, that there is no element of profit reimbursement, the $800,000 recovered under the U&O policy would be treated exactly the same as the $1 million recovered under the fire insurance policy. Thus, the proceeds of the conversion would be $1,800,000.

There would be certain expenses in connection with the fire loss including overhead items (salaries of executive personnel), plus the expense of cleaning up the debris. A Service representative advised that it would not be necessary to offset such expenses against the insurance proceeds. Such expenses could be deducted under Sec. 162 even though any gain was taxed as a capital gain. However, if attorney's fees or other expenses were incurred in connection with obtaining insurance proceeds such expense items would be required to be offset against the gain. However, for precedent to the contrary, see *Ticket Office Equipment Co., Inc.*, 20 TC 272 (1953), acq.

Advantage of Stock to Replace Involuntary Conversion Property

Assume an apartment building originally cost $1 million and has been depreciated to a $100,000 basis. The building was destroyed by fire and $500,000 of insurance proceeds were received. If the $500,000 were used to acquire another apartment building, the basis of the replacement property for tax depreciation purposes would be only $100,000. However, replacement could be

made by acquiring the stock in a corporation that owns an apartment building with a tax basis of $2 million, but whose stock can be acquired for $500,000 since this is what it is worth after considering outstanding mortgages, value of the land, etc. In this case, the basis of the stock would be $100,000 but the tax basis of the apartment building would remain at $2 million and would not have to be reduced by the unrecognized gain of $400,000.

The Code at Sec. 1033(c) refers only to "property" rather than "property or stock" in discussing basis. The Service takes the position that property when used in this connection means either replacement property or stock in a corporation. They consider stock in such case to be property.

Application of Proceeds From Condemnation Awards

May the proceeds from the condemnation of unimproved property used as a parking lot be utilized for the construction of an office building on leased land and still qualify for nonrecognition of gain? While on the surface it may appear that construction costs of an office building and an unimproved lot are not similar assets, under the regulations such a transaction should qualify.

Generally, to avoid recognition of gain, the proceeds of a condemnation must be invested in property which is similar or related in service or use to the property condemned. (See Rev. Rul. 64-237, 1964-2 CB 319, for a more liberal definition of "similar or related" when investment property is involved.) Under Sec. 1033(g), however, where the condemned property is real property used in a trade or business or for investment, it may be replaced by "like-kind" property which will be treated as property similar or related in service or use to the condemned property.

The definition of "like kind" is covered in Regs. Sec. 1.1031 (a)-1(b) and is very broad in scope. A leasehold of a fee with thirty years or more to run is considered to be "like" real estate. Furthermore, under the regulations, the fact that any real estate involved is improved or unimproved is not material. Thus, there would be an investment in "like kind" property where a leasehold of thirty years or more is acquired and improved with a building by utilizing the proceeds of the condemnation of the unimproved parking lot. However, as provided in Sec. 1033 (a)(3)(B), the improvements to the property should be completed not later than two years after the close of the first taxable

 year in which any part of the gain on the condemnation is realized unless an extension of time has been obtained.

The regulations covering involuntary conversions may be confusing in that Regs. Sec. 1.1033(a)-2(c)(9) states that with respect to involuntary conversions occurring after December 31, 1950, there is no investment in property which would be similar in character and use if the proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate. If one were to read this section without reading subsequent Regs. Sec. 1.1033(g)-1, a mistake could easily be made. This latter section resulted from the Revenue Act of 1958 and applies to condemnations of real property occurring after December 31, 1957. It provides that a reinvestment in "like kind" qualifies for deferment of tax. The prior section of the regulations which was published on January 9, 1957, has not been changed to conform to the later law. See also Rev. Rul. 68-394, 1968-2 CB 338.

Involuntary Conversion of Partnership Property

Partnership *AB* owns property which is the subject of an involuntary conversion. A substantial gain is realized. Partner *A* wants to acquire replacement property in his own name and elect under Sec. 1033 to defer his share of the gain. Partner *B* may or may not want to replace his share.

IRS takes the position that only the partnership may make the election. The Service feels that, pursuant to Sec. 703(b), the only elections that may be made by each partner separately are those under Secs. 615, 617 and 901. All other elections must be made by the partnership.

The solution to the dilemma may be for the partnership to acquire the replacement property and distribute it to partner A at a future date.

Involuntary Conversion and Fiduciary Distributions

When an estate or trust has a Sec. 1033 involuntary conversion, the replacement privilege will be lost if the estate or trust terminates prior to buying replacement property. Rev. Rul. 64-161, 1964-1 CB 298, in reversing Rev. Rul. 58-407, 1958-2 CB 404, holds that the distributees cannot qualify to purchase re-

placement property. Perhaps this need for replacement property might be a good business reason for delaying termination and distribution, where replacement is authorized by the trust instrument, will or state law.

Sec. 1033

New Repossession Rules—New Inequity

Sec. 1038

For many years a seller of real property, who found it necessary to repossess the property, realized gain or loss measured by the fair market value of the repossessed property. In many instances, this resulted in taxing to the seller unrealized appreciation in the value of the property even though the appreciation may have occurred prior to the original sale transaction. In order to remove that inequity, Sec. 1038 was enacted in 1964.

Under Sec. 1038 the gain on repossession of real property is the excess of payments prior to repossession over the amount of gain previously reported. The basis of the repossessed property is the same as the basis of the purchaser's unpaid obligation to the seller (face less unreported gain) increased by the gain recognized plus repossession costs.

Regs. Sec. 1.1038-1(h) contains several examples of the application of these provisions but none includes a situation in which a sales commission was paid on the original sale. In such cases (probably the usual rule) it would appear that the commission paid will not always be an offset against gain to be reported, but becomes an adjustment to the basis of the repossessed property.

For example, assume property with a basis of $20,000 is sold for $100,000 with gain reported on the installment basis. After $30,000 in payments is received, the property is repossessed. If no commission was paid on the sale, 80% of each payment received would be reported as gain; if a $5,000 commission was paid, 75% would be reported.

The effect of Sec. 1038 on the repossession is shown in the examples below. In both cases, the seller reports a total of $30,000 on the payments received and upon repossession. The commission paid does not reduce the gain but increases the basis of the property reacquired. Thus where a commission is paid, the total gain reported actually exceeds the net cash received by the seller because the commission does not reduce the "payments received" for the purpose of Sec. 1038. This inequity is eliminated where the money collected before repossession exceeds the gain real-

Sec. 1038 ized on the sale (determined net of commissions and other selling expenses) since the total income to be recognized is limited to the gain.

EFFECT OF SEC. 1038 ON REPOSSESSION OF REAL PROPERTY

	No Sales Commission	*Sales Commission*
Payments received before repossession	$30,000	$30,000
Less gain previously reported	24,000	22,500
Gain on repossession	6,000	7,500
Adjusted basis of indebtedness	$14,000	$17,500
Gain on repossession	$ 6,000	$ 7,500
Assume repossession costs	3,000	3,000
Basis of repossessed property	$23,000	$28,000

Sec. 1091

Wash Sales Available During Consolidated Return Period

The wash sale rule (Sec. 1091) appears to be inapplicable to a consolidated return year where different members of the group buy and sell the same security in completely arm's-length transactions since the rule applies to transactions by the same taxpayer.

Create Wash Sales

Under certain circumstances it may be desirable to create a wash sale so as to add back to the basis of the newly acquired security the disallowed loss and holding period. This might be the case where the investor, within 30 days after the sale of his security at a loss, realizes the disadvantageous timing of such disposition.

For example, *T*, after holding SIC stock for five and one-half months, liquidates his position to realize a short-term loss. Subsequently, but within the next 30 days, SIC stock suddenly starts to rise. *T* now feels that SIC stock has potential appreciation. By repurchasing SIC stock within 30 days after the previous sale, under the wash sales provisions, his loss is not recognized for tax purposes and, instead, such loss will, in effect, increase the basis of the newly acquired shares. What is more important

is that the SIC stock will start off with a five and one-half month holding period, thus making long-term capital gain treatment possible by merely holding SIC stock for an additional period of one-half month, plus a day.

Substantially Identical Securities—Convertible Bonds

Do the wash sale provisions of Sec. 1091 apply to subordinated convertible debentures and the underlying common stock of the same corporation?

The Internal Revenue Service defines the term "substantially identical property" in accordance with regulations under Sec. 1233 on the basis of the facts and circumstances in each particular case. In a recent private ruling the Service set forth the factors to be considered in making such a determination. The factors considered were (1) a comparison of the gross annual yield in the form of interest on the debentures and a return in the form of dividends on an equivalent investment in the common stock and (2) a comparison of the share value of the conversion feature of the debentures and the number of shares which could have been purchased in the open market with the same dollar investment. The latter factor would change with changes in the relative prices of the debentures and the stock, and the relationship would be most significant at the time of "switching" from debentures to stock or vice versa.

The taxpayer had purchased 4¼% subordinated convertible 25-year debentures at a premium. The market value of both the debentures and common stock subsequently declined, and the taxpayer later disposed of the debentures, at a loss, and immediately reinvested the proceeds of sale into the shares of common stock of the issuing corporation.

The gross annual interest yield on the debentures approximated 4% as compared to a dividend return on a common stock equivalent (based on conversion of the bonds at that time) of approximately 1½%. The conversion feature of the debentures at the time of their sale provided substantially fewer shares than could have been purchased then in the open market at the same dollar investment, because the common stock price had dropped proportionately more than the debentures.

On the basis of these significant differences in the characteristics of the two securities being compared, the convertible deben-

Sec. 1091 tures and the common stock of the issuing company were held not to be substantially identical within the meaning of Sec. 1091.

Of particular interest in this case is the fact that the Service was willing to rule on what is essentially a question of fact.

CAPITAL GAINS AND LOSSES

Sec. 1223

Holding Period for Optional Valuation Date

Where the optional valuation date is selected by the executor in valuing securities includable in the gross estate, and a sale of securities takes place within six months thereafter at a substantial profit, is the gain long-term or short-term? Sec. 1223 which deals with the holding period of property does not make any reference to the alternate valuation date privilege and for that matter does not make any specific reference to the date of acquisition of property acquired from the decedent. The court-established rule, which deals with property acquired from a decedent which was valued in the gross estate at date of death, is that the holding period starts on the date of death. It would seem, in the absence of a specific requirement concerning the optional valuation date, that the same rule should apply and the holding period would begin on the date of death. The only published authority on the point is a special ruling dated September 24, 1946 (to which some of the services refer) which confirms this conclusion. The special ruling dealt with inclusions of property in the gross estate at the alternate valuation date. Accordingly, it would appear that the gain would be long-term even though measured by the fair market value on the optional valuation date.

Sec. 1233

Short Sales Beneficial During Consolidated Return Period

Sec. 1233 provides that where a taxpayer enters a short sale and at that time has identical securities which it has held for less than six months, any gain on closing such short sale shall be considered short term.

However, in a consolidated return year where one affiliate has a short-term gain in a security, it would appear that the rules of Sec. 1233 would apply, and the gain could qualify as long-term gain even though within six months another affiliate sold the same security short. If the security subsequently declined in value, the company selling short would experience a short-term gain upon covering the short sale; the company holding the security would have reduced long-term gain. On the other hand, if the security were to increase in value, the company holding the security would have an increased long-term capital gain while the company selling short would realize a short-term capital loss. The support for this position is that Sec. 1233 applies to transactions by the same taxpayer and should not apply to separate members of the same group.

Sec. 1233

Short Sale Closed Out by an Estate

A person who owns securities which have substantially increased in value may, for various reasons, wish to make a short sale of substantially identical securities. If he dies before the short sale is closed, the estate will close the short sale by delivering the substantially identical securities which were owned by the decedent at the time of his death and which pass to the estate. IRS has ruled privately that the gain or loss on the short sale is to be computed by using the estate tax valuation as the basis of the securities used to cover the short sale, and that there is no income with respect to a decedent in connection with such transaction. However, income with respect to a decedent was found in *Trust Company of Georgia* v. *Ross*, 392 F2d 694 CA-5 (1967), where a short sale was not involved.

Incorporation of a Partnership and Sec. 1244

Sec. 1244

The incorporation of a partnership may be accomplished in one of two ways:

1. The assets of the partnership are transferred to the newly created corporation, in exchange for stock of the corporation which results in control of such corporation (Sec. 351). The partnership subsequently liquidates and distributes the stock tax-free to the partners (Sec. 731).
2. The partnership is liquidated and the assets of the partner-

ship are distributed to the partners (Sec. 731). Shortly thereafter the partners transfer the assets to the newly created corporation in exchange for stock which results in control of the corporation (Sec. 351).

Generally, both procedures result in no taxable transaction and the same basis will result for the stock received by the individuals who were members of the liquidated partnership. However, Sec. 1244 will not apply to the second procedure above.

Normally, an individual stockholder of a corporation will realize and recognize a capital loss if the stock is sold at a loss, or if it becomes worthless. Sec. 1244 provides for an ordinary loss of up to $25,000 per year ($50,000 on a joint return, even though the loss may have been sustained by only one taxpayer) where a loss is realized on Sec. 1244 stock.

The stock must be issued in accordance with a plan which provides for the requirements specified in Sec. 1244. One requirement is that in order for the stock to qualify, it must be held by the individual or partnership to whom issued originally.

In the event a partnership transfers its assets to a newly created corporation in exchange for stock in the corporation (Sec. 351) which had issued the stock in accordance with requirements of Sec. 1244 and then the partnership liquidates and distributes the stock to the partners (Sec. 731), the stock received by the partners will not qualify for Sec. 1244 ordinary loss treatment. The reason is that the partners are not the parties to whom the stock was issued. The reverse is true if the second method described above is used.

When a partnership contemplates incorporation, it should consider the desirability of qualifying in accordance with the provisions of Sec. 1244 before deciding which route of incorporation to follow.

READJUSTMENT OF TAX BETWEEN YEARS AND SPECIAL LIMITATIONS

Mitigation of the Statute of Limitations *Sec. 1311-15*

In order for a taxpayer to invoke Sec. 1311-1315 of the Internal Revenue Code dealing with mitigation of the statute of limitations in the case where an inconsistent position is taken, there must be a final "determination" as to the issue in the open year giving rise to the closed year adjustment. While it is generally understood that the execution of Form 870 is not a final "determination" as contemplated by the statute, there is some doubt as to whether the execution and acceptance of Form 870-AD is such a final "determination."

In *Uinta Livestock Corp.*, 335 F2d 761 (CA-10, 1966), the taxpayer brought a refund suit after executing a Form 870-AD which had been accepted by the government. The court held that the Form's language ("it is not, however, a final closing agreement") overcomes the statement thereon that "no claim for refund or credit shall be filed or prosecuted." Accordingly, it seems possible that the execution of Form 870-AD will similarly be held not to constitute a final "determination" as required by the mitigation provisions.

As a result, if the taxpayer seeks to invoke the mitigation sections after a settlement with the Appellate Division, Form 870-AD should only be executed upon the express condition that an agreement under Sec. 1313(a)(4) will be executed by the government. Otherwise, the taxpayer could be forced to go through the expensive and time-consuming refund claim-suit procedure in order to arrive at a final "determination" as to the open year. Sec. 1313(a)(4) specifically provides that an agreement under that section is a final "determination" for purposes of invoking the mitigation provisions.

If the government is the party seeking to invoke the mitigation sections, where the taxpayer is the party taking the inconsistent position, the same principles should apply. Accordingly, if the government accepts a Form 870-AD which is not conditioned upon the taxpayer's execution of a Sec. 1313(a)(4) agreement and if the taxpayer subsequently refuses to execute such an agreement, the requisite final "determination" could be lacking, and the government could be precluded from

Sec. 1311-15

asserting a deficiency for the year barred by the statute of limitations, and could be barred forever from recovery, in the absence of a subsequent closing agreement or re-examination. There would thus never be any final "determination" as envisioned by the statute.

Sec. 1341

Don't Overlook Sec. 1341

Frequently taxpayers may have to report a substantial capital gain upon the liquidation of a corporation, and then subsequently repay an amount in excess of $3,000 on behalf of the corporation. The capital loss arising from the repayment may be of little tax benefit in the year of payment.

Under these circumstances, the benefit of Sec. 1341 should not be overlooked. This section, in effect, permits recomputation of the *prior* year's tax liabilities after reducing the gain previously reported by the repayment in the *current* year. The tax reduction for the prior year is then deducted from the tax liability for the current year computed without taking the repayment into account.

ELECTION OF CERTAIN SMALL BUSINESS CORPORATIONS AS TO TAXABLE STATUS

Sec. 1371-78

Disallowed Expenses Under Subchapter S

Practitioners have become familiar in recent years with the IRS practice of disallowing travel and entertainment expenses of a closely held corporation and of taxing the disallowed expenses as dividends to a shareholder. It is interesting to note how this affects the taxpayer where an election is made under subchapter S.

Assume an electing corporation has accumulated earnings of $20,000. During 1967, the corporation has a profit of $15,000. There are no distributions during the year. Thus, the $15,000 is picked up by the shareholders on their returns for 1967 as undistributed taxable income. Upon examination of the return the

IRS disallows $5,000 of travel and entertaining expenses.

Income of the shareholders will be increased by only $5,000 whether the $5,000 disallowance is considered an increase in undistributed taxable income (with a corresponding increase in the amount reported by the shareholders) or as a money distribution of current earnings (offsetting the increase in taxable income so that undistributed taxable income remains $15,000).

Now, assume that instead of a profit for 1967 the corporation has a loss of $15,000 and the loss is deducted by the shareholders on their returns for 1967. Again, upon examination of the return, the IRS disallows $5,000 of travel and entertaining expenses which reduces by that amount the loss available to the shareholders. In addition, the $5,000 will be considered a distribution out of accumulated earnings and profits. The effect is to increase income of the shareholders by $10,000—twice the amount of disallowed expenses.

Subchapter S—Danger and Opportunity

A, *B*, and *C* each contribute $50,000 in cash to form a corporation which elects tax treatment under subchapter S and which uses the cash method of accounting. It is a service business in which wages and other expenses are paid currently but collections from customers lag quite a distance behind. In its first year the corporation reports a loss of $100,000 (although it really isn't doing badly), and each shareholder deducts his respective share of the loss ($33,333) in his individual return.

In the middle of year two, shareholder *A* sells his stock to *B* and *C* at its original cost. At the end of year two, the corporation reports income of $100,000, all taxable to *B* and *C*, since they are the shareholders on the last day of the year. Results:

1. *A* has a breakeven economically, but deducted $33,333 ordinary loss in year one and had $33,333 long-term capital gain in year two, assuming the corporation is not a collapsible corporation.
2. *B* and *C* each have net taxable ordinary income of $16,667, although the corporation has broken even for the period to date.

The anomalous situation is both a danger to people like *B* and *C* and an opportunity for tax planning for a person like *A*. If *B* and *C* are low-bracket types, they may be able to interest a high-bracket taxpayer in a situation such as just outlined.

Sec. 1371-78

Subchapter S Corporations Claiming Percentage Depletion

Because of the difference between "taxable income" and "current earnings and profits" a venture entitled to percentage depletion (in excess of cost depletion) will be denied the percentage deduction with respect to "earnings and profits" if it incorporates and elects taxable status under subchapter S.

The excess of percentage depletion over cost depletion is considered "earnings and profits" of a corporation. Thus, if the stockholders withdrew in cash such excess, it would be taxable as a dividend out of current earnings and profits, thus placing the stockholders in the position of paying tax on taxable income computed without percentage depletion.

Income-Averaging and Subchapter S

There are a number of important tie-ins between the income-averaging provisions and subchapter S. Obviously, in the first year or so under the subchapter S election, a shareholder may experience a significant increase in his income as compared with the preceding four years. Therefore, the advisability of making the subchapter S election in the first place may be increased because income-averaging will reduce still further the overall taxes which would have been paid if the subchapter S election had not been made. It is possible that certain situations will arise where it is advisable to make the subchapter S election to obtain the benefits of averaging for a year or two, then revoke the election, wait five years, re-elect subchapter S, and again take advantage of income-averaging.

Subchapter S Profit Year Followed by a Loss Year

Corporation *X* (calendar year basis) had substantial retained earnings before it elected to be a subchapter S corporation. In its first year as a subchapter S corporation (1965) it had a profit of $10,000 but, because of need of working capital, it did not distribute the profit to the stockholders. In the second year as a subchapter S corporation (1966) it incurred a loss of $20,000. The corporation and its stockholders are on the same taxable year.

It will be to the advantage of the shareholders for the corporation to distribute the $10,000 profit of the first year before the

end of the loss year. The reason for this is that the net operating loss does not affect the shareholders' share of previously tax income for purposes of determining the nature of distributions during the loss year. However, once the loss year is ended and the net operating loss is allowable to the shareholders, such loss reduces previously taxed income and thus affects the nature of distributions subsequent to the loss year. For example, if the above corporation distributed the $10,000 1965 income in 1966, it would be a distribution of previously taxed income (because there are no current earnings), and not taxable to the shareholders in 1966. If the distribution were made in 1967, it would be taxable to the shareholders since there would be no previously taxed income.

Authority for this is in Sec. 1375(d)(1) and Regs. Sec. 1.1375-4(d). Note that the *timing* of distributions of undistributed taxable income (but not previously taxed income) is affected by Sec. 1375(f) which provides for a throwback of such distributions made within the first two and one-half months of a taxable year.

Life Insurance Owned by a Subchapter S Corporation

Subchapter S corporations are, by definition, closely held and are generally managed by officer-shareholders. A subchapter S corporation is, therefore, the type that will frequently find a need for insurance on the lives of its officer-shareholders. Although discussions of subchapter S often seem to be based upon the assumption that the corporate income retains the same character when passed through to the shareholders that it had when received by the corporation, this rule applies only for long-term capital gains. Where a corporation receives nontaxable income, a distribution of such income to the shareholders will be treated as a distribution of accumulated earnings.

Since the proceeds of life insurance are received only once, there is a possibility that proper planning for the tax treatment of such income will be overlooked. The fact that the corporation has no accumulated earnings and profits at the time that the life insurance is received will not enable the shareholders to avoid being taxed on the insurance proceeds when distributed. Regs. Sec. 1.312-6(b) requires that earnings and profits available for dividends be increased by the amount of nontaxable income received by the corporation.

These rules suggest that in case of a subchapter S corpora-

tion, insurance on the lives of officers or shareholders should be owned by the shareholders, not the corporation. The usual reason for having the corporation own the insurance is that, if it is owned by the shareholders, they must pay the premiums with after-tax dollars.

This reason is not valid in a subchapter S situation. Looking at the corporation and shareholders as a group, the premium cost will be the same irrespective of whether the policy is carried by the corporation or the shareholders. If the shareholders own the policy and are the beneficiaries, the problem of creating accumulated earnings and having the insurance proceeds taxed to them when distributed is avoided. If part of the funds is required for the corporate business, the shareholders may make a contribution to capital.

A further advantage of having the shareholders carry the insurance will be derived in situations where the insurance must be used to purchase stock of the corporation from the estate of a deceased shareholder. By having the shareholders carry the insurance and purchase the stock from the estate, they have the benefit of additional basis in the corporate stock equal to the purchase price.

If the corporation redeems the stock, the remaining shareholders will have no increase in basis even though the percentage interest of each shareholder in the outstanding stock will be the same as if each purchased a pro rata share of the stock from the estate.

Watch Out for Effect of Termination of Subchapter S Status

The shareholders of a small business corporation as defined in Sec. 1371 must constantly be on guard against an inadvertent termination of their subchapter S status. Such a termination would result in the undistributed previously taxed income being locked in the corporation until final liquidation. Alternatively unintended dividend consequences could occur. Sec. 1372(e)(3) provides that termination shall be effective for the taxable year of a corporation in which it ceases to be a small business corporation and for all succeeding taxable years.

For most subchapter S companies, the problem of "locked-in" earnings of the year before an election is terminated may only be avoided by timely distributions. In many situations, however,

distributions are not made for one reason or another, and a substantial amount of undistributed previously taxed income may exist at any given time. Such a situation presents a crisis at a time when the shareholders are approached to "go public" or to be absorbed in an advantageous merger, etc. Since either of these events would result in a loss of subchapter S status under Sec. 1371, must these possibilities be given up because of a freezing-in of earnings which would be unpalatable to the subchapter S shareholders?

In Rev. Rul. 64-94, 1964-1 CB 317, it is held that a subchapter S election of a small business corporation which merges into another corporation in a Sec. 368(a)(1)(A) statutory merger does not terminate with respect to its final taxable year ending on the date of the merger. The reason advanced is that Sec. 1372(e)(3) applies only to a corporation which ceases to be a small business corporation by virtue of an event which does not terminate its taxable year. In the case of a statutory merger, the event causing the disqualification as a small business corporation also terminates the taxable year. Accordingly, it retains its electing status throughout the entire year so terminated. This ruling permits shareholders, prior to the date of a statutory merger, to draw out their previously taxed income.

Since the ruling applies only to a statutory merger and, by analogy, to a Sec. 368(a)(1)(C) or (D) reorganization, if the stock of the subchapter S corporation were disposed of in a taxable transaction or in a "stock for stock" reorganization under the provisions of Sec. 368(a)(1)(B), it would appear that a termination of the election for the current taxable year under Sec. 1372(e) would occur, with no opportunity to distribute previously taxed income.

Where a subchapter S corporation desires to go public, automatically resulting in a retroactive termination (more than ten shareholders), and because of market conditions the underwriters do not deem it desirable to wait until the end of its taxable year, the shareholders are again faced with a problem of locked-in previously taxed earnings. The solution would be simple if the corporation could close its taxable year prior to the public offering, but this requires permission of the Commissioner (see Regs. Sec. 1.442(e)(4)). It has been reported that where such facts were present the Commissioner has not considered the request to close the taxable year to be a tax-saving gimmick and has ruled favorably.

Under Sec. 1375(f), distributions made within two and one-

half months after the end of the taxable year of a subchapter S corporation are treated as having been made on the last day of the preceding year to the extent of such year's undistributed taxable income, even though the corporation terminates or otherwise loses its subchapter S status for the year in which the distribution is actually made. This section applies to any distribution made after April 14, 1966. It also contains elective retroactive effects. This dividend "throwback" may ameliorate the problems referred to above.

Change in Subchapter S Shareholder After Close of Year

There is a "tax trap" inherent in Sec. 1375(f) concerning distributions of subchapter S corporations within two and one-half months after year end. Basically this section provides that distributions made within two and one-half months after year-end will be considered as distributions of the undistributed taxable income of the year just ended. If the shareholders remain the same during this two and one-half month period up to the date of distribution, there is no problem. If, however, a shareholder should die within this two and one-half month period, his privilege of receiving the distribution as "undistributed taxable income" or as "previously taxed income" ceases upon his death. Consequently, the undistributed taxable income of the subchapter S corporation would have to be included in the decedent's final return, and the distribution within the two and one-half months, but after the death of that shareholder would have to be treated by the shareholder's estate as a current year's distribution.

Subchapter S: Another "Automatic" to Be Filed

Extreme care is always given to the making and continuation of an election by a corporation to be taxed under subchapter S. The securing of consents to the corporation's election, both from shareholders at the time of the initial election and from subsequent new shareholders, has become routine for most practitioners.

Less well recognized is the need for the agreement between shareholders and the electing small business corporation de-

scribed in Regs. Sec. 1.47-4(b)(2), regarding Sec. 38 property. This agreement should be filed with the District Director on or before the due date of the return covering the last fiscal year for which the corporation was taxed as a regular (nonelecting) corporation.

The essence of this agreement is that the shareholders undertake to pay any increase in tax occasioned by the disposition by the electing corporation of any Sec. 38 property acquired prior to the year for which the election is first effective. Failure to file this agreement means that the corporation is subject to recapture of investment credit as of the last day of the last fiscal year for which it was taxed as a regular corporation. For this purpose the tax resulting from recapture is determined as if all property which has previously entered into the computation of the corporation's qualified investment had ceased to be Sec. 38 property on that day.

Consideration of the need for this agreement should become a part of every practitioner's regular procedure in preparing a subchapter S election for a corporate client.

Determination of Receipts for a Subchapter S Corporate Partner

Under Sec. 1372(e)(5), the election of a corporation to be taxed under subchapter S will, with a minor exception, terminate if more than 20% of the corporation's gross receipts is derived from "passive investment income," i.e., royalties, rents, dividends, interest, annuities, and gains from the sale of stock or securities.

Suppose a subchapter S corporation is a member of a partnership or joint venture which is taxable under subchapter K (Secs. 701 through 771). How are its gross receipts computed for the purpose of Sec. 1372(e)(5)?

Sec. 702(c) states that "in any case where it is necessary to determine the gross income of a partner for purposes of this title, such amount shall include his distributive share of the gross income of the partnership." Regs. Sec. 1.702(c) emphasizes the universality of this section.

However, Regs. Sec. 1.1372-4(b)(5)(iv)(a) makes clear that "the term 'gross receipts' as used in Sec. 1372(e) is not synonymous with 'gross income.'" Sec. 702(c) therefore cannot be cited as direct authority for the proposition that a corporate partner's

share of gross receipts of the partnership (whether or not passive investment income) should be taken into account in applying Sec. 1372(e)(5).

Even so, the implication is there. Furthermore, in Rev. Rul. 69-40, 1969-1 CB 188, the Service held that for the purpose of meeting an asset test for qualification as a real estate investment trust, an unincorporated trust which was a limited partner in a partnership owning income-producing real estate was deemed to own its proportionate share of each of the assets of the partnership. It would logically follow that for the purpose of Sec. 1372(e)(5) a corporate partner's share of gross receipts of a partnership should be taken into account.

Subchapter S—A Good Way to Sell Out on Installment Basis

Although Sec. 1378 imposes a tax on certain subchapter S capital gains, the subchapter S election by a corporation planning a liquidation can still effect substantial tax savings. Assume a corporation whose only significant asset is substantially appreciated real property held more than ten years. Assume also that the corporation has rather large earnings and profits and that a prospective purchaser of the property wants a five- to ten-year pay-out. If the corporation sells the property, the gain will be subjected to the usual double tax. If the corporation liquidates under Sec. 331 or Sec. 337, the shareholders will be hit with a tax based on either the value of the property or, if sold, the value of the installment obligations. In either case, they will have little or no cash from the sale to pay the tax. A Sec. 333 liquidation is out because of the ordinary income element generated by the earnings and profits.

If the corporation elects subchapter S and sells the property on the installment basis, with payment terms arranged so that no more than $25,000 of the gain is recognized in each of the first three years, Sec. 1378(a)(1) is not applicable because there is not, in any of the first three years, "an excess of net long-term capital gain over net short-term capital loss" in excess of $25,000. After three years, Sec. 1378(c)(1) prevents the application of tax to the balance of the gain. The net result is that there is only one tax—at the shareholder level—and the tax is paid as the cash is received.

However, caution must be exercised so that imputed or actual

annual interest under the installment contract and other passive income do not exceed 20% of the corporation's gross receipts so as to invalidate the subchapter S status.

Valid Subchapter S Election Though No Gross Receipts

Taxpayers should not overlook the possibilities of making a subchapter S election for the early years of a corporation which will ultimately be disqualified from the election. Often a corporation will anticipate no gross receipts for the first few years of its existence, though there will be large interest deductions which could be passed through to the shareholders (as operating losses) if subchapter S treatment were elected. Even though the only possible type of gross receipts the corporation could have in the next few years would be personal holding company type income, there can be no current termination of a subchapter S election as a result of the corporation's having no gross receipts.

We understand that the IRS agreed informally that, even though the only possible prospective gross receipts would be personal holding company type income, if there is in fact no personal holding company income, there is no termination under Sec. 1372(e)(5). Termination will not occur until the taxpayer fails to meet the gross receipts test for a particular year. That failure may, however, result from a very small amount of prohibited gross income, with disastrous consequences if a large net loss is involved. See *Temple N. Joyce,* 42 TC 628 (1964). However, Sec. 1372(e)(5)(B) permits a corporation to retain its subchapter S status during its first two years in business if the prohibited income is less than $3,000 per year.

Capital Gain on Repayment of Subchapter S Debt?

A relatively simple formality can mean the difference between recognizing gain as capital or ordinary in nature.

A shareholder-creditor's total basis in a subchapter S corporation includes the basis of his stock and the amount of the debt. A pro rata share of corporate net operating losses may be deducted by the shareholder to the extent such losses do not exceed the total basis, first in the stock, then in the debt. Upon repayment of the debt by the corporation, the shareholder-creditor

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realizes a proportionate amount of gain and return of capital in each payment.

Rev. Rul. 64-162, 1964-1 (Part 1) CB 304, where the Service originally announced that such gain was to be recognized as capital gain, has been distinguished and amplified. In Rev. Rul. 68-537, 1968-2 CB 372, the Service held that the gain should be recognized as ordinary income unless the corporation had issued its shareholder a note as evidence of the indebtedness. Only formal notes in the hands of the shareholder-creditor were eligible for capital gain treatment.

Subchapter S Trap to Be Avoided

A corporation can qualify under subchapter S if it owns short of 80% of the stock of a subsidiary company. If a taxable liquidation of the subsidiary occurs, the possible investment income including capital gain could easily exceed 20% of the gross revenues in the year of liquidation. This could terminate the subchapter S election with disastrous results. Such a termination could be avoided by spreading the liquidation over a period of years to prevent the capital gain and other passive income in any one year from exceeding 20% of the gross revenues for that year.

Subchapter S and Sale of Corporate Assets

Sec. 1378 is intended to prevent a corporation from electing the provisions of subchapter S in order to pass through large capital gains to its stockholders, thereby avoiding tax at the corporate level. However, the section, which in effect imposes capital gains tax on the corporation, does not appy when the subchapter S election has been in effect for the three taxable years immediately preceding the year in which the long-term capital gain is recognized.

As a result of this "three-year" provision limiting the application of Sec. 1378, a subchapter S election, used in conjunction with an election to report on the installment method, may still avoid double tax on certain sales of Sec. 1245 or Sec. 1250 property.

Regs. Sec. 1.1245-6(d) and proposed Regs. Sec. 1.1250-1(b)(6) provide that upon an installment sale of Sec. 1245 or Sec.

1250 property the initial gain recognized under the installment method constitutes ordinary income rather than capital gain to the extent of the applicable depreciation recapture. Accordingly, if a corporation entering into a sale of such property elects to come within the provisions of subchapter S, elects also to report gain from such sale on the installment method and is able to arrange the schedule of installment payments so that gain realized in the first three years is limited to ordinary income under the depreciation recapture provisions, Sec. 1378 will not be applicable for the subsequent year or years in which the residual long-term capital gain is recognized. Although the stockholders will have to report their respective shares of operating income as well as of the gain on the sale for a minimum of four years, significant overall tax savings might still be achieved.

Excessive Salaries Also a Problem Under Subchapter S

Many have assumed that adoption of subchapter S will eliminate the controversies regarding excessive salaries paid to officer-shareholders. The thinking is that such payments to the extent that they are disallowed as salaries will be considered as a dividend, thereby reducing the undistributed taxable income and leaving no net tax effect.

However, a question has been raised by agents examining subchapter S corporations, suggesting that a problem still exists for the following reasons:

1. It does not follow that the disallowed compensation can only be considered a dividend. This is especially true where the excessive payments do not bear a close relationship to the stockholdings.
2. If the salary is paid in other than cash, the excessive portion will not reduce the undistributed taxable income created by a salary adjustment.
3. Limitations on pension and profit-sharing contributions may become operative. In this respect, note that the regulations provide that no deduction is allowable under Sec. 404 for the amount of any contribution for the benefit of an employee which, together with other amounts paid to or for the benefit of the employee, is in excess of a reasonable allowance for compensation for the services actually rendered. Some agents are taking the position that, where salaries are already unreasonable, this rule operates to prevent the allowance of any contribution at all

Sec. 1371-78 to a profit-sharing plan. Therefore, the entire contribution for the employee-shareholder group may be disallowed, thereby increasing undistributed taxable income.

4. It may also be anticipated that the Commissioner will still challenge the reasonableness of salaries to avoid the establishment of a pattern of executive compensation which could create a precedent for periods during which an election is not in effect.

5. If the excessive salary is paid in a loss year of the subchapter S corporation, and if the corporation has accumulated earnings and profits, the disallowance will reduce the loss and increase the stockholder's income. The stockholder will not be able to reduce his income by the excessive compensation because it will be treated as a dividend out of the accumulated earnings and profits.

Sec. 1372

Beginning of Operations Determines Timing of First Subchapter S Election

The Tax Court opinion in *Bone* (52 TC 913) demonstrates that state law may not be a completely accurate guide in making federal income tax decisions.

At issue in the case was whether or not a new business enterprise had filed a timely election under subchapter S which would have enabled an individual shareholder to utilize the losses sustained by the corporation on his personal return. Under applicable California law, a newly formed corporation may carry on operations as a corporation (e.g., have a bank account, manufacture goods, provide services and so forth) but it may not issue stock until a permit is received from the Commissioner of Corporations.

The corporation in *Bone* delayed filing its subchapter S election until the permit was received although it had been operating as a corporation prior to that date. Citing Regs. Sec. 1.1372-2 (b), the court held that the election should have been filed when the corporation first began business and that the subscribers could be considered shareholders.

Counsel in states with similar laws have been known to recommend that new corporations delay subchapter S status until a stock permit is received. The opinion in *Bone* makes such delay unnecessary and, in fact, inadvisable if the owners of the business want it to qualify for subchapter S treatment from its inception.

Schedule K, Form 1120S, Misleading for Fiscal Year Subchapter S Corporations

Sec. 1373

With the exception of distributions paid within 2½ months after a subchapter S corporation's year-end which are considered distributions of its previous year's undistributed taxable income under Sec. 1375(f), and distributions of previously taxed income under Sec. 1375(d), all distributions by subchapter S corporations are taxed to the shareholders in their year of receipt. This rule is made clear by, among other citations, Example (1) of Regs. Sec. 1.1373-1(g) and Example (3) of Regs. Sec. 1.1375-6(a)(6).

Example A, a calendar year taxpayer, is the sole shareholder of Corporation Z, a subchapter S corporation, which has a June 30 year-end. For the year ended June 30, 1970, Z realized $60,000 taxable income which equalled its earnings and profits. Dividends were paid to A of $25,000 in December 1969 and $20,000 in June 1970. No further distributions were made during 1970.

Form 1120S and the instructions to Schedule K indicate that A should report the entire $60,000 in 1970 rather than $25,000 in 1969 and $35,000 ($20,000 dividend + $15,000 undistributed taxable income) in 1970.

Under these facts the instructions serve to defer the taxation of dividends received by a shareholder in his calendar year ending before the subchapter S corporation's fiscal year-end. Thus, the instructions may operate to the detriment of the IRS. In given circumstances however, they may also prove costly to taxpayers who blindly follow them.

Sec. 337 Overrides Subchapter S Tax on Capital Gains

Sec. 1378

Knowing how to use Sec. 337 in conjunction with the subchapter S provisions may result in impressive tax savings as illustrated by the following example:

ABC Corp. has been under a subchapter S election for two years. It receives an attractive offer to sell substantially all its assets. If consummated, the sale will result in a substantial capital gain which will exceed $25,000 and 50% of its taxable income for the year. Under Sec. 1378 and contrary to the usual pattern of subchapter S, the gain will be subject to double taxation: once at the corporate level and again at the stockholder

Sec. 1378 level. One method of avoiding double tax is to liquidate the corporation under Sec. 337.

An analysis of Sec. 1378 in conjunction with a review of Sec. 337 indicates that by using a Sec. 337 liquidation, the tax imposed by Sec. 1378 will be avoided. Sec. 1378(a) is applicable only under particular circumstances, namely (1) the excess of the net long-term capital gain over the net short-term capital loss of the corporation must exceed $25,000 and 50% of its taxable income for the year and (2) the taxable income for such year must exceed $25,000. If these tests are not met, no tax will be imposed at the corporate level.

If, in our example, the corporation sells substantially all its assets and liquidates under Sec. 337, any gain on the sale will be sheltered from the Sec. 1378 tax. The reason for this is clear. The proceeds of the sale that might be taxed as capital or Sec. 1231 gain are not "taken into account in computing gross income" under Sec. 337. Thus, by definition none of these proceeds can be included in "net long-term capital gain," which is the basis for determining whether or not Sec. 1378 is applicable (see Sec. 1222).

CONSOLIDATED RETURNS

Sec. 1502

Watch Out for Reverse Acquisitions

The "reverse acquisition" is a concept described in Regs. Sec. 1.1502-75(d)(3). Briefly, a reverse acquisition occurs if one corporation, in exchange (in whole or in part) for its stock, acquires either substantially all the assets of a second corporation or sufficient stock of the second corporation so that the second corporation would become (but for the reverse acquisition rule) a member of the group of which the first corporation is either the common parent or a member, and the former shareholders of the second corporation, by reason of such ownership, own immediately after the acquisition more than 50% of the fair market value of the outstanding stock of the first.

Following the example given in the regulations, suppose that there are two affiliated groups, *PS* and *TU*, of which *P* and *T* are the respective common parents. If *P* is merged into *T*, and

if immediately after the merger the former shareholders of *P* own more than 50% of the fair market value of the outstanding stock of *T* as the result of their having owned stock in *P*, it is deemed that the *TU* group ceased to exist as of the merger date, and that the *PS* group remains in existence, with *T* taking the place of *P* as the common parent.

The reverse acquisition rule has immediate effect in determining whether a consolidated federal income tax return must continue to be filed. Under the present regulations, a group must file a consolidated return if it filed one for the immediately preceding taxable year, unless certain highly restricted circumstances permit the group to file separate returns. Thus, if the above-described *PS* group filed a consolidated return for the period ending with the merger, the continuing *PS* group (with *T* as the common parent) must continue to file a consolidated return unless circumstances permitting separate returns exist. On the other hand, if *P* had properly filed a separate return for the period ending with the merger, the continuing *PS* group (with *T* as the common parent) could file separate returns if desired, without regard to whether the *TU* group (which ceased to exist) filed a consolidated return. Of course, a group has the privilege of filing a consolidated return at any time.

The reverse acquisition concept is expressly incorporated into Regs. Sec. 1.1502-1(f)(3), so that taxable years of *T* and *U* ending on or before the date of the merger must be treated as "separate return limitation years." Taxable years of *P* and S ending on or before the date of the merger may or may not be "separate return limitation years," depending on their prior circumstances. Thus, reverse acquisitions directly affect the ability to use "built-in deductions," as well as carryovers of investment credits, foreign tax credits, net operating losses, and capital losses.

In a similar manner, the reverse acquisition concept is expressly incorporated into Regs. Sec. 1.1502-1(g)(4), so that reverse acquisitions affect the ability to use the above carryovers in circumstances where a "consolidated return change of ownership" has occurred.

There are several other sections of the consolidated return regulations which do not expressly incorporate the reverse acquisition concept, but for which the concept logically should be applicable. Regs. Sec. 1.1502-1(a) states: "See §1.1502-75(d) as to when a group remains in existence." Note that the reference is to the entire paragraph -75(d), which includes subpara-

 graph -75(d)(3), which contains the reverse acquisition concept. It therefore appears that the reverse acquisition concept is a rule of general application.

As a rule of general application, reverse acquisitions would also have impact on the restoration of deferred gain or loss on deferred intercompany transaction. Regs. Sec. 1.1502-13(f)(1)(iii) provides that any such remaining deferred gains or losses shall be taken into account immediately preceding the time when either the selling member or the member which owns the property ceases to be a member of the group. Thus, any item of such deferred gain or loss betwen *T* and *U* would be taken into account immediately prior to the merger, but any item of such deferred gain or loss between *P* and *S* would not be affected by the merger. However, proposed Regs. Sec. 1.502-13(f)(2)(i), if adopted, would change this result.

Without going into detail, reverse acquisitions could for similar reasons have an effect upon the establishment, or recovery, of the "initial inventory amount" under Regs. Sec. 1.1502-18. In addition, reverse acquisitions will "trigger" under Regs. Sec. 1.1502-19 any excess losses with respect to members of the group which is deemed to go out of existence.

Finally, it should be noted that a reverse acquisition may occur as the result of either a nontaxable or a taxable transaction. Also of interest is the fact that the reverse acquisition concept (although not referred to as such) is contained in Regs. Sec. 1.1562-5(c)(3), which relates to a successor controlled group of corporations for the purpose of the multiple surtax exemption election.

Avoiding Excess Loss Account By "Deemed Dividend" Election

Election of the "deemed dividend" under consolidated return Regs. Sec. 1.1502-32(f)(2) offers a way to minimize income taxes in certain cases. The subsidiary is deemed to have paid a dividend to the parent which is deemed to have returned such amount as a contribution to the capital of the subsidiary. As a result, the earnings and profits of the subsidiary, as of the beginning of the year for which the election is made, increase the parent's basis of its investment in the subsidiary. The annual election may be made with the return by one or more of the subsidiaries.

Assume a sale of stock in 1970 of a subsidiary for which the parent's investment was $200,000. The subsidiary's accumulated earnings and profits at the beginning of the year are $500,000 and a consolidated return is filed for 1970. At the time of sale, the subsidiary has a loss of $500,000 which is used by the parent in 1970. If the election is not made, the excess loss account of $300,000 ($500,000 less $200,000) will be immediately restored to income with the result that the parent gets only a net $200,000 deduction (Regs. Sec. 1.1502-19). If the election is made in a timely filed 1970 return, however, the parent's investment in the subsidiary will be increased to $700,000 as of the beginning of the year, thus avoiding an excess loss account.

Loss Carryover to Consolidated Group From Separate Return Year

An interesting question presented is whether the net operating loss of S Corporation of approximately $260,000 from separate return years, or years when it was included in another consolidated group, may be carried over against the ordinary income of other members of a new consolidated group in the year 1967 where the income contributed to the group by S Corporation in 1967 is all long-term capital gain.

Under Regs. Sec. 1.1502-21(c)(2) such carryover is in general effect allowed to the extent that S Corporation has taxable income (including capital gains). Since S Corporation will have taxable income, all of which is capital gain, sufficient to absorb the net operating loss carryover, then the entire carryover is allowable in 1967 as a deduction. Once we have decided under (c)(2) that the deduction is allowable we look to the mechanical computations of consolidated taxable income to determine against what income the loss is deductible. By following the language of the regulations, it appears that the carryover is offset against ordinary income of the group and the capital gain is undiminished.

Thin Capitalization Everywhere?

An election to consolidate income is available to domestic corporations connected through stock ownership with a common parent corporation which also must be an includable corpora-

tion. The statutory test of consolidation stipulates direct ownership of at least 80% of the voting power of all classes of stock and an equivalent percentage of each class of the nonvoting stock.

It is possible that direct ownership of the stipulated percentage of stock is not enough to satisfy the stock ownership test. In one interesting case, *Book Production Industries, Inc.*, 24 TCM 339, the Tax Court ruled that the ownership of the entire capital stock did not constitute the required control. The parent owned only a nominal amount of capital stock in relation to debt owned by nonmembers, and the Tax Court held that there was insufficient "equity interest in the subsidiary to meet the stock affiliation requirements of the statute." Advances from the prior parent "have all the earmarks of capital contributions —and hence could constitute another class of stock." Thus, the Tax Court indicated that the thin incorporation concept can be applied to a subsidiary in determining whether or not the 80% ownership test is met.

Election Not to Defer Intercompany Gains or Losses

Under Regs. Sec. 1.1502-13(c)(3), a group may elect with the consent of the Commissioner not to defer gain or loss on deferred intercompany transactions.

The IRS National Office has advised informally that most requests thus far not to defer have been denied. In order for the Service to consider such a request, certain questions must be answered and substantial information must be submitted by the taxpayer.

Even then the Service is reluctant to approve requests not to defer intercompany transactions under the regulations. If it should grant such approval, there would probably be a provision that the company cannot utilize net operating loss carryovers as a result of such election which it would not otherwise have been able to use.

Benefits From Nontaxable Transactions Between Affiliates

Gains on deferred intercompany transactions between affiliates during a consolidated return period must be reported as income

by the "selling" corporation upon the occurrence of any of the events set forth in Regs. Sec. 1.1502-13(f). These events include, for example, the departure of either the purchasing or the selling member from the group, and the filing of a separate return by the common parent after less than three consecutive consolidated returns. The reporting of such income by reason of any of the specified events can be quite costly, especially since the installment method is not available to the selling member by reason of Regs. Sec. 1.1502-13(c)(1)(ii)(a).

The above rules, however, do not supersede the ability to make intercompany transfers without the recognition of gain or loss. Regs. Sec. 1.1502-13(c)(1)(i) states that gains or losses are deferred only on deferred intercompany transactions with respect to which gain or loss would (but for the deferral resulting from the consolidated return) be recognized under the regular provisions of the Code. Example (2) of Regs. Sec. 1.1502-13(h) seems to make clear that any unrecognized gain resulting from a Sec. 351 transaction survives such events as the departure of the purchasing or selling member from the group or the filing of consolidated returns for less than three years. Other examples of intercompany transfers of property without the creation of deferred gain which would be reportable upon the occurrence of any of the specified events are contained in Regs. Sec. 1.1502-14.

If in the context of a consolidated return there is any likelihood of an event which would "trigger" a deferred gain before the related property is disposed of outside the group, consideration should be given to a transfer in which the gain would be wholly or even partially nonrecognized, rather than merely deferred.

Using Separate Return Losses in a Consolidated Return Year

A parent and its subsidiaries have been filing separate returns and pursuant to Sec. 1562 have claimed multiple surtax exemptions in each of these years. The parent has a large loss carryover coming into the current year. Its earnings this year will not be sufficient to use all of the loss carryover. The group plans to file a consolidated return.

Since multiple surtax exemptions were claimed in earlier years, these years are separate return limitation years and the

 loss from such years may not be used in the consolidated return except to the extent of a limitation described in the regulations. The multiple surtax election for prior years can be revoked and the parent's carryover could be used without limitation to offset the income of the subsidiaries in the consolidated return. However, this would mean paying up a substantial amount of tax represented by the tax saving in each of the years subject to the election.

An alternate proposal, and one that is more palatable, is to merge the subsidiaries into the parent. This would increase the parent's income in the consolidated return. Even if the limitation on deduction of losses in the consolidated return continues to be applicable, the increase in the parent's contribution of income to the consolidated return may be sufficient to permit full absorption of the losses.

Is Form 1128 Required for Newly Affiliated Subsidiaries?

Whenever an affiliated group elects to file a consolidated return or when a new subsidiary joins an affiliated group already filing a consolidated return, it is necessary for the subsidiary or subsidiaries to adopt the annual accounting period of the common parent. The consolidated return regulations applicable to years beginning before January 1, 1966, specifically required that if a change of accounting period was necessary to adopt the common parent's taxable year, Form 1128 had to be filed at or before the filing of the consolidated return for the taxable year for which the subsidiary first adopted the common parent's year (Regs. Sec. 1.1502-14A(b)). The regulations applicable to years beginning after December 31, 1965, are silent as to the requirement of filing Form 1128, although, of course, the requirement for adoption of the common parent's year by other members of the affiliated group has not changed.

The old consolidated return regulations provided that failure to file any form required by such regulations (including Form 1128) would allow the Commissioner to recompute the tax liability of the group on a separate return basis unless (1) the forms were filed within the time permitted by the Commissioner upon notice to the group that such forms had not been filed or (2) a consolidated return was otherwise required by the regulations (Regs. Sec. 1.1502-18-A(a)). The new consolidated

return regulations do not contain any such rule which would apply to failure to file Form 1128, but the regulations do state that other provisions of the Code apply absent specific exclusion by the consolidated return regulations (Regs. Sec. 1.1502-80).

While it appears that Form 1128 is no longer required, the regulations under Sec. 442 (relating to change of accounting period) continue to require the filing of Form 1128 for a subsidiary corporation to change its accounting period to comply with the regulations under Sec. 1502 (Regs. Sec. 1.442-1(d)). Obviously, the citations in Sec. 442 regulations are outdated, as presumably is the requirement for filing Form 1128. In addition, the instructions of Form 1128 require that a subsidiary corporation changing its accounting method to conform to the common parent's year must file Form 1128 with the District Director with whom the consolidated return will be filed at or before the filing of the consolidated return for the year of change.

The consequences of failure to file Form 1128 under the new consolidated return regulations are not clear. It seems apparent that filing of a consolidated return reflecting the proper includable taxable income for subsidiaries is all that is necessary to change a subsidiary's accounting period. If this conclusion is correct, the regulations under Sec. 442 and Form 1128 should be amended to conform with this procedure. Nevertheless, until such changes are made, the tax practitioner may be well-advised to file Form 1128 for newly electing consolidated return groups.

Tax Liability of Subsidiary Withdrawing From Group

In connection with the acquisition of the stock of a corporation, the possibility of additional federal income tax assessments must be evaluated and taken into consideration in determining the ultimate purchase price. Although this matter is generally covered in warranties obtained from the seller, the government looks first to the transferred corporation to satisfy its tax obligations.

Where the acquired corporation was a member of an affiliated group filing consolidated return, the potential tax liability of the acquired corporation cannot be restricted to the "separate return tax liability" of the acquired corporation, but could include potential tax deficiencies of the entire consolidated group

Sec. 1502 because of the several liability provisions of Regs. Sec. 1.1502-6.

Regs. Sec. 1.1502-6(b) describes a procedure whereby the District Director may make an assessment and collect a deficiency from a subsidiary which has ceased to be a member of a consolidated group in an amount not exceeding the portion of such deficiency which the District Director may determine to be applicable to it. This procedure is intended to be utilized when the District Director determines that the assessment or collection of the balance of any consolidated tax deficiency will not be jeopardized. This procedure merely means that the District Director may, at his discretion, proceed against the former affiliate only for its applicable portion of the consolidated return tax deficiency when he is satisfied that the affiliated group (excluding the former affiliate) is financially able to satisfy the remaining portion of any tax deficiencies assessed against it. This provision should not be interpreted as any limitation on the portion of any consolidated tax deficiency which may be assessed against or collected from any company which joined in the consolidated return. Although the several liability features of the consolidated return regulations may appear inequitable where a new owner of a former affiliate is involved, it is a fact which must be taken into consideration in negotiating a purchase or for working out the terms of any warranty agreement, inasmuch as such agreements will not be binding on the IRS as to any future assessments on accounts of prior years' taxes.

Consolidated Regulations "30-Day Rule"

Suppose a parent corporation, *P*, has two wholly owned subsidiaries, *S-1* and *S-2*. *P*, *S-1*, and *S-2* have filed consolidated returns on a calendar-year basis for several years. There is a consolidated operating loss carryover attributable under Regs. Sec. 1.1502-79 entirely to *S-2*.

On January 15, 1968, *P* sold all its stock in *S-2* to an unrelated corporation. *P* would like to claim *S-2*'s loss carryover on a 1968 consolidated return which it proposes will include *P*'s and *S-1*'s income for the calendar year 1968 and *S-2*'s income for 15 days. Since *S-2*'s loss is part of a consolidated loss carryover, it can be used without limitation on the 1968 consolidated return of *P* and affiliates if *S-2* can be included in the return.

Regs. Sec. 1.1502-76(b)(5)(ii) states that if a corporation "has been a member of such a group for a period of 30 days or

less, then such corporation may, at its option, be considered as not having been a member of such group during such year." If the corporation which acquired S-2 wishes to maximize the loss carryover of S-2, it can apparently cause S-2 to elect not to be included in P's 1968 consolidated return. In such situations, it would appear advisable to obtain the consent of a subsidiary to be included in a consolidated return before such subsidiary is sold.

Sec. 1502

Avoid Consolidated Return Double Tax From Depreciation Recapture

In a highly leveraged situation, such as a corporation owning principally depreciable property, the use of accelerated depreciation could result in net operating losses and, if utilized in a consolidated return, could result in an excess loss account. If the subsidiary is disposed of, the excess loss account, due to accelerated depreciation, will be restored to income (Regs. Sec. 1.1502-19). A further recapture with respect to depreciation can result under Secs. 1245 and 1250, if the purchaser liquidates the company under Sec. 334(b)(2). This harsh result can be avoided if the subsidiary *sells* the depreciated *property* directly. Depreciation recapture in the subsidiary will become part of the subsidiary's earnings and profits and reduce or eliminate the excess loss account as a result of the positive investment adjustment (Regs. Sec. 1.1502-32).

Affiliated and Controlled Group Problems

Sec. 1561-63

There may be a difference between an affiliated group under Sec. 1504 for consolidated return purposes and a controlled group under Sec. 1563 for surtax exemption purposes. For example, where the parent of an affiliated group owns 26% of the stock of A and holds an option to purchase the other 74% of A's stock, A would not be an affiliate for consolidated return purposes, but it would be a component member of a controlled group for surtax exemption purposes. The option would make the parent the constructive owner of all the stock of A under Sec. 1563(d)(1)(B) and (e)(1).

A domestic U.S. corporation may be excluded from an affiliated group under Sec. 1504(b) because it is entitled to the bene-

Sec. 1561-63 fits of Sec. 931 (large percentage of income from sources within a possession of the United States). But the excluded corporation (and its subsidiaries, if any) would be a member of a controlled group.

Failure to recognize the difference between the definition of an affiliated group and a controlled group in exercising surtax exemption elections can result in the loss of surtax exemption benefits where no election or an improper election is made and the Commissioner arbitrarily allocates the surtax exemption among all the members of the component group, including loss or inactive corporations.

ESTATE AND GIFT TAXES

Sec. 2031

An Estate Tax Credit That May Be Missed

Most practitioners are aware of the credit against the estate tax for the tax paid on prior transfers under Regs. Sec. 2013. Briefly, if a transferee dies within ten years after or two years before the transferor, the transferee's estate is entitled to a credit for estate taxes imposed on the property in the transferor's estate. Interestingly, however, the property does not have to be included in the transferee's estate in order for his estate to be entitled to a credit.

For example, decedent had a life estate in a trust created under the will of her father. The value of the trust property was taxed in the father's estate. On the transferee's death no part of the trust property was included in her estate.

In Rev. Rul. 59-9, 1959-1 CB 232, the IRS held that since the transferee died within ten years of her father, her estate is entitled to the Sec. 2013 credit. The IRS reasoning is that the decedent's life estate is an interest in property received from her father. It is immaterial that the trust principal itself is not included in her estate.

Of course, the amount of the credit turns on a valuation of the property (life estate) transferred from her father. Rev. Rul. 59-9 directs that the value of the life estate be computed as of the date of her father's death using recognized actuarial principles. However, in Rev. Rul. 66-307, 1966-2 CB 429, the IRS

holds that such principles give way if, on the valuation date, the death of the life tenant from known causes was predictable and imminent. Furthermore, if the distribution of income to the life beneficiary is subject to the discretion of the trustee, and any accumulated income eventually goes to the remainderman, the value of the life interest cannot be valued according to recognized valuation principles as of the date of the transferor's death. In such a case, therefore, the life beneficiary's estate gets no credit (Rev. Rul. 67-53, 1967-1 CB 265).

Sec. 2031

Optional Valuation Date Sometimes Prohibited

Sec. 2032

Where a decedent leaves an estate of less than $60,000 so that an estate tax return is not required to be filed, Regs. Sec. 20.2032-1(b)(1) denies the executor the election of using the optional valuation date in order to take advantage of an increased basis for the beneficiaries. This rule applies even if the value of the gross estate, which did not exceed $60,000 on the date of death, does exceed $60,000 on the optional valuation date.

There is no prohibition against using the optional valuation date to obtain an increase in basis, however, where the value of an estate at date of death is, for example, $100,000, and where the marital deduction reduces the estate below $60,000 and no estate tax is due. In the latter situation, an estate tax return is required to be filed.

Gifts in Contemplation of Death

Sec. 2035

Why not a gift in contemplation of death in lieu of a testamentary disposition? Normally it is desirable to avoid gifts in contemplation of death because amounts so transferred are included in the decedent-donor's taxable estate. Where death is imminent, however, tax savings can result through a gift in contemplation of death. Although a gift so tainted is included in full in the decedent's gross estate, the gift tax payable thereon is deductible as a debt of the estate and, in addition, is a direct credit against the estate tax liability.

For example, a single individual with an estate of $1 million makes a taxable gift of $500,000 to the person named as sole beneficiary in his will. The gift is made although the donor does not expect to survive the three-year statutory period, and

Sec. 2035 dies before the gift tax is paid. The gift tax liability is $109,275 (disregarding previous gifts, exemptions and exclusions). The gross estate including the $500,000 gift in contemplation of death is $1 million. But the net taxable estate is reduced by the gift tax liability of $109,275. The estate tax liability amounts to $285,268 less the credit of $109,275 for gift tax, or a net estate tax of $175,993. The combined estate and gift taxes of $285,268 compare to an estate tax liability of $325,000 which would have been payable on an estate of $1 million had no gift been made. The tax saving of $40,432 represents 37% (the top estate tax bracket) of the amount of gift tax ($109,275) for which credit has been received. Thus the gift tax serves as both a credit and a deduction.

Sec. 2042 Watch Details on Transfers of Life Insurance Policies

Life insurance policies must be formally assigned in conformance with the policy terms to exclude the proceeds from estate taxation. The *Kearns* case highlights the dangers in improper policy transfers (*Tom Kearns, Jr.*, 399 F2d 226). The controlling shareholder treated his corporation as the owner of two life insurance policies on his life. The corporation paid all the premiums, assigned the policies as collateral on bank loans, and reported the cash surrender values as an asset on the company's books and financial statements. Written notice was given to the insurance company in each instance of a bank loan. The corporation had physical custody of the policies and also was the beneficiary. Despite the obvious intent to transfer ownership of the policies to the corporation, the Court held that the proceeds were includable in the stockholder's estate at the time of his death. The fatal factor in the taxpayer's case appeared to be the lack of a written notification to the insurance company of the policy assignments. Without a valid assignment of his rights under the policy, the decedent retained all the incidents of ownership and the policies were includable in his estate.

All incidents of ownership must be transferred to avoid includability of insurance proceeds in the transferor's estate. Apparent ownership by a corporation or other entity is not enough. One worthwhile step in a tax checklist would be to contact insurance companies to determine the true owner of a client's policies.

This is to be contrasted with the situation where individual partners had entered into a buy-sell agreement funded by insurance policies. Although the insurance brokers had been instructed that the beneficiary of the policies and not the insured was to be the owner, the policies failed to reflect this intention. The Tax Court in the *Estate of Bert L. Fuchs,* 47 TC 199, acq., held that the decedent did not retain taxable incidents of ownership in the policies because of the overriding impact of the buy-sell agreement which deprived the decedent of any economic benefits from the policies.

An interesting assertion was made by the taxpayer in *Kearns* that the policy proceeds had already been included in the estate as part of the value of decedent's stock in the corporation. The Court held that there was insufficient proof to support this argument. The revenue agent's report merely stated that the value of the stock was redetermined upon "consideration of book value, earnings, dividend-paying capacity, and other factors." The insurance proceeds easily could have been one of the other factors influencing the agent's higher valuation of the stock.

Copy Life Insurance Policies Before Surrendering

Experience has shown that in cases where life insurance on a decedent's life is excluded from a Form 706, as for example in cases of key man insurance, the examining agent may ask to see the insurance policy. This request is usually made in the course of the audit of the return and is difficult to comply with if the policies have been surrendered to the insurer. It is advisable to prepare for that eventuality by having copies of such policies made before they are surrendered. This should be particularly easy in cases of business life insurance when one can obtain copies of policies as part of the audit or tax work done for the client, before maturity.

Assignment of Group Life Insurance To Avoid Estate Tax

Generally, the IRS position (see Rev. Rul 68-334, 1968-1 CB 403) is that an employee may transfer his rights to group life

Sec. 2042

insurance only if the group policy as well as state law allows an absolute assignment of all incidents of ownership. Furthermore, absolute assignment is considered to be allowable only where the law of a particular state *specifically* takes such position (e.g., Virginia, Ohio).

However, both the Court of Claims (*Lillian Landorf,* 408 F2d 461) and more recently, the Tax Court (*Max J. Gorby,* 53 TC No. 12), respectively involving the laws of New York and California, are of the opinion that there may be an effective assignment even where there was no specific statutory authorization under the particular state law. (Note: Present New York law does specifically authorize such assignments.)

To avoid potential IRS challenges to the assignment of group life insurance, the following important points should be considered:

The assignment should be made based upon the underlying master group policy of the employer.

The assignment should be made in terms of a specific state rather than in general terms when the employee lives in one state but works in another.

When the insurance premiums are paid through payroll deductions, reimbursements should be made to the insured by the assignee (wife, etc.) from *separate* funds. Evidence of payment from separate funds should be retained. (Of course, direct payments of the premiums to the employer by the insured's assignee are preferable; however, this procedure is frequently not feasible.)

It is imperative, of course, that no incidents of ownership be retained by the insured. The incidents of ownership include the rights to change the beneficiary, to surrender or assign the policy, and to borrow against the policy or to pledge it as collateral.

Sec. 2053

Expenses of Tax-Exempt Income— Estate Taxes

Expenses attributable to exempt income may not be deducted for income tax purposes. Don't forget, however, that, in the case of an estate, to the extent that administration expenses are so disallowed for fiduciary income tax purposes, they are allowable for estate tax purposes as an administration expense (Rev. Rul. 59-32, 1959-1 CB 245).

Marital Deduction Mathematics

Sec. 2056

In financial planning for a married couple, provisions for the estate tax effects of a marital deduction, if otherwise desirable, should not be avoided merely because the separate estates of the spouses are not materially different in value. Except in cases of advanced ages of both parties the survivor will ordinarily have a life expectancy of several years after the death of the first to die. Investment of the funds made available from the saving in estate tax by using all or part of the available marital deduction in the first estate may exceed the sum necessary to compensate for the resulting increase of tax on the ultimate estate of the surviving spouse.

What to Give Away

Sec. 2501

Occasionally a client will ask the practitioner's advice on the selection of property to be made the subject of gifts. The practitioner might offer a few suggestions such as these:

From the standpoint of the donor it is generally not considered good planning to give away cash. Many estates have serious cash problems in meeting death taxes and expenses of administration, and gifts of cash in any substantial amounts tend to make an individual's estate less liquid and to increase the problem of the executor.

Assuming that one of the purposes of the gift is to reduce the donor's estate, it would appear reasonable to transfer property that has a potential for appreciation in value. For example, if an individual makes a gift of bonds and retains a substantial number of shares of a young and vigorously growing company, the shares may rapidly appreciate to the point that the individual's estate exceeds what it was before any gifts were made. In such a case it would seem prudent to include at least a portion of such shares in gifts.

Another general proposition to consider might be the desirability of giving away property that the donor might not want converted to cash or that might be very difficult to liquidate. Very often shares in a closely held corporation fit into this general description. A note of caution might be advisable. If it is planned to pay death taxes and expenses of administration through redemptions of such shares by the company under the protection of Sec. 303, be sure that enough shares will remain in the estate to meet the Code requirements.

Sec. 2501 Attention should also be accorded Sec. 1015(d) of the Code which provides that gift taxes paid on the transfer of property may be added to the basis of the property with the limitation that the increased basis may not exceed the fair market value at the date of the gift.

All other things being equal, it would appear desirable to select property for gift purposes with a cost basis to the donor that is low enough to permit the gift tax paid to be added to that cost by the donee so the gift tax might possibly be partially recovered through reduced capital gains taxes at some future date.

Another consideration in selecting property to be given away is the income needed by the potential donor. Many people with substantial property have an after-tax income insufficient for their needs. In such a case the property to be given away should be the least productive of income. For example, paid-up life insurance policies or investments that produce a low rate of fully taxable income might be considered as likely prospects for gifts.

Basic to any gift problem is the consideration that gifts should be integrated with the overall plan of the donor for dealing with his property and should not be isolated, spur-of-the-moment actions.

Sec. 2504 Preventing Revaluation of Gifts Made in Prior Years

Prior to the enactment of the 1954 Code, a revenue agent could increase the valuation of gifts made during preceding years for purposes of determining the gift tax liability for the year under examination. Sec. 2504(c), enacted in 1954, prevents such a revaluation if a tax was paid or assessed for the prior year.

When a gift is planned of property not subject to a reasonably accurate valuation, such as stock in a closely held corporation, sufficient property should be given in order that some tax will be paid with the return. This result may be accomplished by utilizing only a part or none of the specific gift tax exemption. After the statute of limitations runs out on the return, the valuaion placed on such gift will be fixed for purposes of computing subsequent years' gift taxes.

Timing of a Gift

Sec. 2511

For gift tax purposes, a gift close to the end of a year may raise questions as to the time the gift was completed. Rev. Rul. 67-396, 1967-2 CB 351, states that a gift will be deemed completed when the donor has parted with dominion and control and has no power to change the disposition of the property.

"A gift is not consummated by the mere delivery of the donor's own check or note. The gift of a check does not become complete until it is paid, certified, or accepted by the drawee, or is negotiated for value to a third person."

On the other hand, a gift which qualifies as a deductible contribution for income tax purposes is complete on delivery. Regs. Sec. 1.170-1(b) states ". . . the unconditional delivery (or mailing) of a check which subsequently clears in due course will constitute an effective contribution on the date of delivery (or mailing)." Thus, if a check were mailed to a charity on December 31, 1967, and clears in due course, the deduction is allowable for 1967.

Valuation of Closely Held Stock for Gift Tax Purposes

Sec. 2512

Two individuals owned all the stock of a medium-sized electronics corporation. Three months prior to "going public," the individuals each made gifts of 16,000 shares of stock to their children. The stock had a book value of less than $2 per share but was valued at $4 per share for gift tax purposes. The initial public offering price was $9.50 per share (20% of the outstanding stock of the company was sold) and the stock rose to $31 per share within a year.

The examining agent insisted that because of the close proximity of dates the stock should be valued for gift tax purposes at $9.50 per share. After several informal conferences, a $6 per share valuation, reflecting the "nonmarketability discount," was agreed upon. It was possible to rely somewhat on the dictum in *Bruce Berckmans* (20 TCM 458), and also on the fact that the investment letters which the two shareholders had executed (at the time the stock went public) limited the amount of their holdings which they could sell within a reasonable period after the underwriting. In other words, just because 20% of the company's stock was marketed for $9.50 per share, it did not mean that the balance of the stock "closely" retained was worth

Sec. 2512 the same amount. See also *Morris M. Messing,* 48 TC 502, acq., in which the Tax Court found the value of stock for gift tax purposes to be $13 per share despite a public sale four months after the gift at $36 per share.

Because of the $4 per share original valuation which they placed on their stock, gift tax returns were not filed. The total value placed on the gifts by the donors was more than the annual exclusion but less than the specific exemption. When it was called to the taxpayer's attention that gift tax returns were required to be filed even though no tax was due, delinquent returns were filed five months after the due date. The IRS has imposed the 25% delinquency penalty on the tax resulting from the increased value, and would not accept as "reasonable cause" the fact that the original valuation placed on the gift did not result in a tax liability, because the value used exceeded the annual exclusion.

Sec. 2513 Gift Tax—Reportable Gifts

There appears to be considerable misunderstanding regarding the requirements for filing a gift tax return where a gift in excess of $3,000, but not more than $6,000, has been made by a married individual to a person other than his spouse. Regs. Sec. 25.6019-2 requires a return to be filed in such a case, even though the $3,000 exclusion which is available to each spouse will result in no taxable gift for the year.

Some persons feel that reporting such gifts is unreasonable and unnecessary. However, the regulations provide that after a notice of deficiency has been sent to either spouse the consent to divide gifts for the taxable year may not thereafter be signified. The results can be costly. Don't be half safe—file!

Split Gifts Can Be a Disadvantage

Ordinarily, split gift tax returns of husband and wife, like split income tax returns, are tax savers. As is the case in other matters affecting taxation, there are exceptions.

Tread cautiously about split returns, when the one making the gift (we'll say it is the husband) is not likely to survive three years. The gift is then presumptively made in contemplation of death and may be subject to estate tax, with a credit for the

Sec. 2513

gift tax paid. The credit includes the wife's tax attributable to the husband's gift. However, the part reported in the wife's gift tax return still stands for the purpose of figuring her rate brackets on subsequent gifts. The net result is that her lifetime exemption is used and her gift tax brackets have been unnecessarily hiked (*Rachel Ingalls,* 336 F2d 874, CA-4, 1964).

If the wife applies her $30,000 lifetime exemption against the gift, the exemption is gone forever. One way to play safe is for the wife to apply the exemption to the gifts she herself makes, rather than to any portion of the husband's gifts.

PROCEDURE AND ADMINISTRATION

Identification Numbers for Minors' Bank Accounts and Securities

Sec. 6109

Taxpayers are being asked by payers of dividends and interest to submit their "taxpayer identifying numbers" so that information returns (Form 1099) can identify the recipients by numbers as well as names. All of this, of course, results from the use of automatic data processing to match payments with the income tax returns of the recipients. Presumably, if a particular payment of income which is identified by the payer under a certain taxpayer number does not show up in the tax return of the holder of that number, the Service's ADP machines will grind out an automatic invitation to a revenue agent's examination.

To encourage thrift on the part of a child or to build up a college education fund, parents and grandparents frequently open up savings accounts or transfer securities for the benefit of minors. Most of such donors undoubtedly believe that the ensuing interest or dividend income is taxable, if at all, only to the minor, and in the past probably have not been including such income in their own returns. Unfortunately, depending upon the manner in which the ownership of the savings account, bond, or stock certificate is expressed, the income may be that of the adult donor.

There are many ways in which property can be held for the benefit of a minor: (1) he can hold it outright in his own

 name; (2) he can be a joint owner of property with an adult; (3) he can be named a beneficiary to take title upon the death of another person; (4) he can be the beneficiary of an informal trust sometimes loosely called a "revocable trust"; (5) he can be the beneficiary of a formal trust created under a written trust agreement; (6) he can be the beneficial owner of property held in the name of a legal guardian; (7) he can be the beneficiary of a custodianship arrangement under either the Model Gifts of Securities to Minors Act or the Uniform Gifts to Minors Act. Each will be considered.

1. In most states a minor may have a savings account in a savings and loan association in his sole name and will be irrevocably bound by his action in withdrawing money or giving a release. Naturally, such a minor should have reached the age of reason (usually seven) and should be able to sign his own name. Where an account in a bank or savings and loan association is in the sole name of a minor, any interest or dividend income should be his alone and the social security number of the minor should be furnished.

Placing securities in the sole name of a child will create problems if later on it becomes advisable to dispose of them by sale or in a merger. Nevertheless, it will happen that a parent or grandparent will transfer securities into the sole name of a minor. In such an instance, care should be taken to effectuate a completed gift;[1] otherwise any dividend income will be taxable to the donor.

Where securities are registered in the sole name of a minor, his account number should be furnished. If the securities are in the name of an adult under a designation such as "John Parent as natural guardian for Joseph Minor," the regulations seem to permit furnishing the minor's account number.[2] If the securities are registered in the name of an adult alone without any designation of him acting as an agent, the adult's number should be furnished.[3] Then that adult should disclose that he is only a

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[1] For the requirements of a completed gift see *Estate of Lorenzo W. Swope,* 41 BTA 213. In determining whether each requirement has been effectuated, state law controls. Completed gifts were found in: *James T. Pettus, et al.,* 45 BTA 855 (acq.) (Missouri): *P. Miller Trust,* 7 TC 1245 (acq.) (Oregon); *Emil Frank,* 27 BTA 1158 (acq.) (Ohio); *Herbert L. Dillon,* 32 BTA 1254 (acq.) (New York). To the contrary: *Weil* v. *Comm'r,* 82 F2d 561, 17 AFTR 666 (5th Cir. 1936), aff'g 31 BTA 899, cert. denied 299 U.S. 552 (Alabama). Also see Mertens, *Law of Federal Income Taxation,* Sec. 7.12.

[2] Regs. Sec. 1.6109-1(b)(1)(iii), last sentence.

[3] Regs. Sec. 1.6109-1(b)(2)(i) — an interpretation of the last sentence.

nominee of the minor by filing information return Form 1087 on or before each February 28 following the close of each calendar year in which dividends are received.[4]

2. In most states it is possible for an adult and a minor to own a bank account, securities or other property as tenants in common or as joint tenants with right of survivorship. In addition, U.S. savings bonds may be jointly owned without any such designation of a particular type of tenancy.

The creation of a joint bank account in joint tenancy with right of survivorship does not give rise to gift tax liability with respect to the person making the entire deposit, until the other joint owner actually withdraws funds.[5] Similarly, if the joint account is opened in alternative names, such as "John Parent or William Minor," or in any other manner under which the donor can regain the entire fund without the donee's consent, there is no gift subject to gift tax until the donee makes a withdrawal.[6] Consistently, with respect to any of these types of bank accounts, any interest or dividend income is taxable to the joint owner who provided the funds.[7] Equally consistent is the requirement that the amount on deposit must be included in the taxable gross estate of a joint owner upon his death to the extent of his contribution to the bank deposit.[8]

The regulations require that the identifying account number of the parent be furnished,[9] and such identification of the taxpayer seems correct.

In the case of U.S. savings bonds, the purchase by a parent and registration in both his name and that of his minor child as co-owners under a designation such as "John Parent or William Minor" will not constitute a taxable gift to the child unless and until the child surrenders the bonds for cash.[10] Interest income on the bond will be taxed in full to the parent because he supplied the full consideration.[11] Finally, of course, the value of the bond will be included in the parent's estate if he predeceases his child. The identifying number of the parent is the right one to use.[12]

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[4] Regs. Sec. 1.6042-2(a)(1)(ii) and (e).
[5] Regs. Sec. 25.2511-1(h)(4).
[6] Regs. Sec. 25.2511-1(h)(4); Mertens, *Law of Federal Gift and Estate Taxation*, Sec. 34.61.
[7] *K. M. Emmons*, 20 TCM 1513.
[8] IRC Sec. 2040; *Estate of M. A. Doyle*, 32 TC 1209 (1959).
[9] Regs. Sec. 1.6109-1(b)(2)(iii); Rev. Rul. 64-122, IRB 1964-17.
[10] Regs. Sec. 25.2511-1(h)(4).
[11] I.T. 3301, 1939-2 CB 75; Rev. Rul. 54-143, 1954-1 CB 12.
[12] Regs. Sec. 1.6109-1(b)(2)(iii).

Sec. 6109 When securities are held in the names of a minor and an adult as joint tenants with right of survivorship, the tax consequences will be different from those in the case of a joint bank account. It will be held that a completed gift to the extent of one-half the value has been made where the adult provides the purchase price or contributes the property and where under applicable state law either party may "sever his interest" such as by conveying an undivided one-half to another.[13] Then, the income would be taxable one-half to each joint tenant, provided that under local law each joint tenant is entitled to his or her share of the dividends.[14] From the standpoint of the estate tax, however, the full value of the property would fall into the adult's taxable estate if he died first.[15]

The regulations[16] call for the account number of the parent joint tenant to be furnished. This could quite possibly lead to trouble.

As to securities held as tenants in common, there seems to be no clear-cut rule. Some authorities seem to support the proposition that if a valid completed gift is made of an undivided one-half interest, then only one-half of subsequent dividends will be taxed to the donor.[17] Where a parent purchases securities, has them issued in his name and the name of a minor child as tenants in common, and otherwise completes the gift of an undivided interest, such gift is subject to gift tax.[18] Upon death of the donor, only his undivided one-half interest is subject to federal estate tax.

The regulations[19] again call for the social security account number of the parent only. The IRS computers, therefore, may cause a revenue agent to scrutinize any claim that only one-half of the dividend income on shares of stock owned as tenants in common is taxable to the parent donor.

3. In some instances a minor is designated as a beneficiary to take title on death of a parent owner of property. For example, a U.S. savings bond may be registered in the name of the parent who purchases it with a provision that upon his

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[13] Regs. Sec. 25.2511-1(h)(5); Mertens, *Law of Federal Gift and Estate Taxation*, Sec. 34.61.

[14] *Haynes*, 7 BTA 465 (acq.); I.T. 3754, 1945 CB 143; Regs. Sec. 1.34-1(d) pertaining to dividends-received credit and exclusion.

[15] IRC Sec. 2040.

[16] Regs. Sec. 1.6109-1(b)(2)(vi), Example (9).

[17] *Walter F. Henningsen*, 30 BTA 301 (Oregon); Mertens, *Law of Federal Income Taxation*, Sec. 17.02 and 17.03.

[18] Mertens, *Law of Federal Gift and Estate Taxation*, Sec. 36.07.

[19] Regs. Sec. 1.6109-1(b)(2)(iii).

death the proceeds shall be payable to his son. In this case the interest income is taxable to the father; no gift is considered to have occurred; and the father's identification number is required.

4. Many states permit savings accounts to be opened in the name of one person as trustee for another, such as "John Parent as trustee for Mary Jones, a minor," but without any formal trust instrument being executed. The trustee can revoke the arrangement at any time and may freely deposit in and withdraw from the account. On death of the trustee, the balance in the account becomes the property of the minor beneficiary. Trusts of this nature are sometimes called revocable trusts.

In each instance, state law and the facts will determine whether a completed gift has been made giving rise to gift tax, but the general rule seems to be that for gift tax purposes there is not a completed gift until the beneficiary actually receives the money.[20]

In income tax cases, to the contrary, completed gifts to minor children have been found by the courts and the Internal Revenue Service to have been effected upon the transfer into accounts set up in the name of a parent as trustee for a minor, where no trust instrument was ever executed, the donor did not intend to create a trust, the funds were never used for the personal benefit of the donor, and no amounts were withdrawn for the support and maintenance of the children.[21]

With respect to identifying numbers to be furnished for the recipient of the dividend or interest income, the regulations state that (a) if under state law no valid trust is created and the donor-parent is the owner of the account, his account number should be furnished,[22] whereas (b) if under state law the so-called "trust" account is legally the property of the minor and the parents are not legally permitted to use any of the funds to satisfy their obligations to support the child, the minor

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[20] Beveridge, *Law of Federal Gift Taxation*, Sec. 4.05; Mertens, *Law of Federal Gift and Estate Taxation*, Sec. 34.55 and 34.58.

[21] *Jolly's Motor Livery Company*, 16 TCM 1048—deposits in a so-called trust account for the benefit of minors in a federal savings and loan association located in Tennessee; *Edward H. Heller*, 41 BTA 1020—deposits in so-called trust accounts for the benefit of minors in a commercial bank located in California. Rev. Rul. 55-469, 1955-2 CB 519 citing *Prudence Miller Trust*, et al., cited above in footnote 1; Rev. Rul. 58-65, 1958-1 CB 13.

[22] Regs. Sec. 1.6109-1(b)(2)(vi), Example (4). A valid trust may be revocable or irrevocable. Solely for the purpose of determining whether the trust's identification number should be used, the maker of the trust instrument may determine if the trust is valid (Rev. Rul. 64-122, *supra*).

Sec. 6109 child's account number should be furnished.[23] Question 18, IRS Publication No. 459, "Questions and Answers Regarding Taxpayer Identifying Numbers," states that an informal trust account of the type here discussed "ordinarily . . . is not recognized by state law as a legal or valid trust during the trustee's lifetime nor is it a valid gift to the beneficiary." It is fair to assume that if the minor's account number is furnished, the IRS will question its use and attempt to tax the parent.

5. A parent or grandparent who wishes to set property aside for the benefit of a minor child will frequently use a formal irrevocable trust agreement. The gift, estate, and income tax liability will vary depending upon the provisions of the trust instrument and quite technical rules contained in the tax law. The trust will identify its fiduciary income tax return with its own "employer identification number" and then as to beneficiaries will show their account numbers.

6. A parent is the natural guardian of his children. He is not their legal guardian unless so appointed by a court. As a legal guardian he can unquestionably accept gifts on the part of his minor child and manage his investments, with all income being taxed to the minor. The minor's identification number is then appropriate.

7. Solely from the tax aspect the simplest and best way of transferring property to minors is under the Uniform Gifts to Minors Act (in effect in most states) or the Model Gifts of Securities to Minors Act (in effect in a few states). All the income, estate, and gift tax results are certain.[24] The income is taxable to the minor except to the extent used to discharge a parent's support obligation, and the minor's account number is the correct one to use.[25] Being able to furnish the minor's account number will avoid future arguments with revenue agents.

With respect to joint savings accounts or informal trust accounts now existing in the names of an adult and a minor, strong consideration should be given to closing them out prior to the next interest payment date and opening up new accounts under the Uniform Gifts to Minors Act. As to securities, the same recommendation is made, but first the taxpayer's attorney should investigate the present legal rights of the minor in the

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[23] Regs. Sec. 1.6109-1(2)(b)(vi), Example (6).
[24] Rev. Rul. 59-357, 1959-2 CB 212; Rev. Rul. 56-484, 1956-2 CB 23.
[25] Regs. Sec. 1.6109-1(b)(2)(vi), Example (5).

securities and the proper legal method of transferring them to the parent as custodian.

Sec. 6109

Where the amounts are large, a formal trust may be more satisfactory than custodianship arrangement.

Identify Those Checks for Tax Payments

It cannot be said too often: Put social security numbers or employer identification numbers on checks sent to the IRS. Go a step further and note on the check what you are paying, for example 1968–1040 ES. Thus the Service can credit your check properly even if it is separated, for one reason or another, from the return to which it was attached.

Interplay of Secs. 303 and 6166

Sec. 6166

The payment of estate taxes for a decedent whose major asset is stock in a closely held business often presents a substantial problem for his estate. However, Secs. 303 and 6166 provide some measure of relief for the estate. Subject to certain conditions and limitations. Sec. 303 provides for capital gain treatment for a distribution of cash or property by a corporation in redemption of shares of its stock which are included in the gross estate of a decedent. (Ordinarily the gain or loss will be minimal.) Sec. 6166 provides for an election to pay all or part of the estate tax in two or more equal installments, not to exceed ten payments, where the estate consists largely of an interest in a closely held business.

Benefits for both the estate and a closely held corporation might be obtained by combining the provisions of both sections. A potential plan, for a qualifying estate, would be to redeem the maximum number of shares pursuant to Sec. 303. As consideration, the closely held corporation would issue serial notes payable in ten equal installments corresponding to the installment payments allowed under Sec. 6166.

The benefit to the estate would be to permit the use of Sec. 303 even where the cash position of the corporation was not sufficiently strong to permit a current redemption of stock for cash. Moreover, even though the corporation might be in a position to redeem the stock currently, a payout over a period of years would conserve working capital for business needs and

Sec. 6166 would, therefore, benefit the corporation. In order to provide the estate with a source of income, an interest differential between the serial note rate and the 4% rate payable on the estate tax installments under Sec. 6601(b) could be established. However, it should be noted that the running of the statute of limitations for collection of any tax is suspended during the payment of the installments by the estate under Sec. 6166. This may or may not be a desirable situation.

The IRS has issued no formal publication on the interplay of Secs. 303 and 6166. However, proponents of the technique find no conflict in the two sections and are of the opinion that it constitutes a useful tool in estate tax planning.

Sec. 6312 Purchases of U.S. Bonds to Pay Estate Taxes

The advantage of paying federal estate taxes with certain U.S. government obligations is fairly well known. Under Sec. 6312, treasury bills, notes, and certificates of indebtedness that qualify for such purposes under the regulations must be accepted at par in payment of federal estate taxes. The regulations provide that qualifying issues are those specifically made acceptable for these purposes by the terms of issue. Quite a number of issues qualify.

Even though includable in the gross estate for tax purposes at par and accrued interest to the extent these issues are usable to pay taxes (Rev. Rul. 56, 1953-2 CB 253; Rev. Rul. 55-301, 1955-1 CB 422), the profit is attractive. On the other hand, there is a practical disadvantage in tying up funds for any substantial period of time in view of the possible low yield.

To secure the ultimate advantage and yet avoid the investment problem, some individuals have used one of two methods. Method I involves the granting of a limited power of attorney to some trusted individual (family member, business associate or a lawyer) enabling him to purchase the desired bonds at a bank from which he is authorized to borrow the necessary funds, in the event that the death of the taxpayer becomes imminent. The arrangements should be cleared with the bank in advance in order to permit a quick purchase if speedy action becomes desirable. This method assumes that local law permits such a power of attorney to remain effective even though the taxpayer should be declared legally incompetent before he dies.

Method II would seem to avoid this problem of state law pertaining to incompetency. Instead of a power of attorney, an individual could use a revocable trust which terminates upon his death with the corpus then going to his estate. Included in the trustee's powers could be the power to borrow money and buy U.S. government bonds of the kind which qualify in satisfaction of federal estate tax liability.

Sec. 6312

Form 1139 or Form 843— There Can Be a Difference

Sec. 6411

Form 1139, Application for Tentative Carryback Adjustment, must be filed within the 12-month period following the end of the year in which the net operating loss arises and the refund resulting from the carryback will be made on the basis of the information contained in the form. A claim for refund on Form 843 can be timely filed within three years from the due date of the return for the year in which the net operating loss arises, and the refund is made after field examination. Interest on the refund, in the case of either method, begins at the end of the loss year.

If the years involved are examined by the federal government after the refund has been allowed on the Form 1139, a complex question may arise regarding the application of the statute of limitations. The government may find that it cannot properly disallow any part of the net operating loss carryback, but that there are some errors in the earlier year to which the carryback is taken. This earlier year would ordinarily be barred by the statute of limitations because of the passage of the three-year period. Can these changes in this third preceding year be made to recover the refund which grew out of the net operating loss carryback? The answer is "no" unless a consent had been signed extending the statute of limitations for that year. Any changes must necessarily be limited to the loss year itself (see *Leuthesser* v. *Comm'r,* 18 TC 1112, and *Bouchey* v. *Comm'r,* 19 TC 1078).

If the three-year period from the due date of the return covering the loss year has not elapsed, a deficiency may be asserted by the government to the extent of adjustments made to the loss year. It may not give effect to any adjustments applicable to the statute-barred year to which the loss was carried.

Sec. 6411 For example, let us assume that a net operating loss carryback from the year 1966 in the amount of $50,000 is claimed against the year 1963. A Form 1139 is filed, the refund is made and upon later examination it develops that the loss for 1966 should be $25,000 instead of $50,000. Also, it appears that the income for 1963, now barred by the statute, should be $125,000 instead of $100,000. Under these circumstances, the IRS can disallow $25,000 of the net operating loss and assert the resulting tax as a deficiency. It cannot offset the remainder of this loss by the increase in income of $25,000 in 1963.

A different position could be taken by the Treasury if a Form 843 claim had been filed. The earlier year would be examined to determine the amount of refund allowable from the net operating loss carryback. The claim would be offset by any adjustments that would serve to increase the income of the year to which the loss is carried. In making the change, the government would rely upon the decisions of the Second Circuit Court of Appeals in the cases of *Comm'r* v. *Maurice H. Van Bergh*, 209 F2d 23 (1953), and *Phoenix Coal Company* v. *Comm'r*, 231 F2d 420 (1956). Following the example in the preceding paragraph, the $25,000 increase in the 1963 income, while it would not be added to assert a deficiency in tax, would be used to offset the claim based on the loss carryback. In addition, the $25,000 adjustment in the 1966 loss would be made.

Note, however, that if the Commissioner arbitrarily disallows the Form 1139 application, there would appear to be no remedy available to the taxpayer (other than filing a Form 843), as Regs. Sec. 6411-3(c) provides that his action may not be challenged in any proceeding. The Code authorizes a disallowance only for errors of computation or material omissions in the Form 1139, but in actual practice the disallowance may be quite arbitrary.

Sec. 6425 "Quickie" Refund of Estimated Tax Overpayments

Sec. 6425 permits application for a "quickie" refund of estimated tax payments by corporations under certain circumstances. Application is made on Form 4466.

A question arose whether separate Forms 4466 had to be filed by each corporation in an affiliated group required to file a consolidated federal income tax return.

The affiliated group had filed a consolidated return for the

prior year. Under Regs. Sec. 1.1502-5(a)(1) and (2), and prior to Rev. Rul. 69-622 (IRB 1969-50, 15) each member of the affiliated group had made estimated tax payments on a separate basis. *Sec. 6425*

The aggregate separate payments of estimated tax exceeded substantially the expected consolidated tax liability, and in the need to secure a prompt refund, the taxpayers wished to follow the quickie refund procedure of Sec. 6425.

In response to an informal inquiry, the IRS indicated that a consolidated Form 4466 should be filed, even though each corporation separately had made payments of estimated tax. It was suggested that the consolidated Form 4466 should list each of the corporations which had made payments of estimated tax and should furnish for each corporation the other information required by the form.

Figuring the Statute of Limitations on Tax Refunds *Sec. 6511*

A claim for refund of federal income tax, in order to be timely, must be filed within three years from the time the return was filed or two years from the time the tax was paid, whichever is later (Sec. 6511(a)). Despite its apparent simplicity, this provision, when read with Sec. 6513(a), has given rise to doubts which in one case could only be resolved by the Supreme Court.

Sec. 6513(a) states that "any return filed before the last day prescribed for the filing thereof shall be considered as filed on such last day." Thus, a calendar-year corporation whih files its return on February 1 is considered to have filed it on March 15, and a refund claim filed on March 15 three years later would be timely. This is obvious enough. However, trouble has arisen in interpreting the third sentence of Sec. 6513(a) which states that ". . . the last day prescribed for filing the return shall be determined without regard to any extension of time granted the taxpayer. . . ." Does this sentence mean merely that where the return is on extension, the three-year period for filing a refund claim begins to run on the date the return was actually filed rather than on the extended due date, or does it mean that the period begins to run on the original due date for filing the return?

The 1968 decision of the Supreme Court in *U.S.* v. *Habig,* 390 U.S. 222 (1968) involved the question whether the government's

 indictment had been filed within the six-year statute prescribed by Sec. 6531. This section provides that the rules of Sec. 6513 shall be applicable in determining when the period of limitations begins. Here, the return, originally due on May 15, 1960, was not filed until August 12, 1960, pursuant to an extension; the indictment was filed August 12, 1966. The taxpayer argued that by reason of the third sentence of Sec. 6513(a) the starting date for computing the six-year limitation period was the original due date of the return, May 15, 1960. Since the indictment was based upon the filing of a fraudulent return, the court understandably had difficulty in accepting the idea that the limitations period began to run before the criminal act was committed. Accordingly, it rejected the taxpayer's argument and pointed to the legislative history of Sec. 6513(a) as supporting its conclusion (see H. Rep. No. 2333, 77th Cong. 2d Sess., p. 119). All that the third sentence of Sec. 6513(a) says is that where a return is on extension but is filed before the extended due date, the limitations period starts with the date of filing rather than the date to which the return has been extended.

Thus Secs. 6511(a) and 6513(a), when read together, provide that in applying the statute of limitations, a claim for refund must be filed within three years of either the due date (without regard to any extension of time) or the filing date, whichever is later.

New Dimensions in Carrybacks

It is to be noted that the limitation on the investment credit is and always was determined by reference to the income tax (with certain exclusions) as reduced by three tax credits: the foreign tax credit, the credit relating to partially tax-exempt interest and the retirement income credit.

Fortunately, there are no carryback and carryover provisions with respect to the credit relating to partially tax-exempt interest or the retirement income credit. However, the foreign tax credit for a particular year may be increased as the result of the carryback of an excess foreign tax credit from a subsequent year (which did not arise from a net operating loss carryback). Such an increase would have an effect upon the investment credit limitation and thus could create or increase an excess investment credit. Even before PL 90-225, this excess investment credit could be carried back three years (provided the

carryback was made to a year ending after December 31, 1961), since it arose by reason of a foreign tax credit carryback and not by reason of a net operating loss carryback. *Sec. 6511*

PL 90-225 repealed the application of Sec. 46(b)(3) with respect to a net operating loss incurred in years ending after July 31, 1967. There is now possible a completely interlacing pattern of carrybacks and carryovers.

A complexity exists in that the "quickie refund" procedure (Form 1139 or Form 1045) is applicable only with respect to refunds resulting from carrybacks of net operating losses or investment credits. The procedure has not been extended to carrybacks of foreign tax credits. Form 843 is required for this purpose. In practice, it is extremely difficult to exclude from Form 1139 or Form 1045 the foreign tax credit refund since all refunds are interrelated in computation.

The period within which to file claims should be checked very carefully with Sec. 6511, as amended by PL 90-225.

Penalty for Failure to File Where Depository Forms Are Used

Sec. 6651

Where a corporation income tax return is not timely filed for other than reasonable cause, the IRS is empowered under Sec. 6651 to add a penalty of 5% per month on the tax required to be shown on the return, up to a maximum of 25%. The key phrase is "tax required to be shown." Sec. 6651(b) indicates that any tax paid on or before the date prescribed for payment of the tax shall reduce the tax required to be shown. Thus if a corporation utilizes depository receipts during the year and makes a proper final payment on or before the due date of the return, the 5% per month penalty cannot be imposed. Barring subsequent revenue agent's examination and deficiency, there will be no unpaid "tax showing on the return" as of the return's due date, whether or not the return itself has been filed.

Negligence Penalty Is Weapon Against Abuses

Sec. 6653

In *Byron Farwell,* 35 TC 454, the Tax Court approved the imposition of the 5% negligence penalty for intentional disregard of rules and regulations. Upon examination a revenue agent had disallowed an amount paid in 1952 for renegotiation

Sec. 6653 of a lease. The taxpayer had deducted the same item once again in 1954 even though it had been indicated at the time of the 1952 disallowance that it should be amortized over the term of the lease. No disbursement or other event had occurred in 1954 to support the deduction.

There are two features of the negligence penalty under Sec. 6653(a) of the Code which should be borne in mind in relation to dubious items of income or expense. One is that after the penalty has been asserted by the Commissioner the burden is on the taxpayer to prove that he was not negligent; that is in contrast with the 50% fraud penalty where the burden of proof is on the Commissioner. The other point is that the penalty applies to the entire deficiency and not merely to the item in respect of which the taxpayer was negligent. This is a potent weapon against abuses in reporting which has not been used with great frequency in the past.

Sec. 6901 Estates—Limitation Periods

The period of limitation on assessment of income, estate and gift taxes, including the liability of a transferee or fiduciary, normally becomes four years from the due date of the return in the case of an estate. This accords with the Service position that transferee liability exists under Sec. 6901 if any person described in Subsection (h) has received any property included in the taxable estate, even though the three-year period from the due date of the return may have expired prior to the distribution of any property to such person. Thus, for estate tax, the total period is five years and three months from date of decedent's death, unless no person has become a transferee within such time (*Melba Schuster*, 312 F2d 311 (CA-9, 1962)).

For a taxable gift the total period for assessment cannot be less than four years since the donee is necessarily a transferee.

Sec. 7502 Some Points on Timely Mailing

Under Sec. 7502 timely mailing generally constitutes timely filing of a return, claim, statement or other document. Sec. 7502 is no exception to the rule that even the simplest of sections can have ramifications, especially in these days when numerous complaints of mail delays are reported.

Sec. 7502

The typical taxpayer visualizes meeting the requirement of timely filing simply by rushing down to the corner mailbox at 11:59 P.M. on April 15. Whatever the practical merits of this procedure might be, it does not satisfy the Code and regulations (see *Luther A. Madison,* 28 TC 1301 (1957)). Sec. 7502(a) states that the date of the *postmark* stamped on the envelope or other mailing cover shall be deemed to be the date of delivery. Thus, the envelope mailed at 11:59 P.M. on April 15 will probably bear a postmark of April 16 and will not be considered timely filed pursuant to Regs. Sec. 7502-1(c)(1)(iii)(a).

Another point to be borne in mind is that a timely postmark made other than by the United States Post Office (as by a private postage meter) does not by itself constitute delivery. If in fact the letter is received not later than the time it would ordinarily have been received if it were postmarked at the same point of origin on the last date permitted, there is timely filing (see *P. P. Leventis, Jr.,* 49 TC 353 (1968)). Otherwise the burden falls upon the taxpayer to prove actual timely mailing as well as the cause for delay. This burden was not met in *Irving Fishman,* 51 TC 869.

For this purpose, only domestic service of the United States Post Office (which includes territories, possessions, and Army, Air Force and Navy post offices) counts. Mail service of a foreign country does not fall under Sec. 7502 (*Luis Cespedes,* 33 TC 214 (1959)). It is also a requirement that the mail be properly addressed and postpaid.

Timely mailing can be extremely important. For example in *Joseph W. Feldman,* 47 TC 329 (1966), an attempted subchapter S election was postmarked one day too late. The attempted election was invalid not only for the year initially sought to be covered, but also for any subsequent year before one for which there was a timely filed election.

Practitioners and taxpayers should give close attention to the details of mailing. If a document is really important (such as a subchapter S election) registered or certified mail should be used because such mail constitutes prima facie evidence of delivery. In ordinary mail, risk of loss falls upon the taxpayer.

Tax Status of Limited Partnerships

Sec. 7701

Whether a particular organization is classified for purposes of taxation as a corporation or as a partnership, trust, or estate

is generally determined by taking into account the presence or absence of the six corporate characteristics. These characteristics are: (1) associates, (2) an objective to carry on a business and divide the profits, (3) continuity of life, (4) centralization of management, (5) limited liability, and (6) free transferability of interest. The first two characteristics are common to most organizations; the remainder are used to distinguish between an association taxable as a corporation and an association taxable as a partnership.

Where the organization is a limited partnership and the sole general partner is a corporation, the limited liability aspects are closely scrutinized. The IRS's informal guidelines for the issuance of favorable rulings of partnership status for a limited partnership with a sole corporate general partner are based on the organization's meeting the following requirements:

1. Limited partners cannot own over 20% (directly or indirectly through attribution under Sec. 318) of the outstanding stock of the corporate general partner.

2. If the total contributions to the partnership are less than $2,500,000, the corporate general partner must have a net worth equal to the lesser of $250,000, or 15% of the total contributions to the partnership. If the total contributions to the partnership exceed $2,500,000, the corporation is required to have a net worth of at least 10% of the total partnership contributions.

3. If there is more than one corporate general partner in the limited partnership, equity ownership by the limited partners in the corporations would be combined for purposes of the 20% test. The minimum corporate equity may be waived where an individual general partner of "substantial means" is a general partner in addition to the corporate general partner.

Difficulties may also be encountered with regard to transferability of interest in those cases where restrictions upon transferability lack substance. For example, many limited partnership agreements provide that a partnership interest cannot be transferred without the approval of the general partner. Where these conditions are strictly administrative procedures (i.e., notification in writing to the general partner, transfer to be made by an instrument in writing, etc.), the limited partnership interests may in fact be considered freely transferable with the result that the entity be considered a corporation for federal income tax purposes.

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